FILE

DE-OHIO EXHIBIT ___

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Duke Energy Ohio for an Increase in Electric Distribution Rates	)	Case No. 08-709-EL-AIR
In the Matter of the Application of Duke Energy Ohio for Tariff Approval	)	Case No. 08-710-EL-ATA
In the Matter of the Application of Duke Energy Ohio for Approval to Change Accounting Methods	)	Case No. 08-711-EL-AAM

DIRECT TESTIMONY OF

PAUL G. SMITH

ON BEHALF OF

DUKE ENERGY OHIO

_____ Management policies, practices, and organization

_____ Operating income

_____ Rate Base

_____ Allocations

_____ Rate of return

_____ Rates and tariffs

__X__ Other: Drivers for rate request, overview of rate case process, and reasonableness of regulatory proposals

August 8, 2008

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INDEX

Testimony discussing drivers for Duke Energy Ohio's requested rate increase, an overview of the revenue requirement, cost of service and rate design, and the reasonableness of the various regulatory proposals.

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I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Paul G. Smith, and my business address is 139 East Fourth Street, Cincinnati, Ohio 45202.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by the Duke Energy Corporation (Duke Energy) affiliated companies as Vice President, Rates – Ohio and Kentucky.

Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS.

A. I received a Bachelor of Science in Industrial Management Degree from Purdue University and a Master of Business Administration Degree, with Honors, from the University of Chicago Graduate School of Business. I am a Certified Public Accountant (CPA) in the State of Ohio and a member of the American Institute of Certified Public Accountants. I am also a member of the Edison Electric Institute's Economic Regulation and Competition Committee, and a former member of the Budgeting and Financial Forecasting Committee.

Q. PLEASE SUMMARIZE YOUR WORK EXPERIENCE.

A. Upon graduation from Purdue University in 1982, I began my career as a public accountant in the Chicago office of Deloitte & Touche (formerly Touche, Ross & Co.), and from 1984 to 1987, in the Indianapolis office of Crowe, Chizek & Co., CPAs. Since 1987, I have held various positions of increasing responsibility with Public Service Company of Indiana, Inc. (PSI), Cinergy Services, Inc., and Duke Energy Shared Services, Inc., including assignments within Rates and Regulation, Budgets and Forecasts, Investor Relations, and Corporate Development as well as the International Business Unit.

Most recently, in 1998 I was named Distribution Price Control Program Manager at Midlands Electricity, the regional electric company in the United Kingdom of which Cinergy Corp. (Cinergy) previously held a 50% equity ownership. In 1999, I was named Revenue Requirements Manager with responsibilities related to the implementation of Amended Substitute Senate Bill No. 3, Ohio's electric restructuring legislation. In 2001, I was appointed General Manager, Budgets & Forecasts with responsibility for Cinergy's financial planning activities, and in 2005, I was responsible for strategic and financial planning related to the due diligence and integration of the Cinergy/Duke Energy merger. I was appointed to my current position as Vice President, Rates in April 2006.

Q. PLEASE DESCRIBE YOUR DUTIES AS VICE PRESIDENT, RATES.

A. As Vice President, Rates, I am responsible for all state and federal regulated rate matters involving Duke Energy Ohio, Inc. (DE-Ohio or Company), and Duke Energy Kentucky, Inc.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE PUBLIC UTILITIES COMMISSION OF OHIO?

A. Yes. Most recently, I provided testimony in support of DE-Ohio's gas rate case application in Case No. 07-589-GA-AIR, *et al* and DE-Ohio's Electric Security Plan Application in Case No. 08-920-EL-SSO, *et al.*

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I discuss the background of DE-Ohio's requested rate increase and the drivers for DE-Ohio's current revenue deficiency. I support the reasonableness of DE-Ohio's base rate increase request and provide an overview of the revenue requirement, cost of service, and rate design aspects of this rate case. Further, I support the reasonableness of the various regulatory proposals, including the request for approval of a new tracking mechanism to recover the direct investment and operating expenditures, net of savings, to maintain a safe and reliable electric distribution system, including the implementation of DE-Ohio's SmartGrid project.

II. BACKGROUND AND DRIVERS FOR REQUESTED RATE INCREASE

Q. WHEN DID THE COMMISSION APPROVE DE-OHIO'S CURRENT ELECTRIC DISTRIBUTION RATES?

A. DE-Ohio's current electric distribution rates were approved by this Commission pursuant to an Order dated December 21, 2005, in Case No. 05-59-EL-AIR. The test period in that proceeding was the twelve months ended June 30, 2005, and the date certain was September 30, 2004. The rates went into effect on or about January 1, 2006.

Q. WHY DOES DE-OHIO BELIEVE A DISTRIBUTION RATE INCREASE IS NECESSARY AT THIS TIME?

A. Since current rates were implemented in 2006, DE-Ohio has invested over $275 million in distribution facilities necessary to provide safe and reliable electric distribution service. DE-Ohio's current rates are not sufficient to recover the costs associated with the investments made. In addition, distribution-related operating and maintenance (O&M) expenses have increased. For example, as explained in the testimony of DE-Ohio witness Mr. James Mehring, DE-Ohio has implemented a number of programs since the previous rate case to increase reliability such as its ground-line inspection program. The increased investment and operating costs prevent DE-Ohio from earning a reasonable return on its distribution business.

DE-Ohio electric distribution operations are projected to earn a 3.56% return on rate base during the twelve-month test period ended December 31, 2008. This return is below the 8.24% return on rate base authorized by this Commission in Case No. 05-59-EL-AIR, *et al.* and is below the 9.10% return on rate base proposed in this proceeding. In order to earn a fair return, DE-Ohio's retail rates must be increased by $86 million to satisfy a total revenue requirement of approximately $403 million.

Q. WHAT ARE THE PRIMARY DRIVERS FOR THIS EARNINGS ATTRITION?

A. The primary drivers of the proposed $86 million rate increase include:

- $18 million is attributable to incremental plant investment;
- $12 million is attributable to increased financing costs;
- $45 million is attributable to increased operating costs;
- $8 million is attributable to higher real estate taxes; and
- $10 million is attributable to increased depreciation expense.

A factor offsetting these rate increase drivers is:

- $7 million attributable to increased retail sales and the proposed increase in the pole attachment rate.

Q. WHAT RATE RELIEF IS DE-OHIO REQUESTING IN THIS PROCEEDING?

A. In its July 25, 2008 Application, DE-Ohio specifically requested that the Commission issue an Order:

- To increase base rates by $86 million;
- To implement the proposed Distribution Reliability Rider (Rider DR); and
- To implement the proposed Development Incentive Rider (Rider DIR).

III. DE-OHIO'S PROCESS AND METHODOLOGY FOR PREPARATION OF ITS RATE CASE

Q. WHAT IS THE OVERALL GOAL OF THE RATEMAKING PROCESS?

A. The overall goal of the ratemaking process is to give utilities the opportunity to recover all of their prudently incurred operating expenses and to earn a fair return on their capital invested in the business. Such a goal should be achieved by charging rates that fairly assign the cost of service to the various customer classes.

Q. HOW DOES DE-OHIO PREPARE AN ELECTRIC DISTRIBUTION RATE CASE?

A. The lengthy and often complicated electric distribution rate case preparation process essentially consists of three primary steps: (1) determine the annual electric distribution revenue requirement; (2) develop a cost of service study that assigns and allocates the electric distribution revenue requirement to each retail rate schedule based on the applicable cost to serve; and (3) design the retail rates and rate schedules to yield the necessary retail revenue requirement.

Q. PLEASE GIVE AN OVERVIEW OF THE REVENUE REQUIREMENT DETERMINATION PROCESS EMPLOYED BY DE-OHIO.

A. DE-Ohio's revenue requirement process focuses on determining: (1) the current level of capital invested in the electric distribution business; (2) the appropriate capital structure and cost of capital to finance the investment; and (3) the ongoing level of annual expenses related to operating and maintaining the electric distribution business. DE-Ohio witness Mr. William Don Wathen Jr. supports the determination of DE-Ohio's jurisdictional revenue requirement.

Q. PLEASE GIVE AN OVERVIEW OF THE RETAIL COST OF SERVICE STUDY PROCESS EMPLOYED BY DE-OHIO.

A. The retail cost of service study assigns each component of revenue requirement formula to the various retail rate schedules. The components are directly assigned, or allocated, based on operational and/or accounting data. DE-Ohio witness Mr. Donald L. Storck discusses DE-Ohio's retail cost of service study.

Q. WHAT ARE THE OBJECTIVES OF THE RATE DESIGN PROCESS?

A. The primary objectives of the rate design process are to develop rates that: (1) provide the utility with the opportunity to recover its annual revenue requirement; and (2) distribute the revenue recovery among customers within each retail rate schedule in a manner that is consistent with the cost of providing electric distribution service. DE-Ohio witness Mr. James E. Ziolkowski supports DE-Ohio's proposed rate design.

IV. MERGER RELATED ADJUSTMENTS

Q. PLEASE DESCRIBE DE-OHIO'S PROPOSALS IN THIS PROCEEDING RELATED TO THE CINERGY/ DUKE ENERGY MERGER.

A. In April 2006, subsequent to the issuance of the Commission's Order approving DE-Ohio's (then The Cincinnati Gas & Electric Company's) current electric distribution rates, Cinergy merged with Duke Energy. As a result of the merger, several proposals are appropriate in this proceeding: (1) to adjust test period O&M to properly reflect the ongoing level of merger savings that should accrue to DE-Ohio's electric distribution ratepayers; (2) to recognize DE-Ohio's capital structure as the appropriate capitalization for purposes of determining the cost of capital; and (3) to adjust DE-Ohio's capital structure so as to eliminate the purchase accounting and the contributed generation assets recorded pursuant to the merger.

Q. PLEASE EXPLAIN HOW THE MERGER BETWEEN CINERGY AND DUKE ENERGY HAS CREATED BENEFITS FOR DE-OHIO'S RATE PAYERS AND SHAREHOLDERS?

A. Numerous merger benefits were identified in Case No. 05-732-EL-MER, *et al.* including a projected reduction in annual operating expenses. DE-Ohio estimated that it would realize approximately $85 million in net benefits during the first five years following consummation of the merger. To equitably share such benefits, DE-Ohio and numerous parties in that proceeding agreed that DE-Ohio's ratepayers would receive $35.8 million, or 42% of the projected savings. Further, to ensure ratepayers receive the benefit, in an accelerated manner, DE-Ohio committed to provide the customers' five-year net merger savings credits upfront, in the first year. This benefit was passed through to customers via a bill credit in 2006 (and trued-up in 2007). During that period, DE-Ohio's customers received approximately $36 million in total bill credits, which slightly exceeded the agreed-upon amount of benefits to be shared. Of this total, approximately $16.4 million was received by DE-Ohio's electric distribution customers.

Q. **WHAT ADJUSTMENT ARE YOU RECOMMENDING TO THE COMPANY'S REVENUE REQUIREMENT RELATED TO THE MERGER SAVINGS SHARING COMMITMENT?**

A. Because DE-Ohio has already satisfied its merger savings sharing commitment by crediting its electric distribution customers with the agreed amount equal to 42% of projected five-year net savings, it would be inappropriate to also build the same merger savings into base rates during the same five-year period. Said differently, if DE-Ohio's test period operating expenses were to include the Year 3 net merger savings, ratepayers would inappropriately receive, in Year 4 and Year 5, a duplication of the merger savings benefit they received in 2006. Conversely, DE-Ohio would not receive its share of the projected five-year merger benefits as the parties agreed.

Attachment PGS-1 is a copy of the projected five-year merger savings schedule, as originally sponsored by Mr. John P. Steffen as Exhibit JPS-2 in Case No. 05-732-EL-MER, *et al.* The Year 3 net savings of $10.3 million (line 6, column C) is part of the total projected five-year savings of $39.0 million (line 6, column F). Customers have already received 42% of this projected five-year merger savings via the '2006 merger credits. If such merger savings are also included in this proceeding as a reduction in the test period O&M, DE-Ohio's electric distribution customers will receive an additional $20.5 million in benefits (essentially two additional years of $10.3 million savings per year) over and above the amount agreed to in the merger proceeding. Accordingly, I propose that the merger savings remain a reduction in the test period O&M, and that the excess benefit be amortized as a regulatory expense over a three-year period. Mr. Wathen includes this proposal as an adjustment in Schedule C-3.19.

Q. DE-OHIO WITNESS MR. STEPHEN DE MAY SPONSORS DE-OHIO'S CONSOLIDATED CAPITAL STRUCTURE AS OF MARCH 31, 2008. WHY DO YOU RECOMMEND USING DE-OHIO'S CONSOLIDATED CAPITAL STRUCTURE FOR ESTABLISHING RATES IN THIS PROCEEDING?

A. I believe the DE-Ohio consolidated capital structure is the appropriate capital structure to use as the basis for setting DE-Ohio's electric distribution rates. The use of an alternative capitalization, such as Duke Energy's capital structure, would cause the rates in this proceeding to be impacted by a number of factors unrelated to DE-Ohio's electric distribution operations. For instance, Duke Energy's capitalization reflects the practices and events of its regulated operations in Indiana, North Carolina, and South Carolina; its non-regulated domestic and international operations; and the spin-off of the gas pipeline businesses. It would be inappropriate to allow the capitalization practices and events in these affiliate activities to impact DE-Ohio's electric distribution rates.

Q. DO YOU RECOMMEND ANY ADJUSTMENTS TO DE-OHIO'S CONSOLIDATED CAPITAL STRUCTURE FOR RATE SETTING PURPOSES?

A. Yes. I recommend that DE-Ohio's consolidated capital structure be adjusted to eliminate two impacts: the impact of purchase accounting recorded pursuant to the Duke Energy/Cinergy merger and the impact of the electric generating plants contributed to DE-Ohio in 2006. These adjustments are quantified and sponsored by DE-Ohio witness Ms. Peggy A. Laub.

Q. PLEASE DESCRIBE THE PROPOSAL TO ELIMINATE FROM THE CAPITAL STRUCTURE THE IMPACT OF PURCHASE ACCOUNTING.

A. As a result of the merger, DE-Ohio recorded various purchase accounting adjustments in conformance with Generally Accepted Accounting Principles (GAAP). These adjustments impacted DE-Ohio's balance sheet, including the amount of shareholder equity. I recommend that the impact of purchase accounting be eliminated so as to avoid an inappropriate increase in DE-Ohio's cost of capital.

Q. PLEASE DESCRIBE THE PROPOSAL TO ELIMINATE THE CONTRIBUTION OF THE ELECTRIC GENERATING PLANTS.

A. I also recommend that DE-Ohio's consolidated capital structure be adjusted to eliminate the impact of Duke Energy North America LLC's contribution of electric generating plants to DE-Ohio. This contribution to DE-Ohio's equity should be excluded for ratemaking purposes because this transaction relates solely to DE-Ohio's non-regulated electric operations and, therefore, should not be used as a basis for setting DE-Ohio's regulated electric distribution rates. Without this adjustment, DE-Ohio's proposed rate increase would be significantly higher.

Q. AFTER ADJUSTING THE ACTUAL CAPITAL STRUCTURE AS YOU DESCRIBED, WHAT IS THE CAPITALIZATION OF DE-OHIO FOR PURPOSES OF THIS PROCEEDING?

A. DE-Ohio's consolidated capital structure at March 31, 2008, as adjusted, is approximately 41.7% debt and 58.3% common equity. This is shown on Schedule D-1A.

V. PROPOSED DISTRIBUTION RIDER (RIDER DR) AND DEVELOPMENT INCENTIVE RIDER (RIDER DIR)

Q. IN YOUR OPINION, IS THE DISTRIBUTION RIDER (RIDER DR) A REASONABLE COST RECOVERY MECHANISM?

A. Yes, I believe so. Rider DR is designed to allow timely recovery of DE-Ohio's capital investment in its electric distribution system, including the investment related to DE-Ohio's SmartGrid (formerly called Utility of the Future) metering infrastructure modernization initiative. Rider DR will provide timely recovery of a return of and on incremental investment in electric distribution plant and O&M expenses that are specifically distribution or distribution-related, and instrumental in allowing DE-Ohio to continue to provide safe and reliable service. DE-Ohio will implement its SmartGrid initiative over the next few years. The Company will install an advanced communications network and smart meters for its electric distribution system. This new technology will produce operating cost savings and will address a long-standing challenge relating to Company access to a significant number of "inside" meters. Although we keep over 60,000 house keys to enter the premises of our customers with inside meters, this is only a fraction of the approximate 215,000 inside electric meters on the system. As these figures indicate, we have a significant number of customers with inside meters who have not provided us with keys and who need to be present for us to perform our monthly meter reads. The Company and, not surprisingly, customers alike prefer that we not enter customers' premises to read meters. Among other things, the new system will virtually eliminate the need to estimate meter reads. DE-Ohio witness Mr. Todd W. Arnold describes the SmartGrid initiative in more detail. Mr. Wathen supports the Rider DR mechanism in his direct testimony.

In the short-term, costs of the SmartGrid project will outweigh the savings but the benefits will exceed the costs over the long-term. Rider DR is a reasonable cost recovery mechanism because it will flow through to customers the costs and savings related to this program. DE-Ohio witness Mr. Christopher D. Kiergan discusses the cost and benefits of the SmartGrid initiative in his direct testimony.

Q. IN YOUR OPINION, IS THE DEVELOPMENT INCENTIVE RIDER (RIDER DIR) REASONABLE?

A. Yes. Rider DIR is simply a reshuffling of DE-Ohio's current economic development incentive mechanism. The three existing mechanisms, Brownfield Redevelopment Rider (Rider BR), Economic Development Rider (Rider ED), and Urban Redevelopment (Rider UR), are simply being combined into a single Rider with similar terms to ease administration. The Commission has already approved these programs in Case Nos. 98-585-EL-ATA and 05-633-EL-ATA, respectively.

Q. HAVE YOU REVIEWED DE-OHIO'S APPLICATION IN THIS PROCEEDING?

A. Yes. I also reviewed the testimony and exhibits of all witnesses. I believe that the Company's total electric distribution revenue requirement is properly computed, the costs of service are properly allocated to customer classes, and the rate design is equitable.

Q. DO YOU HAVE AN OPINION REGARDING WHETHER DE-OHIO'S RATE REQUEST IS REASONABLE?

A. Yes.

Q. PLEASE STATE YOUR OPINION.

A. DE-Ohio's rate request is fair and reasonable. The date certain in DE-Ohio's last rate case was September 30, 2004, and the date certain for this case is March 31, 2008. Despite more than three years of inflationary pressures and capital investment, DE-Ohio is requesting an overall increase in rates of approximately 4.8%. Through aggressive cost management practices, we have been able to hold our increase request to a reasonable level.

VI. CONCLUSION

Q. WAS ATTACHMENT PGS-1 PREPARED BY YOU OR UNDER YOUR SUPERVISION?

A. Yes.

Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?

A. Yes.

The Cincinnati Gas and Electric Company
Case Nos. 05-0732-EL-MER; 05-0733-EL-AAM

Sharing of Merger Savings
(Electric Service)

Line No.	Description	Year 1 (A)	Year 2 (B)	Year 3 (C)	Year 4 (D)	Year 5 (E)	Five Year Total (F)	Annual Average (G)
1	Total Estimated Savings	$ 9,778.8	$ 14,659.8	$ 17,101.8	$ 18,888.4	$ 20,648.9	$ 81,077.7	$ 16,215.5
2	Allocated Share to Distribution Service (1)	$ 8,740.3	$ 13,102.9	$ 15,285.6	$ 16,882.5	$ 18,456.0	$ 72,467.3	$ 14,493.5
3	Total Estimated Costs	$ 15,128.9	$ 10,139.7	$ 5,628.8	$ 3,277.1	$ 3,278.0	$ 37,452.5	$ 7,490.5
4	Allocated Share to Distribution Service (1)	$ 13,522.2	$ 9,062.9	$ 5,031.0	$ 2,929.1	$ 2,929.9	$ 33,475.1	$ 6,695.0
5	Total Estimated Net Savings	$ (5,350.1)	$ 4,520.1	$ 11,473.0	$ 15,611.3	$ 17,370.9	$ 43,625.2	$ 8,725.0
6	*Allocated Share to Distribution Service (1)*	$ (4,781.9)	$ 4,040.0	$ 10,254.6	$ 13,953.4	$ 15,526.1	$ 38,992.2	$ 7,798.4
7	Gross Savings Returned to Distribution Service Customers	$ 7,474.3	$ 8,254.0	$ 9,035.2	$ 9,815.0	$ 10,594.7	$ 45,173.2	
8	Amortization of Costs Collected from Distribution Service Customers	$ (6,695.0)	$ (6,695.0)	$ (6,695.0)	$ (6,695.0)	$ (6,695.0)	$ (33,475.0)	
9	Net Savings to Distribution Service Customers	$ 779.3	$ 1,559.7	$ 2,339.5	$ 3,119.4	$ 3,899.2	$ 11,698.2	

10 Notes:
11 (1) 89.38% Allocated to Distribution Service (See Attachment JPS-4)