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FILE

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Duke Energy Ohio, Inc. for an Increase in Electric Distribution Rates	))))	Case No. 08-709-EL-AIR
In the Matter of the Application of Duke Energy Ohio, Inc. for Tariff Approval	)))	Case No. 08-710-EL-ATA
In the Matter of the Application of Duke Energy Ohio, Inc. for Approval to Change Accounting Methods	))))	Case No. 08-710-EL-AAM
In the Matter of the Application of Duke Energy Ohio, Inc. for Approval of its Rider BDP, Backup Delivery Point Rider	)))	Case No. 06-718-EL-ATA

Prepared Testimony

of

Stephen R. Chaney

Capital Recovery and Financial Analysis Division
Utilities Department Staff

Exhibit __

March 30, 2009

Prepared Testimony of Stephen R. Chaney

1. Q. Please state your name and business address?

A. My name is Stephen R. Chaney. My business address is 180 East Broad Street, Columbus, Ohio 43215.

2. Q. Who are you employed by?

A. I am employed by the Public Utilities Commission of Ohio (PUCO).

3. Q. What is your current position with the PUCO?

A. I am employed as a Utilities Specialist in the Capital Recovery and Financial Analysis Division of the Utilities Department.

4. Q. Would you briefly state your educational and occupational background?

A. I have received a Bachelor of Science Degree in Civil Engineering from Purdue University in December, 1978, and a Master's Degree in City and Regional Planning from Ohio State University in December, 1981. I have been employed by the Public Utilities Commission of Ohio since January, 1982. I have presented testimony supporting the Staff's rate of return recommendations in several rate proceedings before the Commission, including

Cincinnati Bell Telephone Company's alternative regulation case, 96-899-TP-ALT.

5. Q. What are your responsibilities in this proceeding?

A. The purpose of my testimony is to address objections to the rate-of-return on rate base (ROR) analysis included in the Staff Report docketed in this proceeding, and to support the Staff Report recommendation.

6. Q. What is Staff's return on rate base recommendation?

A. Staff's ROR recommendation, from the Staff Report is shown below:

Long Term Debt Capitalization	48.41%
Common Equity Capitalization	51.59%
Cost of Deb	6.45%
Return on Equity Range	10.12% - 11.14%
Return on Rate Base Range	8.34% - 8.87%

7. Q. What objections were submitted relating to capital structure?

A. Office of Consumers' Council Objection D 3 concerning, "Capital Structure" states, "The OCC objects to the Staff Report's use of a hypothetical capital structure for Duke Energy-Ohio, which reflects the average capital structure of a group of publicly traded electric utilities. Using a hypothetical capital structure is inconsistent with the concept of rate of return - rate base regulation which implies that the capitalization used for rate making purposes should reflect the coital structure used to attract and raise coital for the Company. Further, Staff fails to match the Company's capital structure and its cost of debt capital. The Staff Report, using the capital structure for the proxy companies and DE-Ohio's debt cost rate, has not properly combined capital structure and debt cost rate. Finally, using a hypothetical capital structure is inconsistent with Commission precedent." "Duke Energy's Rate of Return Objection 2, regarding "Capital Structure" states, "DE-Ohio objects to the use of hypothetical capital structure for determining the Company's overall rate of return on rate base. The Staffs proposal departs from the Commission's traditional position for establishing capital structure; it is at odds with its positions taken in other recent rate proceedings and workshops; encourages undesired financing behavior, and disregards the plain facts in this case as to the Company's actual capital structure. DE-Ohio has fulfilled its regulatory commitment to maintain a strong balance sheet and to measure its return on actual outstanding equity as opposed to an imputed total. The Staffs recommendation undermines the Company's goal of ensuring its financial integrity by maintaining a strong equity ratio, thereby putting the Company and its ratepayers at greater risk. The current economic crisis has constrained access to credit and has increased the cost of debt. DE-Ohio will likely be able to lower debt rates by moving more gradually toward a balanced capital structure. The Company's rates should not be established on a hypothetical capital structure during this unprecedented financial crisis when raising additional debt would be more costly than under normal economic conditions."

8. Q. What is the Staff's position regarding the use of a hypothetical capital structure based on a comparable group?

A. The Staff's capital structure is reflective of the risk profile required for an electric distribution company. It is also consistent with the average capital structure of the comparable group companies used by Staff to estimate the cost of common equity. Given the current industry structure, any particular book consolidated capital structure may not reflect the risk associated with a regulated utility operating company. In this case, a capital structure based on a comparable group of electric distribution companies makes more sense than the Applicant's parent consolidated capital structure which involves gas operations to significant degree. In addition, given current industry financial practices, stand-alone capital structures for operating companies, in general, may not reflect the risk associated with a regulated utility operating company or the risk associated with the parent company.

The Staff is compelled by statute to utilize an embedded cost of debt. In this instance the 6.45% cost of debt is that of Duke Energy-Ohio. While not averaged over the comparable group, and not an industry average, this is, however, a cost of debt for an electric distribution company.

9. Q. Duke Energy-Ohio and OCC object to the Staff's application of the CAPM. Duke Energy-Ohio's Rate of Return Objection 3(b) states, "Staff has overweighted the importance of the Capital Asset Pricing Model (CAPM) results in arriving at its final ROE range recommendation. Staff neglected to take into account the risks inherent due to the current economic crisis and financial market instability, including the risks identified in the preceding objection. Less weight should be accorded to the CAPM results under present economic circumstances. The betas employed in the Staffs CAPM analysis are estimated over five-year historical periods and therefore the impact of the ongoing financial crisis is not appropriately captured in the five-year historical betas. OCC's Objection D-2, regarding, "Capital Asset Pricing Model Analysis," states," The OCC objects to the Staff Report's exclusive reliance on arithmetic

growth rates from Morningstar, rather than both the arithmetic and geometric growth rates because investors have access to both and likely rely upon both. Mutual funds and Value Line report on geometric averages." How does the Staff respond?

A. Staff will not predict economic conditions for the rate period when formulating its CAPM recommendation. Staff believes that growth rates occur in a manner independent of the preceding growth rate. Short term forecasts involve arbitrarily selective guesses as to which conditions that have occurred before will be prevalent in the near-term. Staff admits that it cannot predict the future and, thus incorporates parameters that reflect broad general conditions in its analysis. Staff believes the period in question is a reasonable tradeoff between stability and timeliness. Staff's CAPM is based on long term Treasury yields. This suits the investment horizon consideration for equity investment and data availability considerations. Staff's CAPM is as conceptually valid as a cost of equity measure, and is internally consistent in its matching of datasets which are available. Staff believes its use broad and long term historic parameters in the CAPM allow for its equal weighting with the DCF.

10. Q. Does Staff recognize and adjust for the perceived inadequacies of CAPM model by using the ECAPM model?

A. Use of Value Line betas, which vary less with risk, compensate for these shortcomings.

11. Q. Duke Energy-Ohio's Rate of Return Objection 3 (e) states, "Staff estimates the Market Risk Premium (MRP) from historical data using the *total* return, rather than the *income* return, on government bonds." How do you respond?

A. Staff is correct in using total return consistently for both large company stocks and long term government bonds. Duke Energy-Ohio, on the other hand, is advocating a comparison of apples to oranges. The Staff uses total return because investors are exposed to both income returns and capital escalation returns.

12. Q. Duke Energy-Ohio's Rate of Return Objection 3 (d) states, "Staff only considered the Discounted Cash Flow (DCF) and CAPM models for estimating the cost of equity and did not consider other models proposed by DE-Ohio. How do you respond?

A. Duke Energy-Ohio's witness Morin uses risk premium equity estimation, in addition to DCF and CAPM. (Morin Direct page 59) His risk premium equity estimates, as well as his overall average estimate, is not unreasonable. Indeed these levels of equity estimation are consistent with the Staff's recommendation.

13. Q. Duke Energy-Ohio's Rate of Return Objection 3 (c) states, "Staff neglected to account for the possibility that a lower return on equity creates the risk that the financial community may view the outcome negatively, making it more difficult to access capital at a reasonable cost, ultimately costing customers more when those costs are reflected in rates." How do you respond?

A. A high authorized rate of return would be viewed positively by existing shareholders. But if it were high enough it would obviate any need to raise new capital.

14. Q. How do you respond to the Greater Cincinnati Health Council's Rate of Return objection stating, "At page 14, the Staff Report recommends a rate of return in the range of 8.34% to 8.87%.This recommendation was based upon economic data that did not reflect the severe downturn in the economy that has occurred in 2008 and early 2009, which should be taken into account to project an appropriate rate of return for the period in which the rates will be in effect. Approval of a rate of return in the recommended range would result in excessive earnings. The Staff Report failed to recommend a

point in the recommended range that should be used to establish DE-Ohio's revenue requirements and should have recommended a point at the low end of the range." ?

A. Staff's recommendation was developed after the onset of the severe downturn in the economy and reflects the conditions in effect after the downturn. Treasury yields, stock prices, dividends,and analysts, growth estimates are all post-downturn.

15. Q. How do you respond to OPAE's Objection I, stating, "OPAE objects to the Staff Report recommendation that the rate of return be set in the range of 8.34% to 8.87% because this range provides an excessive return when compared to the risk faced by Duke as a provider of monopoly electric distribution service. The Staff Report fails to quantify the level of reduction of the rate of return that is appropriate given the reduced risk to Duke as a provider of monopoly electric distribution service. The Staff Report errs in not reducing the rate of return sufficiently to reflect the minimal risk faced by the Company for purposes of a return on its investment to provide monopoly electric distribution service." ?

A. Duke Energy-Ohio has always been a monopoly provider. Staff's analysis assumes that Duke Energy-Ohio was previously and is presently a monopoly provider.

16. Q. What objections were submitted concerning the Staff's DCF analysis?

A. OCC objects to the Staff's use of DCF analysis in its Objection D-1.

17. Q. What is the Staff's response to the first paragraph of OCC's Objection D-1, which states, "The OCC objects to the Staff Report's short-term (5 year) growth rate, which relies only on a single indicator of growth -- analysts' forecasts of earnings per share("EPS"). Reliance on just one statistic cannot reflect investor behavior and is not proper. Investors do not rely only on EPS projections when making short-term investments. This can be deduced from the information provided by Value Line to subscribing investors, which includes both historic and projected EPS, dividends per share, book value per share and retention growth. It is clearly improper to assume, as does the Staff Report, that investors/ Value Line subscribers ignore all of these statistics and only consider EPS projections in making their investment decisions." ?

A. Investors realize returns from dividends and from growth. Earnings growth rate is the proper growth rate to consider since dividends must be pulled out of earnings. Over time dividend growth be less than or equal to earnings growth. As Staff considers return from dividends and from capital appreciation, Staff must utilize the earnings growth estimates. Earnings encompass dividend and appreciation returns. Dividends encompass only dividend returns.

18. Q. What is the Staff's response to the second paragraph of OCC's Objection D-1, which states, "The OCC objects to the Staff Report's inconsistent reliance upon historic data, gross domestic product ("GDP"), for one statistic (long-term growth), while ignoring historic growth for another statistic (short-term growth). The Staff Report only considers projections of growth for its short-term growth factor and only considers historic measures of growth for its long-term growth factor. In both cases, the selection of the growth rate measure has the effect of unreasonably increasing the DCF results of the Staff Report." ?

A. OCC's allegation is in violation of the facts. From the Staff Report the average of constant DCF equity estimates, which uses only the analysts' five year growth estimates, over the comparable group is 13.12%. For the non-constant DCF, the same average is 12.56%, which is obviously lower, and which is what the Staff used. (See Attachment 1).

Using recent historic growth results with or in place of analysts' estimates would produce erratic results. The use of truly long term historic growth on a company by company basis would not be representative, as particular companies would experience much change over the historic period and, likely, would be in the present much different companies than they were in the distant past. Analysts are useful for short term estimates like the five year estimates addressed here. They take into account recent history and near term issues to arrive at <u>expected</u> growth rates for the short term. For the long term GNP, analysts opinions are not as good as actual GNP growth history from 1929 forward. Obviously they can not have specific knowledge eighty years ahead of time. Basically, OCC's problem is that a short prospective growth estimate can and should take into account near term specific factors and a long term prospective growth estimate has only long term experience to rely on.

Staff will not predict economic conditions for the rate period when formulating its DCF recommendation. Staff believes that growth rates occur in a manner independent of the preceding growth rate. Analysts formulate company-specific growth estimates for the next five years. Staff moderated these growth rates by merging them into the long term GNP growth rate. In the absence of company-specific growth rates for beyond five years, the long term GNP rate is a satisfactory proxy, as it would be an average rate that companies on the balance could not exceed.

19. Q. The OCC's third paragraph to objection D-1 states, "The OCC objects to the Staff Report's equity issuance cost adjustment of 1.01904because neither the Company nor the Staff has provided any evidence or made any claim that the Company will incur any common equity issuance costs." How do you respond?

A. OCC, again, totally misconstrues the purpose and the nature of the Staff's issuance cost adjustment. It is not relevant if the Applicant or its parent or affiliates have plans to issue new equity. Staff makes its equity issuance adjustment to support the portion of the embedded balance of equity that was raised from equity issuance and not generated internally. Merely, the Staff's adjustment is structured to support this balance on an annual basis. The Staff has no intention on reflecting issuance costs as annual operating expense in the revenue requirement.

20. Q. Does Staff's issuance cost adjustment take into account flotation?

A. Staff's adjustment in no way reflects flotation costs, if such a term is meant to refer to dilution, price pressure, or market pressure. Staff's adjustment reflects only properly included issuance costs.

21. Q. What are common stock issuance costs?

A. Issuance costs include expenditures made directly by the company issuing stock, for the purpose of issuing stock. Some of these expenditures would be for filing with the SEC, accounting, legal representation, printing, and exchange listing. Issuance costs also include the underwriting spread, which is not an expenditure for the issuing company. Basically, the underwriting spread is the difference between the proceeds to the company and the price paid by the primary purchasers of an issue. Issuance costs are the difference between the amount paid by the primary purchasers and the net proceeds, which is the amount available for investment by the company.

22. Q. Why is an adjustment for issuance cost necessary?

A. The cost of issuance is properly spread over the life of the stock issue. As long as stock has been issued, an equity adjustment is necessary. It does not matter what future financing plans have been prepared. The investor requires a full return as long as the investor owns the stock. The company issuing new equity, initially receives funds in the amount of the equity issued. The amount of equity issued less the issuance cost is the amount available to the company for investment, yet the investor is, as required, paid a return on the full amount of investment. A greater return, therefore, must be earned on the lesser amount that can be invested. This is made possible by the Staff's adjustment to the baseline cost of equity.

23. Q. Why has the Staff applied its equity issuance adjustment to the common equity balance less retained earnings?

A. A fraction of invested funds, issuance expense, cannot earn a return. The difference, total investment less issuance, is equity and is available for company operations. As retained earnings accumulate, the proportion of invested capital that can earn a return increases. By applying its equity issuance adjustment to the common equity balance less retained earnings, the Staff allows a premium to be earned to compensate for invested funds the company could not commit to operations, but does not apply that premium to retained earnings, which are available in their entirety for reinvestment. As the proportion of investment, which can earn a return, increases, the adjustment commensurately decreases. Retained earnings increases the available pool of capital, but issuance expense, which is not available to the company, increases only with new stock issuance. The adjustment increases commensurately with the occurrence of new stock issuance, by virtue of the retained earnings' proportion of equity decreasing.

24. Q. The Duke Energy-Ohio witness Morin addresses market pressure as a component of "flotation" costs on Supplemental Testimony page 3 lines 14-15, and page 8 from line 17 to page 9 line 11. Morin means "flotation" to be total issuance cost including market pressure, which is to allow for alleged costs do to fluctuations in stock price from before a stock issuance is announced until after the portion of the issuance intended for public sale is sold. Should an adjustment be made to the cost of equity to reflect market pressure?

A. No. The investors pay the public offering price, which reflects any market pressure effect. The investors require a return on the amount they have invested, not the amount that their investment would have entailed had they been able to buy shares at market price prior to any public announcement of stock issuance. Market pressure is a risk factor for the underwriter and has no effect on the investor. The underwriter is compensated for assuming any risk including risk associated with market pressure as the issue is sold. The excess of the price the underwriter receives over the amount paid to the issuer is the underwriter's spread. The underwriter's spread is assumed in the Staff's adjustment to be 3.50%. In essence, the underwriter is paid by the issuer to assume risk. Staff's adjustment supports the cost of assuming risk. The adjustment compensates the utility for what it pays to the underwriter for stock issuance. The ratepayer, therefore, has no obligation to "compensate" the utility for any negative outcomes that underwriter incurred, acting on the utility's behalf. To do so would be redundant.

25. Q. Does this conclude your testimony?

A. Yes.

Attachment 1

Staff Report's Constant and Non Constant DCF Equity Cost Estimates By Comparable Company

Non Constant		Constant
12.24%	D	13.25%
11.98%	DUK	11.09%
12.06%	FPL	13.42%
15.49%	PPL	19.44%
12.51%	PGN	11.71%
11.30%	SO	10.65%
12.35%	XEL	12.26%
12.56%	average	13.12%

CERTIFICATE OF SERVICE

I certify that a copy of the foregoing Testimony of **Stephen R. Chaney** was served via electronic mail and/or regular U.S. mail, postage prepaid upon the following parties of record this 30th day of March, 2009.

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