

FILE

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Investigation into the )  
 Development of the Significantly Excessive ) Case No. 09-786-EL-UNC  
 Earnings Test Pursuant to S.B. 221 for )  
 Electric Utilities. )

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REPLY COMMENTS  
 OF  
 DUKE ENERGY OHIO, INC.

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On September 23, 2009, in the development by the Public Utilities Commission of Ohio (Commission) of a significantly excessive earnings test (SEET), Staff of the Commission (Staff) issued its recommendations for the Commission's consideration in this proceeding. On November 19, 2009, the attorney examiner ordered that comments and reply comments relating to the Staff recommendations could be filed by December 14, 2009, and January 4, 2010, respectively. Initial comments were filed by Duke Energy Ohio, Inc. (Duke Energy Ohio); the Dayton Power and Light Company (DP&L); Columbus Southern Power Company and Ohio Power Company, jointly (AEP); Ohio Edison Company, the Cleveland Electric illuminating Company, and the Toledo Edison Company, jointly (First Energy); Citizen Power, Inc.; and the Ohio Consumers' Counsel, the Ohio Manufacturers' Association, the Ohio Energy Group, and the Ohio Hospital Association, jointly (Customer Parties).

Following the filing of initial comments and a motion for an extension with regard to the reply comments, the attorney examiner ordered that reply comments would be due by January 11, 2010.

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The following are the reply comments of Duke Energy Ohio. The numbered items correlate directly with the issues that were addressed in the Commission Staff's recommendations.

**2. Should the Commission determine SEET on a single-entity basis or a company-wide basis?**

Only Duke Energy Ohio, AEP, and the Customer Parties commented on the Commission Staff's recommendations on this issue. The Customer Parties agree with the Commission Staff that the SEET should be applied on a single-entity basis, while AEP argues that the SEET should be applied on a basis that combines its Ohio operating companies. Duke Energy Ohio suggested that, although the statute prohibits the inclusion of earnings from parents or affiliates, its unique circumstance in Ohio as having a wholly owned regulated utility as a subsidiary, albeit in another state, creates a problem in administering the SEET that may not have been foreseen by the legislature.

In their joint comments, the Customer Parties included a chart that purportedly identifies the magnitude of potential refund obligations for each investor-owned distribution utility, using FERC Form 1 data from 2007 and 2008. As simple and straightforward as this exercise seems to be, and although the Customer Parties' effort is fraught with significant errors, it does illustrate the difficulty in generically applying a SEET to these companies. Consider, for example, that each of the companies shown in the Customer Parties' "Electric Utilities Summary Table" has significant levels of earnings derived from Equity in Earnings in Subsidiaries and from Interest and Dividend Income (see Form 1, page 117). All but DP&L indicate significant ownership interest in subsidiary companies (see Form 1, page 103).

Taken literally, the requirement to exclude “*directly or indirectly, the revenue, expenses, or earnings of any affiliate or parent company*” means that the net income figures in the Customer Parties’ table must be adjusted at least to remove Equity in Earnings in Subsidiaries and to adjust Dividend Income as this income can only be derived from subsidiaries or affiliates. On its face, this seems like a simple adjustment; however, taking the resulting net income and dividing it by the Common Equity of the distribution company also fails to calculate the SEET in the spirit intended by the SEET rules. It is likely that the equity balance for each of the distribution utilities is influenced by its respective interests in subsidiary companies. Although it is a relatively easy exercise to exclude the earnings from a subsidiary, it could potentially be a very difficult exercise to ‘carve out’ the equity that supports the subsidiary from the equity that supports the ‘single distribution utility.’ In Duke Energy Ohio’s situation, it may not be a difficult calculation to determine how much net income it derives from its electric operations in Ohio but it would be a challenge to determine how much of its overall equity balance is attributable to its Ohio electric operations versus all of its subsidiary and affiliate operations.

One of the Commission Staff’s topics relates to the accounting definition of earned return on equity” (Topic Number 4). There appears to be somewhat universal agreement that the definition is “net income divided by average common equity balance.” This seemingly simple calculation is hardly simple when it is necessary first to allocate the common equity balance between parent and subsidiary. Duke Energy Ohio’s recommendation offers a remedy to that problem. To the extent the SEET rules excluding all earnings from affiliates are construed so as to cover subsidiaries and are strictly enforced, the Commission must accept that the determination of common equity balances attributable to the ‘single entity’ will be done on a case-by-case basis and will likely be the subject of much debate.

**3. What adjustments should be included in the SEET calculation? and 11. How should write-offs and deferrals be reflected in the return on equity calculation for SEET?**

Duke Energy Ohio reiterates the position stated in its initial comments that none of the proposed changes advocated by the Staff or other parties should affect the SEET calculation agreed to in the Stipulation approved in Case No. 08-920-EL-SSO.

Duke Energy Ohio would also comment on the proposal by First Energy that adjustments should be made to exclude extraordinary items, nonrecurring items, and items that are not representative of a utility's operations. Although such adjustments might be reasonable in theory, it would be entirely inappropriate to make such adjustments only to the income statement of a utility. The overall investment in common equity supports all of the activities of Duke Energy Ohio, whether such activities are related to the utility aspect of the company or to other aspects of the company's overall business. Nevertheless, Duke Energy Ohio supports the proposal advanced by First Energy as long as all impacts of such adjustments are accounted for in the SEET calculation.

**4. What is the precise accounting definition of "earned return on common equity" that should be used?**

This seemingly straightforward question was answered by most of the commentors with essentially the same answer, which is generally that earned return on common equity is equal to net income available for common divided by some average of common equity balance. Some commentors reiterated that certain adjustments need to be made to net income, as discussed above. The determination of the common equity balance is where the simplicity ends. In addition to adjusting the equity balance for the direct effects of any net income adjustments, it

may be necessary to carve out additional equity for other reasons. Consider the following example: If a utility has \$10 million (after-tax) reflected in its 2008 net income derived from equity in earnings of subsidiary companies, that income becomes part of retained earnings, which is reflected in the company's equity balance. It seems simple enough to remove the \$10 million from net income and \$10 million from the ending balance of common equity. However, assuming that the subsidiary has been generating income for as long as it has been owned by the utility, the overall equity balance of the parent utility is that much higher because of its investment in a subsidiary potentially totally unrelated to the parent utility's distribution business. This is just an example but it illustrates the profound difficulty that will be faced by the all of the utilities, the Staff, and intervenors in applying the seemingly simple equation: NET INCOME divided by COMMON EQUITY.

**5. What is the definition of "significantly in excess of the return on common equity"?**

All of the utilities commented on Staff's recommendations and generally supported at least the concept advocated by Staff of using some multiple of the standard deviation around a calculated average for a comparable group, together with some 'backstop' of either 200 basis points above the mean or some multiple of the utility's regulated rate of return. Duke Energy Ohio supports the concept of a 'floor' on the earnings threshold, whether it is 200 basis points above the comparable group mean or some other floor such as the regulated return as advocated by DP&L.

As indicated in its Initial Comments, however, Duke Energy Ohio believes that the Staff's recommendation is somewhat incomplete, in that it does not recognize the relationship

between the chosen confidence level and the makeup of the comparable group.<sup>1</sup> The level of confidence to be used when determining the level of earnings that is deemed to be “significantly excessive” has to be established in recognition of the selection of the comparable group. As argued by First Energy, the recommended confidence level would increase from 1.28 standard deviations if the comparable group of companies used for purpose of calculating the SEET were to be limited to regulated electric utilities. Staff’s recommendations include substantial discretion in the selection of the comparable group. Thus, under Staff’s approach, there would be no assurance that the Commission would approve a group that includes companies from industries other than the electric utility industry. There should be a recognition of impact of the makeup of the comparable group in the determination of the confidence level that is to be used.

Duke Energy Ohio would also note that the language of the statute mandating the SEET is not as ambiguous as some of the commentors and the Staff suggest. In Section 4928.142(D)(4), Revised Code, the group for comparison is clearly defined as “publicly traded companies, including utilities, that face comparable business and financial risk . . . .” If the lawmakers meant for the comparable group to be *only* utilities, the language would have read “public traded *utility* companies that face comparable risk . . . .” As the legislature did not write the law in that manner, it should not now be so construed.

Interpreting the statute as written undermines the Staff’s recommendation to apply the 1.28 standard deviations to the mean but to use a comparable group that includes only electric utilities. If only electric utilities are used, then the higher confidence level of 95 percent is

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<sup>1</sup> Duke Energy Ohio’s Initial Comments included a reference to a statement by First Energy’s witness, Dr. Vilbert. In those comments, Duke Energy Ohio unintentionally misstated Dr. Vilbert’s advice, incorrectly commenting that the confidence level would have to increase if the comparable group included companies from outside the electric utility industry. Actually, Dr. Vilbert correctly advised that the confidence level would increase if the comparable group were limited to regulated electric utilities.

appropriate. This would require, as discussed by Duke Energy Ohio in its Initial Comments, multiplying the mean by 1.64.

Duke Energy Ohio also strongly disagrees with the approach taken to this topic by the Customer Parties. The Customer Parties spend several pages of their Initial Comments discussing the term “comparable earnings,” as it is defined and applied under federal law with regard to utility rate setting under the jurisdiction of the Federal Energy Regulatory Commission. Unfortunately for the Customer Parties, the Commission is not governed by federal law or case precedent, and such principles are inapplicable to Commission practice. In addition, this is clearly not a ratemaking proceeding. The limitation that was imposed by the Ohio legislature, which is under discussion here, has nothing whatsoever to do with the *setting* of rates, and reference to such principles, even if they related to Ohio, would be inappropriate.

**6. How should companies “that face comparable business and financial risk” be determined? and 9. How should the earnings of a comparable company be adjusted to compensate for the financial risk difference associated with the difference in capital structures?**

As discussed with regard to the topic concerning the definition of “significantly in excess of the return on common equity,” Duke Energy Ohio believes that nonutilities are required, by statute, to be included among the group of comparable companies to which the utilities’ earnings are compared. In addition, Duke Energy Ohio would note that the Customer Parties incorrectly describe the Staff’s proposal as leaving the choice of the comparable group to the discretion of the utilities and complain that the Commission would thereby be abdicating its responsibility.

This is, of course, far from the truth. Nothing in the Staff's proposal would allow this decision to be made by anyone other than the Commission, as Commission approval would still be required.

**8. What does "in the aggregate" mean in relation to the adjustments resulting in significantly excess earnings?**

None of the commentors provided any additional insight as to the Staff's recommendation on this issue; however, Duke Energy Ohio does object to the Customer Parties' strained attempt to add a new requirement to the SEET that even a close reading of the SEET statute does not reveal. On page 18 of their Initial Comments, the Customer Parties now suggest that "[i]n the aggregate" also means cumulative." The legislators did not see it that way.

Using the Customer Parties' creative reading of the SEET statute, it is now not enough, in their opinion, to determine whether a utility had significantly excessive earnings in one year. Now the threshold becomes 'cumulative' earnings over a period of years. Again, it is within the power of the legislature make that distinction and, lacking the written language that the Customer Parties are reading into the statute, the Commission cannot accept the Customer Parties' approach.

Respectfully submitted,



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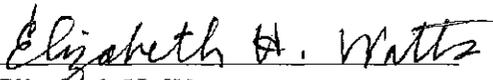
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CERTIFICATE OF SERVICE

I certify that a copy of the foregoing was served on the following parties, this 11<sup>th</sup> day of January, 2010, via regular mail delivery, postage prepaid.

  
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