

**BEFORE**

**THE PUBLIC UTILITIES COMMISSION OF OHIO**

In the Matter of the Application of Duke )  
Energy Ohio, Inc., for the Establishment )  
of a Charge Pursuant to Revised Code ) Case No. 12-2400-EL-UNC  
Section 4909.18. )

In the Matter of the Application of Duke )  
Energy Ohio, Inc., for Approval to ) Case No. 12-2401-EL-AAM  
Change Accounting Methods. )

In the Matter of the Application of Duke )  
Energy Ohio, Inc., for the Approval of a ) Case No. 12-2402-EL-ATA  
Tariff for a New Service. )

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**DIRECT TESTIMONY OF**

**STEPHEN G. DE MAY**

**ON BEHALF OF**

**DUKE ENERGY OHIO, INC.**

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\_\_\_\_\_ Management policies, practices, and organization

\_\_\_\_\_ Operating income

\_\_\_\_\_ Rate Base

\_\_\_\_\_ Allocations

\_\_\_\_\_ Rate of return

\_\_\_\_\_ Rates and tariffs

  X   Other: Financial objectives and credit quality

March 1, 2013

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**I.     INTRODUCTION AND PURPOSE**

**Q.     PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

A.     My name is Stephen G. De May, and my business address is 550 South Tryon Street,  
Charlotte, North Carolina 28202.

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

A.     I am employed by Duke Energy Business Services LLC (DEBS) as Vice President and  
Treasurer. DEBS provides various administrative and other services to Duke Energy  
Ohio, Inc., (Duke Energy Ohio or the Company) and other affiliated companies of Duke  
Energy Corporation (Duke Energy).

**Q.     PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND  
PROFESSIONAL EXPERIENCE.**

A.     I have a Bachelor of Arts degree in Political Science from the University of North  
Carolina at Chapel Hill, and a Master of Business Administration degree from the  
McColl School of Business at Queens University in Charlotte, North Carolina. In 2010, I  
completed the Advanced Management Program at the Wharton School of the University  
of Pennsylvania. I am a Certified Public Accountant (CPA) in the state of North Carolina  
and I am a member of the American Institute of Certified Public Accountants and the  
North Carolina Association of CPAs.

My professional work experience began in 1986 with the public accounting firm  
of Price Waterhouse (now PricewaterhouseCoopers) and, subsequently, Deloitte, Haskins  
and Sells (now Deloitte & Touche), where my work focused on tax accounting and  
consulting for a variety of clients. In 1990, I joined Crescent Resources, Inc., a then  
wholly owned real estate development subsidiary of Duke Power Company (a

1 predecessor company to today's Duke Energy), where I was responsible for real estate  
2 accounting and finance. In 1994, I moved to the Treasury and Corporate Finance  
3 Department, where I have held, except for a two-year period of time, various positions of  
4 increasing responsibility. The two-year exception was for the majority of 2004 and 2005,  
5 during which time I had the lead responsibility for developing and managing Duke  
6 Energy's energy and regulatory policies. I was named Treasurer in November 2007 and  
7 led the Investor Relations function for Duke Energy from October 2009 through June  
8 2012. Upon the closing of the merger with Progress Energy, I was named Vice President  
9 and Treasurer.

10 **Q. PLEASE SUMMARIZE YOUR RESPONSIBILITIES AS VICE PRESIDENT AND**  
11 **TREASURER.**

12 A. As Vice President and Treasurer, I am responsible for treasury-related services to Duke  
13 Energy and its subsidiaries, including Duke Energy Ohio. I monitor trends in the  
14 investment markets and maintain key relationships with debt investors, analysts, and  
15 financial institutions. Under my supervision, the Treasury Department arranges and  
16 executes all capital-raising and liquidity transactions, including credit facilities and  
17 commercial paper, debt securities, preferred and hybrid securities, and common stock, as  
18 well as daily cash management for Duke Energy and its subsidiaries. My responsibilities  
19 include managing Duke Energy's and its subsidiaries' credit ratings and relationships  
20 with the major credit rating agencies, commercial banks, and the capital markets.  
21 Finally, I am responsible for managing the long-term investments associated with Duke  
22 Energy's retirement pension plans and nuclear decommissioning trusts.

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

3 A. Yes. Most recently, I provided testimony in support of Duke Energy Ohio's pending  
4 electric distribution and natural gas base rate cases, filed under Case Nos. 12-1682-EL-AIR,  
5 *et al.*, and 12-1685-GA-AIR, *et al.*, respectively. I have also testified in connection with the  
6 Company's 2011 standard service offer (SSO) filing and its last electric distribution and  
7 natural gas rate case applications.

8 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THESE PROCEEDINGS?**

9 A. My testimony discusses the financial objectives of Duke Energy Ohio. It also discusses  
10 the role that the Company's credit quality plays in meeting these financial objectives and  
11 the expectations of debt investors. I will discuss the importance of equity investors and  
12 how the application of Ohio's regulatory construct could impact the Company's ability to  
13 access this form of capital. Throughout my testimony, I will highlight how a constructive  
14 outcome in these proceedings is important for the Company's ability to meet its financial  
15 objectives.

16 **Q. WHAT ARE THE CRITICAL DIFFERENCES BETWEEN DEBT INVESTORS**  
17 **AND EQUITY INVESTORS, FROM THE STANDPOINT OF MEETING DUKE**  
18 **ENERGY OHIO'S FINANCIAL OBJECTIVES?**

19 A. While equity investors hold an ownership position in the Company, debt investors have  
20 loaned money to Duke Energy Ohio. Equity investors, in general, seek both income from  
21 dividends and appreciation of their underlying capital, through increases in the stock  
22 price. I will discuss both types of investment, although more detail on the perspective of

1 Duke Energy's equity investors will be provided by Duke Energy Ohio witness Julie M.  
2 Cannell.

## **II. DUKE ENERGY OHIO'S FINANCIAL OBJECTIVES**

### **3 Q. WHAT ARE DUKE ENERGY OHIO'S FINANCIAL OBJECTIVES?**

4 A. Duke Energy Ohio seeks to maintain access to debt markets at reasonable rates and to  
5 deliver appropriate risk-adjusted returns to its equity investors. Achieving these overall  
6 objectives helps Duke Energy Ohio maintain its financial strength and flexibility, including  
7 investment-grade credit ratings and reliable access to capital on reasonable terms. For the  
8 term of the Fixed Resource Requirement (FRR) plan, Duke Energy Ohio is required to  
9 maintain and provide capacity for its entire footprint, which will require new and ongoing  
10 capital investments. Financial strength and flexibility are necessary for the Company to  
11 make these investments and continue to provide cost-effective, safe, environmentally  
12 compliant, and reliable service to its customers. Specific objectives that support financial  
13 strength and flexibility include: (a) maintaining an equity component of the capital structure  
14 that is within the rating agencies' guidelines for Duke Energy Ohio's credit rating; (b)  
15 maintaining current credit ratings; (c) ensuring timely recovery of prudently incurred costs;  
16 (d) maintaining sufficient cash flows to meet obligations; and (e) maintaining a sufficient  
17 return on equity to fairly compensate shareholders for their invested capital. The ability to  
18 attract debt and equity capital on reasonable terms is vitally important to the Company and  
19 its customers, and meeting each of these objectives helps the Company meet its overall  
20 financial objectives.

1   **Q.   WHAT REGULATORY FRAMEWORK IS BEING REQUESTED IN THESE**  
2       **PROCEEDINGS AND HOW WILL THE COMPANY'S FINANCIAL**  
3       **OBJECTIVES BE IMPACTED?**

4   A.   Duke Energy Ohio is currently earning negative returns on generating plants, as described  
5       by Duke Energy Ohio witness Brian D. Savoy. It is therefore requesting approval of a cost-  
6       based charge for the noncompetitive, wholesale capacity service it provides in furtherance of  
7       its obligations as an FRR entity in PJM Interconnection, L.L.C. (PJM). Through these  
8       proceedings, the Company is also seeking authority to defer amounts between this cost-  
9       based charge and the market-based pricing it receives from PJM and approval to establish a  
10      tariff through which such deferred amounts will be subsequently collected. The specific  
11      details of the proposal are explained in the Direct Testimony of other Duke Energy Ohio  
12      witnesses.

13           The proposed cost-based charge has been developed using traditional, cost-of-  
14      service ratemaking principles and, if approved, such charge will provide the Company with  
15      just and reasonable compensation for the noncompetitive service it is providing. Such an  
16      outcome will be consistent with the Commission's decision with regard to a similarly  
17      situated Ohio utility. This compensation will improve Duke Energy Ohio's ability to meet  
18      its financial objectives, lower risk to investors, and provide a construct for the Company to  
19      continue to make investments in Ohio that will ensure future safe, reliable, and  
20      environmentally compliant service for its customers. On the other hand, an inconsistent  
21      outcome (*i.e.*, denying the application) would likely result in equity and debt investors  
22      requiring higher returns to compensate for the resultant higher business and financial risk.

### **III. CREDIT QUALITY AND CREDIT RATINGS**

1 **Q. PLEASE EXPLAIN CREDIT QUALITY AND CREDIT RATINGS, AND HOW**  
2 **THEY ARE DETERMINED.**

3 A. Credit quality (or creditworthiness) is a term used to describe a company's overall  
4 financial health and its willingness and ability to repay all financial obligations in full and  
5 on time. An assessment of Duke Energy Ohio's creditworthiness is performed by the  
6 three major credit rating agencies, Standard & Poor's (S&P) and Moody's Investors  
7 Service (Moody's), and Fitch Ratings (Fitch) and results in the Company's credit rating  
8 and outlook.

9 Many qualitative and quantitative factors go into this assessment. The Company's  
10 regulatory framework and climate is one of the most important qualitative factors in  
11 assessing business risk. Consistency and predictability in regulatory outcomes are vital,  
12 as further described in the testimony of Duke Energy Ohio witness Cannell. Other  
13 qualitative aspects include Duke Energy Ohio's track record for delivering on its  
14 commitments, the strength of its management team, its operating performance, and the  
15 economy in its service area.

16 Quantitative measures are primarily based on operating cash flow and focus on  
17 Duke Energy Ohio's ability to meet its fixed obligations (interest expense in particular)  
18 on the basis of internally generated cash, and the level at which Duke Energy Ohio  
19 maintains debt leverage in relation to its generation of cash. As described by Duke  
20 Energy Ohio witness Savoy, Duke Energy Ohio is currently in a negative return position  
21 with regard to its generating assets, thus already compromised with regard to cash flow.  
22 The percentage of debt to total capital is another example of a quantitative measure.



Creditors and credit rating agencies view both qualitative and quantitative factors in the aggregate when assessing the credit quality of a company.

**Q. WHAT IS THE ROLE OF REGULATION IN THE DETERMINATION OF THE FINANCIAL STRENGTH OF A UTILITY COMPANY?**

A. Investors, investment analysts, and credit rating agencies regard the consistent and fair application of regulatory authority as one of the most important factors in assessing a utility's financial strength. Positive consideration is given for utilities operating in states where the regulatory process is streamlined and outcomes are equitably balanced between customers and investors.

The current regulatory framework in Ohio acknowledges the unique noncompetitive services provided by FRR entities – services that are associated with long-term commitments. And there has been further recognition in Ohio that, in providing these services, FRR entities are entitled to just and reasonable compensation as determined with reference to traditional ratemaking principles. Consistent therewith, Duke Energy Ohio is seeking assurance that the costs it incurs as an FRR entity will be recovered. And such recovery will enable Duke Energy Ohio to continue to meet its financial objectives.

**Q. HOW ARE DUKE ENERGY OHIO'S OUTSTANDING SECURITIES CURRENTLY RATED BY THE CREDIT RATING AGENCIES?**

A. As of the date of this testimony, Duke Energy Ohio's outstanding debt is rated as follows:

Rating Agency	S&P	Moody's	Fitch
Senior Unsecured Rating	BBB+	Baa1	A-
Senior Secured	A	A2	A
Outlook	Negative	Stable	Stable

1           The ratings outlook assesses the potential direction of a longer-term credit rating  
2 over an intermediate term (typically six months to two years). Duke Energy Ohio's  
3 "Stable" outlook at Moody's & Fitch means that the credit ratings are not likely to  
4 change at this time; however, a change in outlook or rating could occur if the Company  
5 experiences a change in its business or financial risk. S&P's ratings outlook on Duke  
6 Energy and all of its rated subsidiaries, including Duke Energy Ohio, is currently  
7 negative. This outlook was established in July 2012 and reflects the possibility that S&P  
8 may lower Duke Energy's credit ratings over the next 12 months, due to heightened  
9 regulatory risk. S&P's ratings methodology relies on Duke Energy's consolidated credit  
10 profile, hence the negative outlook on all subsidiaries. A constructive regulatory  
11 outcome in these proceedings would ensure recovery of the Company's embedded costs  
12 for long-term capacity obligations and support Duke Energy Ohio's current credit quality.

13 **Q. PLEASE EXPLAIN WHAT IS MEANT BY THESE CREDIT RATINGS FOR**  
14 **DUKE ENERGY OHIO'S DEBT INVESTORS.**

15 A. Obligations carrying a credit rating in the "A" category are considered strong, investment-  
16 grade securities, subject to low credit risk for the investor. "A" rated debt is presumed to be  
17 somewhat susceptible to changes in circumstances and economic conditions; however, the  
18 debt issuer's capacity to meet its financial commitments is considered strong. By contrast,  
19 ratings in the "BBB" category are considered adequate and have less assurance of access to  
20 the capital markets in challenging market conditions.

21           S&P and Fitch may also modify their ratings with the use of a plus or minus sign to  
22 further indicate the relative standing within a major rating category. An "A+" credit rating  
23 is at the higher end of the "A" credit rating category and an "A-" is at the lower end of the

1 category. Moody's credit rating assignments use the numbers "1", "2", and "3", with the  
2 numbers "1" and "3" analogous to a "+" and "-", respectively. For example, Moody's credit  
3 ratings of "A2" and "A3" would be analogous to "A" and "A-" credit ratings at S&P and  
4 Fitch, respectively.

5 **Q. WHAT STRENGTHS AND WEAKNESSES HAVE THE AGENCIES**  
6 **IDENTIFIED WITH RESPECT TO DUKE ENERGY OHIO?**

7 A. S&P ascribes higher business risk to Duke Energy Ohio when compared to that of the  
8 other entities in the Duke Energy family and with most other U.S. regulated utilities, due  
9 to the impact of retail competition and the uncertainty related to the regulatory  
10 environment. Generally speaking, the credit rating agencies have identified the  
11 challenges of managing Duke Energy Ohio's transition to market, persistent low natural  
12 gas prices, and prospects for more stringent environmental mandates among the issues  
13 that could affect the credit quality of Duke Energy Ohio. Based on the criteria published  
14 by the rating agencies, the Company has lower credit ratings than would otherwise be  
15 indicated by its quantitative metrics, emphasizing the degree to which business risk and  
16 uncertainty in cost recovery for its noncompetitive capacity obligations impacts the  
17 Company's credit quality.

18 **Q. WHY IS IT IMPORTANT FOR DUKE ENERGY OHIO TO HAVE STRONG,**  
19 **INVESTMENT-GRADE CREDIT RATINGS?**

20 A. High investment-grade credit ratings provide Duke Energy Ohio with greater assurance  
21 of continued access to the capital markets on reasonable terms, even during periods of  
22 volatility. Although recent market conditions have improved, the financial crisis of 2008-  
23 2009, as well as the potential for further uncertainty in the financial markets, illustrates

1 the importance of maintaining the financial strength, flexibility, and strong credit ratings  
2 that Duke Energy Ohio currently enjoys. Duke Energy Ohio was able to issue \$450  
3 million of ten-year first mortgage bonds in March of 2009, during the height of the  
4 financial crisis, at a rate of 5.45 percent. In contrast, other companies, with weak credit  
5 quality, were unable to access capital on such good terms, and, in some cases, were  
6 unable to access the debt markets at all. Strong credit ratings result in lower debt costs for  
7 customers and greater assurance of access to capital, even in challenging market  
8 conditions.

9 **Q. HOW DO THE RATING AGENCIES VIEW ELECTRIC UTILITY REGULATION**  
10 **IN OHIO?**

11 A. The credit rating agencies view the regulatory construct in Ohio as an indicator of higher  
12 risk than similarly situated utilities that are 100 percent regulated with a traditional cost  
13 recovery model. Indeed, in recent reports on Duke Energy Ohio, S&P maintains that the  
14 business risk for Duke Energy Ohio is greater than the risk for other regulated utilities  
15 owned by Duke Energy. In January 2013, Moody's lists among the Company's negative  
16 credit attributes a view that the current ESP, although providing regulatory clarity, will  
17 cause further decline in the Company's financial metrics.

18 **Q. WHAT IS THE SIGNIFICANCE OF DUKE ENERGY OHIO OPERATING AT AN**  
19 **ANNUALIZED NEGATIVE RETURN ON EQUITY THROUGH MAY 31, 2015?**

20 A. As described in the Application and the Direct Testimony of Mr. Savoy, Duke Energy  
21 Ohio's generating assets will operate at a significant financial loss over the next several  
22 years if this request is denied. In fact, the annualized return on equity (ROE) between  
23 August 1, 2012, and May 31, 2015, ranges from a negative 3.6 percent to a negative 13.5

1 percent. From a credit and investor point of view, negative ROEs can be damaging to the  
2 Company's quantitative credit metrics, its overall credit quality, and, ultimately, its  
3 ability to raise capital on reasonable terms.

#### IV. EQUITY INVESTORS

4 **Q. WHAT ROLE DO EQUITY INVESTORS PLAY IN THE FINANCING OF DUKE**  
5 **ENERGY OHIO, AND HOW WILL THE OUTCOME OF THESE**  
6 **PROCEEDINGS IMPACT THESE INVESTORS?**

7 A. As I mentioned previously, equity investors, like debt holders, provide capital that allows  
8 the Company to operate. Equity investors provide the foundation of a company's  
9 capitalization by providing significant amounts of capital, for which an appropriate  
10 economic return is expected. Duke Energy Ohio's equity is provided by its parent, which  
11 receives its equity from investors. Duke Energy Ohio, like other investor-owned utilities,  
12 must compensate its equity investors for the risk of their investment by targeting fair and  
13 adequate returns, a stable dividend policy, and earnings growth. Returns to equity  
14 investors are realized only after all operating expenses and fixed payment obligations  
15 (including debt principal and interest) of the business have been paid. Because these  
16 investors are the last to receive surplus earnings and cash flows, it is their capital that is  
17 most at risk if a company suffers a downturn in business or general financial conditions.  
18 For this reason, equity investors require a higher return for their investment. Equity  
19 investors expect utilities like Duke Energy Ohio to recover their prudently incurred costs  
20 and earn a fair and reasonable return for their investors. The Company's proposal for a  
21 cost-based charge for its FRR obligations supports this investor requirement, and better  
22 aligns the risk in the investment with investor expectations. Providing a value proposition

1 to equity investors in this way is critical to maintaining access to this important form of  
2 capital.

3 **Q. HAVE EQUITY INVESTORS EXPRESSED A CONCERN WITH DUKE ENERGY**  
4 **OHIO'S PROJECTED NEGATIVE ROE?**

5 A. Duke Energy's equity investors recognize that the ROE earned by Duke Energy Ohio's  
6 legacy generating assets does not adequately and predictably compensate them. In fact,  
7 as demonstrated by Duke Energy Ohio witness Savoy, without the relief requested in  
8 these proceedings, the generating plants will earn a negative ROE through the term of the  
9 FRR plan and the Company requires \$134 million on an annualized basis through May  
10 31, 2015, just to achieve a zero percent ROE. The risk/return profile for this business  
11 limits the amount of equity capital available for investment in these plants or new  
12 resources, especially when compared to lower risk alternatives. This is of particular  
13 concern to Duke Energy Ohio and to investors in Duke Energy if the investment  
14 community perceives that another, similarly situated Ohio FRR entity is treated  
15 inconsistently, such that the investors' return would be improved by switching their  
16 ownership interest away from Duke Energy Ohio.

**V. CONCLUSION**

17 **Q. PLEASE SUMMARIZE YOUR TESTIMONY**

18 A. Consistent with traditional ratemaking principles, Duke Energy Ohio is seeking the  
19 establishment of a cost-based charge for the noncompetitive, wholesale capacity services  
20 that it provides as an FRR entity. The requested charge and recovery of the deferral thereof  
21 provide for greater assurance of cost recovery, stability, and certainty with respect to  
22 earnings and provide a construct by which ongoing necessary infrastructure investments can

1           be made. The Company believes that this request equitably balances the needs of customers  
2           and investors and maintains the financial viability of the Company.

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

4   **A.    Yes.**

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