BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Commission's Investigation of the Financial Impact of the Tax Cuts and Jobs Act of 2017 on Regulated Ohio Utility Companies.	))))	Case No. 18-47-AU-COI

INITIAL COMMENTS OF DUKE ENERGY OHIO, INC.

February 15, 2018

TABLE OF CONTENTS

Pursuant to the Entry issued by the Public Utilities Commission of Ohio on January 10, 2018, in the above-captioned proceeding, Duke Energy Ohio, Inc., (Duke Energy Ohio or Company) hereby submits its Initial Comments. As invited by the Commission, these comments address: (1) the components of utility rates that the Commission may need to reconcile with the Tax Cuts and Jobs Act of 2017 (TCJA) and (2) the process and mechanics for such reconciliation.

I. Introduction

Duke Energy Ohio proposes that, through this evaluation of the impacts of the TCJA, the Commission consider solutions that will lower customer bills in the near-term, help mitigate volatility due to future rate increases, and protect the individual utility's current credit position for the benefit of customers. Duke Energy Ohio has worked diligently over the years to maintain a strong balance sheet and strong creditworthiness. This solid financial foundation has helped the Company keep customers' rates significantly below the national average for many decades; all while providing safe, reliable and increasingly clean energy for its customers in the state of Ohio.

As the Commission is aware, utilities are among the most capital intensive of all industries in the country. The Company's financial strength has helped it raise many millions of dollars of capital at competitive rates and under favorable terms to fund infrastructure investments across the state. These investments have modernized Duke Energy Ohio's distribution system, providing increased reliability, energy efficiency capabilities, and many other consumer benefits to Ohio residents and businesses. Duke Energy Ohio continues to modernize the energy grid to transform the customer experience, avoid and reduce outages through new technology, help customers become even more energy efficient through the deployment of advanced metering and technology infrastructure, and increase the ability of the grid to connect more distributed and renewable energy resources. The importance of maintaining the Company's financial integrity is thus more important than ever.

The recent changes under the TCJA provide the Commission with an opportunity to reduce and smooth out volatility in customer rates over the short and long term, while maintaining the Company's credit position and ability to provide safe, reliable, and affordable service. Although the Commission has some discretion in its ratemaking treatment of these tax changes, such discretion is not without limitation, particularly with regard to timing of implementation of some of these changes in accordance with Ohio law and the required normalization of certain liabilities created under the TCJA. To this end, no single change established by the TCJA should be viewed in isolation. Rather, all of the changes that affect public utilities should be viewed together, including the consideration of potential impacts on Duke Energy Ohio's current and projected financial position and cash flow, particularly with respect to the timing of the implementation of these changes. The Company urges the Commission to address these tax law changes in a manner that appropriately provides benefits to customers, while allowing the Company to maintain its earnings.

As directed by the Commission, Duke Energy Ohio describes generally the changes caused by the TCJA as well as the impacts, both in the short term and the long term for the Company and its customers. Duke Energy Ohio further describes how customers will eventually receive the benefits of TCJA in accordance with Ohio law, rules, and regulations. Indeed, Duke Energy Ohio has already taken proactive steps to provide its customers with a significant portion of the benefits of the TCJA in a manner that is more expeditious than what is possible through these proceedings. The Commission should remain mindful of mitigating the likelihood of larger future increases that could occur as a result of the TCJA and be cautious not to outweigh the benefit of providing customers with significant short-term benefits to the exclusion of considering potential strategies that could minimize customer rate volatility and accelerated growth in rate base over the longer term. The Company respectfully submits that a balanced approach that benefits customers and keeps utilities in the same financial position as prior to the TCJA's passage is the ideal result, thus avoiding unintended cost increases to customers or financial harm to the utility.

II. Impact of the Federal Tax Cuts and Jobs Act on Utilities.

A. Overview

The TCJA represents the most significant revision to the Federal Tax Code in the last 30 years. One of the stated purposes behind the TCJA was to stimulate business investments and grow the economy. The TCJA has resulted in numerous significant changes for all U.S. citizens and corporations, both positive and negative. The changes take effect beginning January 1, 2018. Most changes to the corporate tax code apply to all U.S. corporations equally, while a limited set of other changes affect regulated utilities uniquely. The key components of the TCJA, as they affect regulated electric and gas utilities, are: (1) lowering the corporate tax rate from 35 percent to 21 percent; (2) retention of net interest expense deductibility; (3) eliminating bonus depreciation; (4) eliminating the manufacturing tax deduction; and (5) revaluing tax assets and liabilities and the normalization of excess accumulated deferred income taxes (ADITs) resulting from the TCJA.

B. Specific Components of the TCJA

1. Reduction in Corporate Tax Rate

The new statutory federal income tax rate of 21 percent represents a 40 percent reduction from the previous rate of 35 percent. This will lower a key component of cost of service; *i.e.*, income taxes going forward. In combination with the elimination of bonus depreciation (see below), a lower corporate tax rate will slow the accumulation of deferred income taxes and have an increasing effect on rate base, thereby causing an effect that is opposite to the lower cost of service effect.

2. Interest Expense Deductibility

The TCJA generally provides that net interest expense is deductible only to the extent it does not exceed a stated percentage of an adjusted taxable income calculation, a calculation that becomes even more restrictive four years hence. However, regulated utilities are exempt from this provision and may deduct their interest expense without limitation. Duke Energy Corp. and Edison Electric Institute (EEI) (the regulated electric utility trade association) worked hard to achieve this important exemption, and the Company's customers will retain the significant benefits that flow from it.

3. Depreciation and Expensing of Capital

The TCJA generally provides that corporations may immediately expense capital as it is placed in service, akin to 100 percent bonus depreciation. However, the TCJA specifically prohibits the immediate expensing of capital by regulated utilities. Instead, utilities are directed to use MACRS (modified accelerated cost recovery system) depreciation for capital investment placed in service. Though no longer accompanied by "bonus" depreciation, MACRS still represents a significantly accelerated rate of depreciation for tax purposes compared to book depreciation. As a result, deferred taxes will continue to accrue under MACRS, but will do so at a slower rate compared to bonus depreciation and at a much slower rate under the lower 21 percent corporate tax rate (see above). This will cause a more rapid increase to rate base relative to pre-TCJA.

4. Excess Accumulated Deferred Income Taxes

At the end of 2017, Duke Energy Ohio had a significant net deferred tax liability, booked at a 35 percent corporate tax rate and driven overwhelmingly by accelerated and bonus depreciation of fixed assets for tax purposes. Because a deferred tax liability represents taxes collected from customers but not yet paid to taxing authorities, and because the ultimate payment of these taxes will now occur at a 21 percent corporate tax rate (down from 35 percent), the balance of deferred tax liability had to be re-measured. The resulting "excess" deferred tax balance is a regulatory liability. The TCJA requires that excess deferred taxes generally associated with the accelerated depreciation of property, must be normalized into customers rates in a highly prescribed manner that mimics the remaining life of the underlying assets. These are known as "protected" excess accumulated deferred income taxes. All other excess accumulated deferred income taxes may be treated by the Commission like any other regulatory liability in the rate-setting process.

C. Short- and Long-Term Impact to Utility Revenue Requirements

These changes must be viewed together when assessing their impact on Duke Energy Ohio. Combined, the changes impact the Company in two principal ways: First, all else being equal, the changes are expected to reduce utility revenue requirements in the short term because the Company will: (i) have a lower future federal corporate tax rate; and (ii) over time, pursuant to the TCJA, excess ADIT balances will be returned. Without reviewing all other components of the Company's cost of providing utility service, it is not possible to say whether the change in the income tax rates would offset other costs that may have increased since the time base rates were last established.

Second, over a period of time, the TCJA will begin to increase the Company's revenue requirements by increasing the Company's rate base. This will begin immediately and increase over time. The increase in rate base is due to the reduced benefit from deferred taxes that will result from the TCJA, resulting from lower federal income tax rates and the elimination of bonus depreciation.[1] In combination with the elimination of bonus depreciation, a lower corporate tax rate will slow the accumulation of deferred income taxes and have the effect of increasing rate base, thereby causing an effect that is opposite to the lower cost of service effect. The bottom line result for customers is that, when the changes are incorporated into rates, the rates will be lower than they otherwise would have been, due the reduction in the federal corporate tax rate in the near-term. However, higher rates will develop over the next several years because of (a) the rate base increasing immediately and more rapidly than otherwise would have occurred absent enactment of the TCJA and (b) the potential increase in the cost of capital.

D. Timing and Treatment of Excess ADITs under the TCJA

Many timing differences exist between when income taxes are collected from customers in rates and when the Company pays those taxes in cash to the Internal Revenue Service (IRS). Sometimes income taxes are paid sooner than when they are collected from customers (which creates a deferred tax asset on the company's books), and sometimes they are paid later (creating

[1] Bonus depreciation, like any other form of accelerated depreciation, has the effect, generally, of reducing taxable income, and therefore deferring associated cash taxes. However, utilities, being very capital-intensive businesses, were often put into tax loss positions (net operating losses) from an abundance of bonus depreciation and, therefore, were limited in their ability to incrementally delay cash taxes. To the extent that a utility could defer cash taxes due to bonus depreciation, however, a deferred tax liability was established. The cash collected from customers but deferred from the taxing authorities was used to fund the operations and investments of the utility and avoided a commensurate level of third-party financings that would otherwise have been necessary but for the additional deferred income taxes.

a deferred tax liability). Deferred taxes balances, therefore, result from book/tax timing differences between the recognition of income and expenses. All deferred tax balances, whether they are assets or liabilities, reverse over time and converge to zero over the life of the underlying item giving rise to the deferred tax balance. The TCJA requires that the utility separate the actual amount of accumulated taxes as of December 31, 2017, which would have been flowed through at 35 percent, from the subsequent amount that will be flowed through at 21 percent. This difference is the "excess" ADIT and is recorded as a regulatory liability that will be returned to customers over time. The TCJA dictates that the "protected" portion of the excess ADIT liability (which is related to deferred taxes originating from accelerated tax depreciation of property, plant and equipment) be used for customer benefits no faster than the deferred taxes would have reversed had the tax rate not changed (essentially over the remaining life of the assets). More specifically, as discussed above, the TCJA results in a differentiation between protected excess ADITs and other excess ADITs. Under the TCJA, and to the extent utilities are required to reverse or refund the excess by their respective regulatory agencies, the excess ADIT reserve may be reduced with a corresponding reduction in the revenue that the utility collects from ratepayers no more rapidly than the reserve would be reduced under the Average Rate Assumption Method (ARAM).[2] There is no discretion to the treatment of these "protected" excess ADITs and the timing of the normalization of those balances. This means that, for utilities, the protected excess ADIT must be reduced consistent with the normalization method of accounting and over the remaining useful life of the underlying property/asset that gave rise to

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[2] ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in the utility's regulated books of account which gave rise to the reserve for deferred taxes. Under such method, during the time period in which the timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying (i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by (ii) the amount of the timing differences which reverse during such period.

the excess. The TCJA includes penalties for violating this normalization requirement as it relates to ADITs.

The remaining excess deferred income tax liabilities are "unprotected." The Commission will have some discretion, limited by Ohio's statutory authority, to determine how and when to use the unprotected excess deferred income taxes. It is with these unprotected excess ADITs that the Commission could exercise its discretion to help mitigate future rate impacts to customers and preserve the utility balance sheet.

As a result of the TCJA, Duke Energy Ohio is required to re-measure its existing deferred tax assets and liabilities as of December 31, 2017, to reflect the decrease in the federal corporate tax rate from 35 percent to 21 percent beginning January 1, 2018 (creating "excess" deferred taxes). The precise impacts of these changes to the 2017 financial statements are still being evaluated by the Company. The financial impacts of the TCJA in future years, including 2018, are not known with certainty as they will be dependent upon the Company's future performance and any interpretations, technical corrections, and other implementing regulations issued by the IRS.

III. Impacts of the TCJA on Customers

Duke Energy Ohio believes that the impacts (positive or negative) of the TCJA should not be unnecessarily or unreasonably delayed. That said, addressing these complicated impacts must be accomplished in a measured approach, in accordance with Ohio law and Commission regulations and in a manner that balances the need to preserve the financial condition of the utility. At a high level, the implications of the TCJA on Duke Energy Ohio's customers' rates can be distilled into three distinct categories: 1) Reduction in the federal income tax rate from 35 percent to 21 percent reduces the utility's tax expense in a given year; 2) Accounting and rate treatment of excess ADITs as of December 31, 2017, subject to normalization rules and Commission approval will be flowed back to customers further reducing rates; and 3) Rate base will be higher in future rate proceedings due to the elimination of bonus deprecation and the reduced value of accelerated depreciation due to the lower federal income tax rate.

Going forward, customers will receive the positive and negative consequences of these changes in two primary ways: through future base rate adjustments and through any rider mechanisms that include a provision for income taxes. For example, Duke Energy Ohio has already taken voluntary, proactive steps to enable its customers to start receiving the vast majority of the benefits from the reduction in the federal income tax rate in 2018:

- On January 26, 2018, Duke Energy Ohio made its quarterly filing in Case No. 17-2088-EL-RDR to adjust its Distribution Capital Investment Rider (Rider DCI).

- In addition, the Company filed an amended application in its Distribution Rider – Infrastructure Modernization Rider (Rider DR-IM) that the Commission approved in Case No. 17-1403-EL-RDR to reflect the impact of the change in income taxes.

- Both of these riders will be effective with rates beginning April 1, 2018. Compared to the annualized revenue requirement at 35 percent, the combined annualized revenue requirement for these two riders will be approximately $20 million less due to the Company's voluntary inclusion of the lower federal income tax rate.

- Similarly, the Company will voluntarily adjust the revenue requirement in its Accelerated Main Replacement Program Rider (Rider AMRP) scheduled to be effective beginning May 1, 2018. The impact of the lower federal income tax will reduce the annualized revenue requirement for Rider AMRP by approximately $2.7 million. For any other Duke Energy Ohio electric or gas riders that include a provision for federal income taxes, customers will commence receiving those benefits as those riders are adjusted in the future.

The formula for Rider DCI effectively provides for a return on 100 percent of the Company's current distribution rate base including a provision for federal income taxes. Insofar as the Company will be reflecting the lower federal income tax rate in computing the return component of its Rider DCI, customers will see 100 percent of the benefit of the lower income tax rate on all of the distribution plant included in Rider DCI, beginning April 1, 2018.

The Company has requested, in its pending rate case, Case No. 17-32-EL-AIR, and its pending electric security plan (ESP) case, Case No. 17-1263-EL-SSO, authority to modify its existing Rider DCI to include all jurisdictional plant, as the Commission has allowed for other jurisdictional utilities. Approval of the expansion to this rider would ensure that *all* of the benefits of the change in federal income taxes flow through to customers immediately, and automatically, upon approval and implementation of the new Rider DCI.

By voluntarily adjusting Rider DCI to be effective April 1, 2018, the Company has expeditiously moved to ensure that customers experience a significant portion of the benefits of the TCJA much sooner than could be expected if the Company waited for this Commission investigation to conclude. The Company's voluntary action[3] does so without causing the Commission to violate Ohio law or regulatory principles, including, but not limited to, the filed rate doctrine and the prohibition against retroactive ratemaking. To the extent any other Duke Energy Ohio electric or gas riders include provisions for income taxes, these riders will adjust on their current terms, and customers will commence receiving additional benefits through those adjustments as well.

The impact of some of the benefits of the TCJA, such as the return of excess ADITs, will have to be addressed by the Commission as part of this investigation or through a negotiated and agreed-upon process with the utility or directive by the Commission in a manner consistent with Ohio law. Nevertheless, the nature of the excess ADITs is such that, regardless of how long it

[3] The Company's voluntary action does not suggest any concession, on the Company's part, that the Commission has the authority to order rate reductions without providing the impacted utility with the required due process, ensuring that rates are just, reasonable, and fair.

takes to fully vet that process, customers are still assured of receiving the full value of the jurisdictional excess ADITs that existed on December 31, 2017.

IV. Timing of Deferrals Ordered by the Commission

In the Commission's January 10, 2018, Entry, impacted utilities were directed to defer,[4] as a regulatory liability (1) all excess ADIT balances created by the TCJA in 2017, and (2) the estimated difference between customer revenues actually billed and what would have been billed taking into effect the reduced corporate tax rate beginning January 1, 2018, until the Commission determines the timing and nature of returning such benefits to customers.

The Commission's authority over a utility's system of accounts is defined by R.C. 4905.13, which provides that the Commission "may, after hearing had upon its own motion or complaint, prescribe by order the accounts in which particular outlays and receipts shall be entered, charged, or credited." Duke Energy Ohio notes that the Commission has not yet conducted a hearing in this matter as required under R.C. 4905.13. Nonetheless, the Company is making the accounting entries on an interim basis, as directed in the January 10 Entry, pending the Commission's final order in these proceedings.[5] Duke Energy Ohio respectfully submits that the Commission's January 10 directive that utilities retroactively establish liabilities reaching back to January 1, 2018, should be considered as temporary, for accounting purposes only (*i.e.*, not for ratemaking purposes), and subject to revision after the due process contemplated in R.C. 4905.13 takes place through this case or a future rate proceeding.[6] Otherwise, the Commission's

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[4] The Company has booked these amounts in FERC Account 254, subject to true-up once final tax returns have been filed for tax year 2017.

[5] *See* Joint Application for Rehearing of Ohio Power Company, Ohio Edison Company, The Dayton Power and Light Company, Duke Energy Ohio, Inc., the Cleveland Electric Illuminating Company, and the Toledo Edison Company, Case No. 18-47-AU-COI February 9, 2018 at 7-9.

[6] *See, e.g., Elyria Foundry Co. v. Pub. Util. Comm.*, 114 Ohio St.3d 305, 2007-Ohio-4164, 871 N.E.2d 1176, ¶ 19. The ratemaking effect of an accounting order must be reviewed and approved in a rate proceeding. *Id.*; *Consumers' Counsel v. Pub. Util. Comm.*, 63 Ohio St.3d 522, 524-525, 589 N.E.2d 1267 (1992).

Entry's retrospective directive to establish a regulatory liability effective January 1, 2018, would be contrary to R.C. 4905.13.

Utilities are permitted only to charge the rates that are filed and approved by the Commission. Ohio law is clear that the Commission may only change those rates prospectively.[7] Therefore, the modifications to utility rates (and riders) ordered by the Commission can only occur prospectively in a rate proceeding (not a generic industry proceeding).

Although this industry-wide proceeding is appropriate for providing a forum to discuss the impacts and inform the Commission regarding issues to be addressed, it is inappropriate to conduct an industry-wide rate adjustment investigation. The impacts of the TCJA on utility rates will vary among rate classes and among customers, based upon the unique circumstances and rate structures of each utility. The equitable distribution of the savings generated by the TCJA is another consideration the Commission must weigh before issuing any order regarding the treatment of the impacts of the TCJA, in order to ensure that the benefits are provided to customers fairly. Indeed individual parties to utility rate proceedings will likely have differing views regarding an appropriate allocation of these impacts between customer classes.

To the extent the Commission's accounting directive in this generic, industry-wide proceeding, without advanced notice and prior to a hearing, forms the basis for changing base rates or approved riders for individual EDUs, the Commission's January 10 Entry would be unlawful.

V. Other TCJA Considerations for the Commission

The implementation of the TCJA has the potential to adversely affect the Company's cash flow needed to fund ongoing operations and new infrastructure investments. An

[7] *Keco Industries, Inc. Cincinnati & Suburban Bell Tel. Co*., 166 Ohio St. 254, 257, 141 N.E.2d 465 (1957).

unmitigated cash flow shortfall could force the Company to rely excessively on third-party capital, to the ultimate detriment of its financial condition.

Stand-alone utility and consolidated financing structures are based on capital flows as of prior to enactment of the TCJA and were formed to support significant investments to benefit customers. An immediate flow-back resulting from tax reform would significantly lower the Company's cash expectations, which would impact its credit metrics, including coverage ratios, and could result in the need to issue additional debt or equity. Negatively affecting the Company's credit metrics or requiring additional capital have the potential to undermine access to capital markets and could cause a deterioration in the Company's financial condition.

Customers benefit directly from a strong balance sheet and strong investment grade credit ratings through low cost of capital and strong access to capital during all market conditions. This was particularly evident during the recent recession. As incoming cash flows decrease, a strong utility equity pad becomes even more important for customers over both the near- and long-term. Reducing rates in isolation, without regard to the other provisions in the TCJA and the overall reasonableness of the Company's rates, would adversely impact the stand-alone utility Company's cash flow, weaken credit quality and put the credit ratings of the Company and its parent company at risk. In fact, on January 19, 2018, Moody's changed Duke Energy Corporation's[8] rating outlook from stable to negative in response to the financial impacts of the TCJA and regulatory uncertainties.

The Commission has recognized the importance of supporting its regulated utilities' capital structure. In recent proceedings involving The Dayton Power & Light Company[9] and

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[8] Moody's also reduced its rating outlook for Piedmont Natural Gas Company, Inc., and twenty-two other utilities and utility holding companies.

[9] *In the matter of the Application of The Dayton Power and Light Company to Establish a Standard Service Offer in the Form of an Electric Security Plan*, Case No. 16-395-EL-SSO, *et al.*, Opinion and Order (October 19, 2017).

FirstEnergy Corp. utilities,[10] the Commission found that it is important to maintain an investment grade credit rating.

For both companies, the Commission determined that the threats to their financial condition warranted additional revenues to ensure that access to capital markets and favorable borrowing terms and conditions enabled investment in the distribution grid. Chairman Haque added, in his concurrence in the FirstEnergy cases, that the purpose of the additional revenue was "to ensure that FirstEnergy retains a certain level of financial health and creditworthiness so that it can invest in future distribution modernization endeavors."[11] That sensible goal should continue to guide the Commission's decisions as it weighs the implications of the TCJA on each regulated utility's financial conditions.

A blanket directive that each regulated utility refund cash that it may or may not be able to do without impacting its financial health would be unwise and adverse to the Commission's stated goal of "ensuring" the financial health of these same utilities.

The Commission should take the time to thoughtfully and thoroughly consider the optimal solution for providing long-term benefits to customers and the utility without harming either. The Company urges the Commission to look beyond the just the reductions in tax expense afforded under the TCJA and to focus on bigger picture of TCJA, being mindful of its responsibility to stand for all stakeholders, as it relates to the reasonableness of the utility's rates and ensuring that utilities are given the opportunity to earn a fair, reasonable, and just return. This measured approach is beneficial for both customers and the utilities and necessarily includes consideration of both the immediate and longer term impacts of the TCJA, the current

[10] *In the Matter of the Application of Ohio Edison Company, The Cleveland Electric Illuminating company, and the Toledo Edison Company for Authority to Provide for a Standard Service Offer Pursuant to R.C. 4928.143 in the Form of an Electric Security Plan,* Case No. 14-1297-EL-SSO, Fifth Entry on Rehearing (Oct. 12. 2016).
[11] *Id*., Concurring Opinion of Chairman Asim Z. Haque, at ¶3.

financial condition of the utility, and an appreciation of what the impact of a sudden reduction in utility rates will have on the quality of service the utility is providing.

These federal tax law changes provide the Commission an opportunity to help smooth out customer rates over the short and longer term. This could be done through using the potential savings afforded under the TCJA to fund future utility investments thereby reducing future costs that would be recovered from customers or even reducing or eliminating existing regulatory assets. The Commission should take this unique opportunity to address these issues in a fair and balanced way that can provide both immediate benefits to customers, preserve the short- and long-term financial integrity of the utility, and perhaps have a meaningful impact on customer rates in the future as well.

VI. Conclusion

For all the foregoing reasons, Duke Energy Ohio respectfully requests that the Commission approve and adopt the recommendations contained in these Initial Comments, enabling the Company to provide benefits to customers and continue building the energy future their customers and communities deserve.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The Commission's e-filing system will electronically serve notice of the filing of this document on February 15, 2018, on the parties referenced on the service list of the docket card who have electronically subscribed to the case.

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