COMMONWEALTH OF KENTUCKY
OFFICE OF THE ATTORNEY GENERAL

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28 September 2005

Via Hand Delivery

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PUBLIC SERVICE
COMMISSION

Beth O'Donnell, Executive Director
Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40601

RE: PSC Case No. 2005-00228

Dear Ms. O'Donnell:

The Attorney General submits for filing the pre-filed Direct Testimony of his witness, Scott J. Rubin. Counsel certifies and gives notice of the filing of the original and ten photocopies of the redacted testimony and the filing of one copy, under seal, of the unredacted testimony.

Service of the redacted testimony was by mailing a true and correct copy of the same, first class postage prepaid, to the parties of record (and to Robert M. Watt, III). The Joint Applicants (and Mr. Watt) have also been served with the unredacted testimony. Mr. Kurtz has not been served with the unredacted copy. Filing and service takes place this 28th day of September, 2005.

Regards,

David Edward Spenard
Assistant Attorney General

Commonwealth of Kentucky
Before the Public Service Commission

**Joint Application of Duke Energy Corporation,
Duke Energy Holding Corp., Deer Acquisition Corp.,
Cougar Acquisition Corp., Cinergy Corp.,
the Cincinnati Gas & Electric Company, and
the Union Light, Heat and Power Company
for Approval of a Transfer and Acquisition of Control**

Case No. 2005-00228

DIRECT TESTIMONY

OF

SCOTT J. RUBIN

On behalf of the
Office of the Attorney General of Kentucky

***** REDACTED – PUBLIC VERSION *****

Dated: September 28, 2005

1 ## Introduction

2 **Q. Please state your name and business address.**

3 A. My name is Scott J. Rubin. My business address is 3 Lost Creek Drive, Selinsgrove, PA.

4 **Q. By whom are you employed and in what capacity?**

5 A. I am an independent consultant and an attorney. My practice is limited to matters
6 affecting the public utility industry.

7 **Q. What is the purpose of your testimony in this case?**

8 A. I have been asked by the Office of the Attorney General (AG) to review the proposed
9 merger between Duke Energy Corp. (Duke) and Cinergy Corp. (Cinergy) that would
10 result in the transfer and change in control of the Kentucky operations of Union Light,
11 Heat and Power Company (ULH&P). For ease of reference, I will refer to the proposed,
12 merged company as New Duke. In particular, my review will include (1) an evaluation
13 of Duke's technical, financial, and managerial fitness to own and operate a public utility
14 in Kentucky; (2) a determination of whether the acquisition is being made for a proper
15 purpose; (3) if the merger is allowed to go forward, any conditions and other protections
16 that are necessary to protect ULH&P and its customers; and (4) if the merger is allowed
17 to go forward, whether and how the projected synergy savings from the merger should be
18 allocated to ULH&P's customers.

19 **Q. What are your qualifications to provide this testimony in this case?**

20 A. I am a graduate of the Pennsylvania State University (B.A. with Distinction in Political
21 Science) and the National Law Center at George Washington University (J.D. with
22 Honors). In addition to my studies in law and political science, I also have taken

1 substantial coursework in economics, including a graduate course in natural resource
2 economics. I also have participated in numerous continuing education courses involving
3 various aspects of the regulation of public utilities.
4 I have testified as an expert witness before utility commissions or courts in the
5 District of Columbia and in the states of Arizona, Delaware, Kentucky, Illinois, Maine,
6 New Jersey, New York, Ohio, Pennsylvania, and West Virginia. I also have served as a
7 consultant to the Connecticut Department of Public Utility Control, private businesses,
8 non-profit organizations, national utility trade associations, state governments, and
9 government-owned utilities. I also have testified as an expert witness on utility matters
10 before committees of the U.S. Congress and the Pennsylvania House of Representatives.
11 Prior to establishing my own consulting and law practice, I was employed by the
12 Pennsylvania Office of Consumer Advocate (OCA) from 1983 through January 1994 in
13 increasingly responsible positions. From 1990 until I left the OCA, I was one of two
14 senior attorneys in that Office. Among my other responsibilities in that position, I had a
15 major role in setting the OCA's policy positions on water and electric matters. In
16 addition, I was responsible for supervising the technical staff of that Office. I also
17 testified as an expert witness for that Office on rate design and cost of service issues.
18 During my last four years with that Office, I chaired the Water Committee of the National
19 Association of State Utility Consumer Advocates (NASUCA).
20 Throughout my career, I developed substantial expertise in matters relating to the
21 economic regulation of public utilities. I have published articles, contributed to books,
22 written speeches, and delivered numerous presentations, on both the national and state
23 level, relating to regulatory issues. I have attended numerous continuing education

1 courses involving the utility industry. I also periodically participate as a faculty member
2 in utility-related educational programs for the Institute for Public Utilities at Michigan
3 State University, the American Water Works Association, and the Pennsylvania Bar
4 Institute.

5 **Q. What is your specific expertise concerning utility mergers and issues associated with**
6 **the relationships between utilities and their affiliates?**

7 A. I began studying the relationships between utilities and their affiliates in numerous rate
8 cases during the 1980s, and more formally for the Water Committee of NASUCA in the
9 early 1990s. Since then, I have testified on several occasions concerning the appropriate
10 relationships and costs among utilities and affiliated companies, including, for example,
11 the following cases:

12-15
- *Re Consumers Maine Water Company Request for Approval of Contracts with Consumers Water Company and with Ohio Water Service Company*, Me. Public Utilities Commission, Docket No. 94-352 (1994), on behalf of the Maine Office of Public Advocate.

16-19
- *In the Matter of the Regulation of the Electric Fuel Component Contained within the Rate Schedules of Cincinnati Gas and Electric Co. and Related Matters*, Public Utilities Commission of Ohio, Case No. 97-103-EL-EFC (1998), on behalf of the Ohio Office of the Consumers' Counsel.

20-23
- *Olde Port Mariner Fleet, Inc. Complaint Regarding Casco Bay Island Transit District's Tour and Charter Service*, Maine Public Utilities Commission, Docket No. 98-161 (1998), on behalf of the Maine Office of Public Advocate.

24-27
- *Hope Gas, Inc., d/b/a Dominion Hope*, West Virginia Public Service Commission, Case No. 05-0304-G-42T (2005), on behalf of the Consumer Advocate Division of the Public Service Commission of West Virginia.

28 In addition, I have examined affiliated cost issues as a consultant in numerous rate cases
29 involving various water and wastewater utilities that receive and/or provide services to
30 affiliated companies.

1 I also have been involved, either as an attorney or an expert witness, in numerous
2 cases to review proposed utility mergers and acquisitions, including the following:

3 • Allegheny Energy – Duquesne Light
4 • Exelon - PSEG
5 • FirstEnergy – GPU
6 • Long Island Lighting – Keyspan – Long Island Power Authority
7 • MCI – Sprint
8 • PSC – Consumers Water
9 • RWE – Thames – American Water Works
10 • SBC – AT&T
11 • Verizon – MCI
12

13 ## Overview of the Proposed Transaction

14 **Q. What is your understanding of the proposed transaction?**

15 A. Duke and Cinergy are proposing to merge to form New Duke. If the merger is
16 completed, Cinergy would become a wholly owned subsidiary of New Duke. Cincinnati
17 Gas and Electric Co. (CG&E) is a subsidiary of Cinergy and the parent company of
18 ULH&P. It is my understanding that CG&E would continue to own all of ULH&P's
19 stock, and would continue to provide some services to ULH&P.

20 If the transaction occurs, it is unclear precisely which types of services would be
21 provided to ULH&P from which entities. It appears that New Duke would have a service
22 company, but it sounds as if one or more Cinergy subsidiaries (including CG&E) might
23 also continue to provide some services to ULH&P. It also appears that New Duke would
24 have a money pool for its operating utilities, including ULH&P.

1 **Q. What standards apply to the Commission's review of the proposed transaction?**

2 A. I am advised by counsel that KRS 278.020 requires the Commission to find that Duke has
3 the financial, technical, and managerial abilities to ensure that ULH&P continues to
4 provide safe and reliable service. I am also advised that this section of the law requires
5 the Commission to determine that the transfer is being made for a proper purpose and is
6 otherwise consistent with the public interest. In addition, I understand that the
7 Commission is required to review and approve agreements between ULH&P and any
8 affiliates.

9 **Q. Will your testimony rely on any information that is subject to protection as**
10 **confidential information?**

11 A. Yes, the Commission has issued an order finding that certain information provided by the
12 applicants is exempt from public disclosure. When I refer to information that the
13 Commission has found to be confidential, I will mark it by enclosing it in brackets and
14 using a double underline like this {**begin confidential** example **end confidential**}.

15 ## Impact of the Energy Policy Act of 2005

16 **Q. If the merger is completed, will New Duke be subject to regulation by the Securities**
17 **and Exchange Commission (S.E.C.) under the Public Utility Holding Company Act?**

18 A. No, the Public Utility Holding Company Act of 1935 (1935 Act) has been repealed by the
19 Energy Policy Act of 2005, which includes a subtitle called the Public Utility Holding

1 Company Act of 2005 (2005 Act).[1] The 2005 Act repeals the 1935 Act effective
2 February 2006 and eliminates S.E.C. jurisdiction over utilities' affiliated relationships.

3 **Q. Does this present any special concerns in this case?**

4 A. Yes, it creates a number of very important issues for the Commission to consider in this
5 case. The 1935 Act would have required the Duke-Cinergy combination to be a
6 registered holding company. As such, the company would have been required to have a
7 single service company, and that service company would have been prohibited from
8 recovering more than its actual costs from affiliates (including ULH&P). The 2005 Act
9 contains no such requirement. With the repeal of the 1935 Act, New Duke will need to
10 decide what type of relationship it wants to have among its subsidiaries and, of course, it
11 will need to comply with state affiliated interest provisions in those states where it
12 provides utility service.

13 In addition, under the 1935 Act, the S.E.C. conducted periodic audits of utility
14 service companies and other affiliated relationships to ensure that they were billing no
15 more than actual costs and to ensure compliance with cost allocation manuals and
16 procedures. Since the S.E.C. will no longer regulate utility holding companies, state
17 commissions can no longer rely on the S.E.C. to audit utility service companies or other
18 affiliated activities (such as money pools).

19 The 2005 Act gives the Federal Energy Regulatory Commission (FERC) the

[1] Sections 1261-1277 of the Energy Policy Act; see also *Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005*, Notice of Proposed Rulemaking, 112 FERC 61,300 (Sept. 16, 2005).

1 authority to review utility affiliates' books and records, but those reviews appear to be
2 limited to any impacts on FERC-jurisdictional rates; that is, wholesale rates.[2]

3 **Q. What will this mean for the Kentucky Public Service Commission?**

4 A. The Commission will need to carefully review transactions between utilities and their
5 affiliates. The Commission also may need to evaluate whether existing statutes, and the
6 Commission's existing regulations and procedures, remain inadequate in light of the
7 repeal of the 1935 Act. For example, the New Jersey Board of Public Utilities has
8 initiated an investigation into the state impacts of the repeal of the 1935 Act.[3] In so
9 doing, the New Jersey Board noted the following "unique problems" involved with
10 regulating affiliates of large utility holding companies:

> 11 Public utilities owned by utility holding companies create unique
> 12 problems that require specific regulatory oversight. First, utility holding
> 13 company investments in non-utility businesses may lead to utility
> 14 ratepayer subsidies of non-utility services. Second, the acquisition of a
> 15 utility by a utility holding company can affect the incentives of utility
> 16 managers, as new managers may have priorities other than local utility
> 17 service and may lack the state-specific and utility experience necessary to
> 18 ensure reliable service at reasonable rates. Third, if the utility's credit
> 19 ratings decline as a result of activities at the parent holding company level
> 20 or of an unregulated affiliate, the compensation demanded by providers of
> 21 capital can increase, placing ratepayers at risk. (Order, p. 1)

22 The New Jersey Board then discussed the areas where the 1935 Act provided
23 protection to consumers, and expressed its concerns about the loss of those protections,
24 stating:

> 25 In order to compensate for these unique circumstances, PUHCA was
> 26 enacted to regulate utility holding companies. PUHCA's protections may

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[2] Section 1264(a) of the 2005 Act.

[3] *In the Matter of the Repeal of the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79a et seq.*, Docket No. AX05070641 (N.J. BPU, Aug 1, 2005).

1 be divided into the following core areas: Market Power, Diversification
2 Risk, Distant Management, Securities Abuses, Corporate Complexity.

3 The Board HEREBY FINDS that in light of the imminent repeal of
4 PUHCA by the Energy Policy Act, in order to ensure that ratepayers
5 continue to receive safe, adequate and proper utility service at just and
6 reasonable rates, the Board must consider whether additional protections
7 are now required at the state level. (*Id.*, p. 2)

8 Importantly, this Commission will no longer be able to rely on the S.E.C. to help
9 ensure the financial integrity of ULH&P's parent companies or provide basic review and
10 oversight of the affiliated relationships within the holding company. The 2005 Act
11 specifically preserves states' authority to regulate utilities' affiliated relationships,
12 stating: "Nothing in this subtitle shall preclude the Commission [FERC] or a State
13 commission from exercising its jurisdiction under otherwise applicable law to determine
14 whether a public utility company, public utility, or natural gas company may recover in
15 rates any costs of an activity performed by an associate company, or any costs of goods
16 or services acquired by such public utility company from an associate company."[4]

17 In short, the Commission will need to be much more vigilant about its oversight
18 and regulation of ULH&P's relationships with its affiliates. It certainly looks like the
19 federal government has ceded regulation of these activities to the states.

[4] Section 1267(b) of the 2005 Act.

1 ## Technical, Financial, and Managerial Fitness

2 **Q. Have you attempted to assess the quality and overall fitness of Duke, from the**
3 **perspective of its technical, financial, and managerial expertise in owning and**
4 **operating public utilities?**
5 A. Yes, I have, in a very general way. I am not a financial analyst or an engineer, but I do
6 have a good, general understanding of what is required to own and operate a public
7 utility.

8 **Q. You said that your assessment was done in a very general way. What does that**
9 **mean?**
10 A. It means that in the limited time I had available, I reviewed investment analysts' reports
11 on Duke, familiarized myself with some of its recent history, and reviewed in some detail
12 the information provided in discovery (such as Cinergy's due diligence of Duke and
13 Duke's Hart Scott Rodino filing with the federal government).

14 **Q. Please summarize what you learned.**
15 A. Duke is a large utility holding company with retail electric operations in North and South
16 Carolina. It also has extensive natural gas production and transmission assets, as well as
17 a retail natural gas utility in Canada. In addition, Duke has made significant investments
18 in energy trading and unregulated power production through its subsidiary known as
19 Duke Energy North America, or DENA. Duke's regulated power production in the
20 Carolinas is primarily fueled by uranium and coal, while its unregulated production is
21 primarily natural gas. Finally, Duke has relatively minor investments in energy
22 operations in foreign countries outside of North America, as well as real estate and other

1 ventures unrelated to energy in this country.

2 Presently, Duke is in the process of recovering from financially disastrous
3 decisions that it made several years ago. Those decisions focused on the unregulated
4 power production and energy trading business, and they have cost Duke dearly. After
5 having some success in the business in the early 2000's, Duke's unregulated energy
6 business collapsed in 2003.

7 Overall, Duke lost more than $1.3 billion that year, and its stock hit a 10-year low
8 of $12.21 per share, compared to a peak of $47.74 per share just two years earlier.
9 Duke's earnings per share growth rate over the past 3, 5, and 10 years is negative. It
10 hadn't increased its common stock dividend since 1998 (until it did so this month in
11 anticipation of the merger with Cinergy, so that the dividend paid to Cinergy's
12 shareholders after the merger would be roughly the same as it is now). One response to
13 this has been for Duke to dramatically reduce its capital spending – its spending in 2004
14 was the lowest it had been since 1997.

15 Another response to Duke's unsuccessful foray into unregulated energy
16 production and trading was to bring in new management. In 2003, Duke hired Paul
17 Anderson as its CEO and President. His goal has been to try to get the company back on
18 sound financial footing. That has involved trying to get Duke to focus again on its core
19 business – being a retail utility and a major natural gas production and pipeline company.
20 Earlier this month, Duke announced that it was finally giving up on the unregulated
21 electricity business. It will be selling all of the power plants owned by DENA (except
22 those in the Midwest that will be operated by Cinergy) and it will be trying to sell or

1 otherwise close out its power trading positions. It appears that Duke will be writing off
2 about $1.3 billion associated with DENA's assets.

3 **Q. What do you conclude from this overview?**

4 A. Based on this overview, Duke has some serious problems, but it appears to be on the path
5 to recovery. Duke has a professional management team that appears to be focused again
6 on its core strengths, and it is trying to get out of businesses where it frankly doesn't have
7 the necessary expertise. Duke has the technical knowledge to own and operate ULH&P.
8 Duke has a sound management team and a new management focus that should not be
9 detrimental to ULH&P's business.

10 On the other hand, I am concerned about Duke's financial position and it is
11 unclear to me if it is willing to make the necessary commitment to long-term capital
12 investments that are necessary to own and operate a public utility. As I mentioned, Duke
13 has reduced its capital spending from a high of more than $5.9 billion in 2001 to a level
14 of less than $2.1 billion in 2004 (the lowest level since 1997). While much of this
15 reduction is the result of its disinvestment in DENA, it still raises a possible concern
16 about the company's commitment to necessary capital investments in its utility
17 operations.

18 Overall, though, based solely on this background, it is my opinion that Duke has
19 the requisite fitness to own and operate a public utility in Kentucky.

20 **Q. Does that mean that you think the merger is a good idea for Cinergy and ULH&P?**

21 A. No. In fact, quite the opposite is true. I do not understand why Cinergy would want to
22 become part of a company that is in the midst of recovering from a serious financial
23 crisis. Ultimately, though, that is a decision that must be made by Cinergy's

1 stockholders. That raises an additional concern, which is that as I prepare this testimony
2 Cinergy has not scheduled a date for its shareholder vote on the transaction and it has not
3 even filed a preliminary proxy statement for S.E.C. review. I am very concerned that the
4 parties and the Commission are being asked to expend substantial resources and effort on
5 a transaction that has not been approved by the utility's owners. While I understand the
6 need to file this case before stockholders approve the transaction, I do not believe that the
7 Commission should approve the transaction before it is known whether the transaction is
8 a real one; that is, whether Cinergy's owners approve of the deal.

9 **Q. You said a moment ago that your opinion about Duke's fitness was based solely on**
10 **your general overview of its history and operations. Has anything happened in this**
11 **proceeding that leads you to change your opinion?**

12 A. Yes, unfortunately it has. When the Applicants filed this case, they acknowledged that
13 they would need to quantify the synergy savings that would result from the merger. They
14 also presented a proposal to share those savings with ULH&P's customers. As a result of
15 examining documents that the Applicants provided during discovery, it appears that the
16 Applicants' presentation of synergy savings before this Commission is not fully candid
17 and may not accurately represent the amount that Duke believes can be saved as a result
18 of the merger. This raises a very serious question of Duke's fitness to own and operate a
19 utility in Kentucky. Based on the information I have today – which is before all of the
20 relevant documents have been provided – I must regretfully conclude that Duke has not
21 been forthcoming with this Commission (and perhaps not with Cinergy or the U.S.
22 Justice Department either). Because of that I conclude that Duke does not have the
23 requisite managerial integrity or fitness to own or operate a utility in Kentucky.

1 **Q. That is a very serious allegation. Please tell us exactly what happened.**

2 A. This issue concerns information that was in Duke's possession – indeed, it was presented
3 to Duke's Board of Directors when they were deciding whether to enter into the merger
4 with Cinergy -- that discusses the level of synergy savings that would be achieved after
5 the merger.

6 **Q. Please back up a minute and put this into perspective. What have the applicants**
7 **said about synergy savings in this case?**

8 A. When this case was filed, it contained the testimony of Thomas Flaherty, an outside
9 consultant who was hired by both Duke and Cinergy to conduct the synergy savings
10 analysis. Mr. Flaherty concludes that the merger would have "the potential for
11 approximately $2.1 billion in total gross cost savings" during the first five years after the
12 merger (Flaherty Direct, p. 5). Mr. Flaherty also shows that it will cost the companies
13 about $767 million to achieve these savings (including costs of the merger itself)
14 (Flaherty Direct, p. 7), so the net cost savings from the merger will be $1.34 billion. He
15 then goes on to explain how much of those savings are associated with regulated utility
16 operations. But I will be focusing on that overall gross savings of $2.1 billion and net
17 savings of $1.34 billion for New Duke.

18 **Q. How does that compare with what Duke and Cinergy said when they announced the**
19 **merger?**

20 A. These figures are fairly consistent with the savings estimates the companies made public
21 when they announced the merger. For example, their press release on May 9, 2005,
22 stated: "the combination will generate approximately $400 million in annual gross
23 synergies -- when fully realized in year three." Similarly, one of the charts in their

1 presentation to financial analysts on May 9 showed total savings of $1.9 billion in five
2 years, less costs to achieve of $690 million, for net savings of about $1.2 billion.

3 **Q. It sounds like the companies have been pretty consistent in saying the merger would**
4 **save about $1.2 or $1.3 billion after costs. So what's the problem?**

5 A. The problem is that Duke's Board of Directors had a savings analysis presented to it, on
6 the day they voted to approve the merger, that apparently showed the savings would be
7 substantially higher. Specifically, at Duke's Board meeting on May 7, 2005, Paul Barry
8 (Duke's Vice President for Mergers and Acquisitions) made a presentation to the Board.
9 According to the minutes of the meeting, {**begin confidential**
10
11
12
13
14
15 **end confidential**}

16 What I don't know yet – because I haven't seen the underlying documents – is the
17 specific areas where Duke's directors believed they could achieve additional savings.

18 In other words, it appears that Duke has information showing that the potential
19 savings from the merger are substantially higher than the savings it has stated publicly or
20 provided on the record in this case. It also does not appear that this updated savings
21 analysis was provided to the U.S. Justice Department as part of the Hart Scott Rodino
22 filing (the document does not appear on the list of documents or in the box of documents
23 that Duke provided to us with the representation that it was their full Hart Scott Rodino

1 filing). It is not even clear to me if Duke shared its study with Cinergy or the team that
2 worked with Mr. Flaherty.

3 **Q. Why is this important?**

4 A. If, as appears to be the case, Duke has withheld highly relevant information from this
5 Commission, the federal government, or its merger partner, that goes directly to the
6 company's fitness to own and operate a utility in Kentucky. The utility industry has gone
7 through incredible turmoil – and the public has lost billions of dollars – in recent years
8 because of corporations (like Enron, Worldcom, Global Crossing, and others) that did not
9 conduct their business honestly and did not disclose accurate information to regulators
10 and the public. I have absolutely no tolerance for companies that try to "hide the ball" or
11 otherwise avoid disclosing relevant information to regulators.

12 In order for the regulatory process to work – a process where the utility holds
13 nearly all of the information – the Commission and other stakeholders must rely on the
14 utility's honesty to provide relevant information in a truthful manner. If, as appears to be
15 the case here, Duke has not done so, then that is an absolutely fundamental breach of its
16 obligations to this Commission and the public. It is, in my opinion, conclusive proof that
17 Duke is not fit to own and operate a public utility in Kentucky.

18 Proper Purpose and Public Interest

19 **Q. Based on your review, do you have an opinion as to whether the proposed**
20 **transaction is for a proper purpose?**

21 A. Yes, from the information I have reviewed, it appears that the transaction is being
22 undertaken for a proper purpose. Duke and Cinergy appear to be motivated by an attempt

1 to make their operations more efficient and to enhance the value of their companies for
2 shareholders. In my opinion, this is a proper purpose for a merger.

3 **Q. Based on your review, do you have an opinion as to whether the transaction is**
4 **otherwise in the public interest?**

5 A. Yes, I have formed such an opinion. As I discussed above, I have very serious concerns
6 about the fitness of Duke to own and operate a public utility in Kentucky. Based on those
7 concerns, it is my opinion that it is not in the public interest for this transaction to occur.

8 In case the Commission disagrees with me, I will discuss below various aspects of
9 the proposed transaction that lead me to conclude that the transaction would not be in the
10 public interest, unless the Commission imposes certain conditions on the Applicants.

11 Primary Recommendation

12 **Q. Before we move into other areas, please summarize your primary recommendation.**

13 A. My primary recommendation is that the Commission should reject the proposed merger
14 between Duke and Cinergy. I have reached this conclusion because of Duke's lack of
15 candor before this Commission, which makes Duke unfit to own or operate a public
16 utility in Kentucky.

17 Conditions to Protect ULH&P and Its Customers

18 **Q. If the Commission rejects your primary recommendation, do you have other**
19 **matters that you believe the Commission should consider?**

20 A. Yes, I do. If the Commission rejects my primary recommendation and finds that Duke is
21 fit to operate in Kentucky, then there are other aspects of the proposed transaction that the

1 Commission should review, and particular conditions that the Commission should impose
2 on the Applicants. I will group my concerns into two general areas: financial risks and
3 risks associated with affiliated transactions.

4 Protection from Financial Risks

5 **Q. The first area you mentioned is financial risks. What do you mean by financial**
6 **risks?**
7 A. By financial risks, I am referring to the need for the Commission to protect the ability of
8 ULH&P to be adequately and appropriately capitalized, so that ULH&P can obtain the
9 capital it needs to operate, maintain, upgrade, and expand its facilities. In addition, the
10 Commission needs to protect against ULH&P being forced to enter into transactions with
11 affiliates that might remove necessary funds from ULH&P, or otherwise restrict
12 ULH&P's ability to operate in a reasonable manner.

13 **Q. What risks might be created by this transaction?**
14 A. There are several risks. First, with any large merger, the new company feels pressure to
15 show that it is saving a substantial amount of money as a result of the merger. Merging
16 parties, including Duke and Cinergy, need to justify to shareholders the extraordinary
17 costs they will spend on the merger. A large part of that justification is that costs and/or
18 capital spending can be reduced by creating a larger, more efficient company (these are
19 referred to as synergy savings).

1 **Q. You said that the costs of the merger were extraordinary. What do you mean by**
2 **that?**
3 A. Mr. Flaherty's Attachment TJF-3 shows that the companies will spend more than $140
4 million just to make the merger happen. These costs are being incurred to retain and
5 relocate key employees, provide liability coverage to directors, obtain regulatory
6 approval, communicate with shareholders and employees, and pay investment advisors
7 and attorneys. In addition, Duke's stockholders are diluting their interest in the company
8 in order to bring Cinergy under the Duke corporate umbrella. In order to justify these
9 costs – before anything has changed – the companies will need to do something to obtain
10 substantial value for their shareholders. My concern is that the "something" they do
11 could be detrimental to the safety, reliability, and quality of service that is received by
12 ULH&P's customers. Thus, there is a need for some protection.

13 **Q. How could the need to generate savings affect ULH&P and its customers?**
14 A. If New Duke needs to raise or conserve cash, it could reduce its spending on needed
15 capital expenditures at ULH&P or other regulated subsidiaries. It also could take other
16 actions that might not be in the best interests of ULH&P customers, such as reducing
17 expenditures on preventative maintenance, reducing levels of customer service, engaging
18 in more risky ventures (which ultimately could lead to even higher capital costs), among
19 others. I am sure that the applicants and all parties hope that such actions are never taken
20 and that New Duke's business prospers just as it plans. It must be recognized, however,
21 that utility holding companies' plans do not always come to fruition and that the
22 consequences to the regulated utilities and their customers can be severe.

1 **Q. Do you have any examples of where this has happened?**

2 A. Yes, unfortunately there are several examples where this has occurred. In March 2002,
3 the *Indianapolis Star* reported that retail customers of Indianapolis Power & Light Co.
4 "may have to pay for investors' waning confidence in AES Corp., the utility's Virginia-
5 based parent." The article reports that the utility's bond ratings were likely to be
6 downgraded because of the parent company's financial problems. Among the concerns
7 are that the parent had borrowed $750 million against the utility's equity, and that the
8 parent was considering selling 20 percent of its interest in the utility in order to raise
9 additional cash. (Customers May Pay for Waning Confidence in Indianapolis Power &
10 Light Parent, *The Indianapolis Star*, Mar. 4, 2002.)

11 Similarly, several times since 2002, Standard & Poor's downgraded the bonds of
12 the utility subsidiaries of Allegheny Energy, primarily because of the increased risk of
13 Allegheny's unregulated operations. In April 2002, S&P's credit analyst for Allegheny
14 explained the downgrade as follows: "Standard & Poor's considers all of the company's
15 core subsidiaries to have the same default risk, and thus the same corporate credit rating.
16 The levelization resulted in the downgrade of the corporate credit ratings of the regulated
17 subsidiaries." S&P's discussion also noted that Allegheny's unregulated operations were
18 "the weakest of the company's core subsidiaries" and that "concerns at Allegheny
19 revolve around its growing trading and merchant business ... The trading operation and
20 merchant power generation are generally considered to be more risky" than the regulated
21 utilities. (Standard & Poor's Corporate Ratings, Allegheny Energy's, Subsidiaries'
22 Ratings Lowered; Off Watch, Apr. 4, 2002.)

23 Similar actions have been taken involving Utilicorp (an energy utility based in

1 Missouri) (Kansas Regulators To Probe Utilicorp's Affiliate Deals, *Dow Jones*
2 *Newswires*, Mar. 14, 2002), Portland General Electric Co. (Enron To Challenge GSA
3 Suspension Of Portland General, *Dow Jones Newswires*, Mar. 18, 2002), and other
4 utilities that are owned by holding companies.

5 **Q. Has Duke been affected by this same problem?**

6 A. Yes, it has. In 2002 and again in 2003, various rating agencies downgraded the bonds of
7 Duke and its subsidiaries, including Duke Power (the retail utility). According to one
8 article, Standard and Poor's was concerned about the "consolidated business or financial
9 profiles" – in other words, the effect on the utility from a deterioration in the financials of
10 unregulated affiliates. ("Duke downgraded by Moody's and S&P; their outlooks are
11 stable and negative," *Electric Utility Week* (June 23, 2003), p. 12.)

12 **Q. Are there other financial risks associated with this transaction?**

13 A. Yes, this transaction also creates a risk that ULH&P might not be able to obtain the
14 capital that it needs or might not be appropriately capitalized. Within a large,
15 multinational corporation like New Duke would be, each subsidiary must compete with
16 the other subsidiaries (and potential new subsidiaries) for access to capital. While the
17 parent company may appear to have unlimited supplies of capital, in fact that is never the
18 case. Each investment must compete with other potential uses of capital and be judged
19 on its ability to produce a return for the parent company.

1 **Q. Are you aware of any instances where it has been alleged that a utility's parent**
2 **company has failed to provide it with access to capital?**
3 A. Yes, during California's electricity crisis a few years ago, allegations were made that the
4 parent companies of Pacific Gas & Electric Co. and Southern California Edison Co.
5 drained capital from the utilities and failed to provide the utilities with adequate working
6 capital to purchase electricity and otherwise meet their obligations to provide service.
7 This was allegedly one of the factors that precipitated the bankruptcy of PG&E and the
8 financial crisis at Southern California Edison.

9 **Q. You raised several concerns about financial risks associated with this transaction.**
10 **What do you recommend to minimize these risks?**
11 A. I recommend that the Commission impose the following conditions on this transaction:

12 Condition 1. Require ULH&P to disclose all uses made of ULH&P
13 personnel, assets, and equipment for any unregulated purpose. The disclosure
14 should be made within 30 days after the use of such personnel, assets, or
15 equipment and should specifically describe the activities; identify the
16 personnel, assets, or equipment involved; and estimate the fully allocated cost
17 of such personnel, assets, and equipment.

18 Condition 2. Require ULH&P to obtain a certificate of public convenience
19 from the Commission prior to the sale or transfer by ULH&P of any land in
20 Kentucky, regardless of the book value of the land.

21 Condition 3. Prohibit ULH&P from including in its rates, in any fashion,
22 any portion of the acquisition premium or goodwill associated with this
23 transaction.

24 Condition 4. Prohibit ULH&P from including in its rates, in any fashion,
25 any portion of the costs associated with analyzing, negotiating,
26 consummating, or seeking approval of this transaction.

27 Condition 5. Prohibit ULH&P, Cinergy, CG&E, New Duke, or any of their
28 subsidiaries from pledging any of the assets of ULH&P or the stock of
29 ULH&P for any purpose without first having obtained a certificate of public
30 convenience from the Commission.

1 <u>Condition 6.</u> Require ULH&P to include in its Annual Report to the
2 Commission copies of its requested and approved construction budgets for the
3 then-current year (for example, the report filed in the Spring of 2007 for the
4 year ending December 31, 2006, would include the requested and approved
5 construction budgets for the year 2007). Included should be an explanation of
6 the reasons why the budget was not funded to the full extent proposed by
7 ULH&P and whether the budget as approved will impose any limitations on
8 ULH&P's ability to provide safe, adequate, and reliable service to its
9 customers.

10 <u>Condition 7.</u> Require ULH&P to report to the Commission within five
11 business days any downgrading of the bonds of ULH&P, Cinergy, CG&E, or
12 New Duke, including a full copy of the report issued by the bond rating
13 agency.

14 <u>Condition 8.</u> Require ULH&P's Annual Report to the Commission to
15 include a complete copy of the annual reports of CG&E and New Duke.

16 <u>Condition 9.</u> Require Cinergy, CG&E, and New Duke to commit that no
17 capital investment shall have a higher priority than the capital requirements,
18 including working capital, of ULH&P.

19 <u>Condition 10.</u> Require ULH&P to maintain a capital structure that contains at
20 least 35% common equity and prohibit ULH&P from paying any dividend to
21 its parent company that would reduce ULH&P's equity ratio to less than 35%,
22 without the Commission's prior approval.

23 <u>Condition 11.</u> Prohibit ULH&P from paying any dividend to its parent
24 company that exceeds more than 80% of its earnings attributable to common
25 equity in the then-current year.
26

27 **Q. Condition 9 through Condition 11 deal with restrictions on the way in which**
28 **ULH&P is capitalized. Aren't these types of restrictions very unusual?**

29 A. No, these types of restrictions are becoming increasingly common, as utilities become
30 part of ever larger holding company structures. Each of these conditions has been
31 adopted by at least one regulatory commission in the United States. For example, in a
32 number of cases, the California Public Utilities Commission has required the parent
33 company to give the utility "first call on capital" and to give the utility's capital needs
34 "first priority by the board of directors." See, e.g., *Roseville Telephone Co.*, 67 CPUC2d
35 145 (Cal. PUC 1996). A similar requirement has been imposed in Louisiana. *Entergy*

1 *Corp.*, 146 PUR4th 292 (La. PSC 1993).

2 The Connecticut Department of Public Utility Control has prohibited a utility
3 from paying more than 80% of its annual earnings as dividends to the parent. In addition,
4 that commission required that "the holding company shall maintain, as its top priority, the
5 provision of quality service in Connecticut" by the utility. This was coupled with a
6 restriction on holding company investment in unregulated operations. *Southern New*
7 *England Telephone Co.*, 71 PUR4th 446 (Ct. DPUC 1985).

8 In Oregon, the Public Utilities Commission has required a utility to obtain prior
9 approval from PUC before making a distribution to the parent company that would result
10 in the utility's equity ratio falling below 40%. The utility also must notify the PUC of its
11 intention to transfer more than 5% of its retained earnings to the parent or to pay a special
12 dividend to the parent. *Scottish Power*, 196 PUR4th 349 (Ore. PUC 1999).

13 Similarly, the Massachusetts Department of Telecommunications and Energy has
14 placed an obligation on a utility's parent company "to give first priority to the capital
15 needs of the regulated utility and to protect its financial integrity." The DTE also
16 reserved the right to impose restrictions on dividend payments if it appeared that such
17 payments were "inappropriate." *Berkshire Gas Co.*, Docket Nos. DTE 98-61 and 98-87,
18 slip op. (Mass. DTE, Nov. 6, 1998).

19 **Q. But aren't you suggesting that New Duke place Kentucky's needs above everything**
20 **else?**

21 A. No, I chose the wording very carefully. I am not suggesting that investments in ULH&P
22 be placed above all else. I am suggesting that nothing have a higher priority; that is, that
23 other companies may have the <u>same</u> priority as ULH&P. I would hope that New Duke

1 would place all of its utility operating companies on equal footing and that, as a group,
2 investments in the utility operating companies would have the highest priority within
3 New Duke. Thus, I am not proposing that investments in ULH&P should be given a
4 higher priority than investments in CG&E or Duke Power, or any other utility operating
5 company owned by New Duke.

6 ## Protection from Risks Associated With Affiliated Transactions

7 **Q. The other category you mentioned is risks from affiliated transactions. What do**
8 **you mean by that?**
9 A. Affiliated transactions are purchases (or sales) of goods or services between ULH&P and
10 another company that is owned, directly or indirectly, by New Duke. As I discussed in
11 the previous section, I am very concerned about the possibility of the holding company
12 draining ULH&P of the resources necessary for ULH&P to serve its customers. There
13 are two ways to do this: through financing transactions (such as dividend payments or
14 intra-company debt) or through requiring ULH&P to purchase various goods or services
15 from affiliates.

16 **Q. Have the Applicants discussed how they intend to conduct affiliated transactions?**
17 A. Yes, they have, at least to some extent. Mr. Blackwell's testimony discusses the
18 proposed relationship between ULH&P and affiliates. Specifically, he states that New
19 Duke will have a service company (Duke Services) that "will provide administrative,
20 management and support services to ULH&P" and some of its sister companies
21 (Blackwell Direct, p. 3).

1 **Q. What types of services would Duke Services provide to ULH&P?**

2 A. According to the proposed agreement (Attachment BFB-1), the service company would
3 be able to provide essentially every type of service that would be needed to operate a
4 utility, including computer systems, executives, meter testing, transportation, utility
5 system maintenance, marketing, engineering, construction, rates, accounting, customer
6 service, and much more. Essentially, the agreement is broad enough that ULH&P could
7 have almost no employees of its own and rely on Duke Services to do everything.

8 **Q. Is that a problem?**

9 A. Yes, it's a very serious problem. The agreement with the service company all hinges on
10 one important provision: that ULH&P will only receive those services that it requests.
11 Thus, section 1.1 of the agreement states:

12 The Service Company shall furnish to the Client Companies [which
13 includes ULH&P] … such of the services described in Appendix A hereto,
14 at such times, and for such periods an in such manner <u>as the Client</u>
15 <u>Companies may from time to time request</u> … . (emphasis added)

16 Similarly, in section 1.2 the agreement states:

17 Each of the Client Companies shall take from the Service Company such
18 of the services … <u>as are requested from time to time by the Client</u>
19 <u>Companies</u> and which the Service Company concludes it is equipped to
20 perform. (emphasis added)

21 These are extremely important provisions of the agreement because they require
22 ULH&P to make a decision and to make an affirmative request for a service. But if the
23 service company provides ULH&P's executive management, and performs other key
24 services for ULH&P (such as procurement, legal, accounting, and engineering), then
25 there is no way for ULH&P to make an informed decision about whether to use the

1 service company, use an unaffiliated company, provide the service itself, or do without
2 the service. That is, if service company employees are running ULH&P and make all of
3 the key decisions for ULH&P, then ULH&P no longer has the ability to decide when and
4 how to use the service company.

5 **Q. How would you correct this problem?**

6 A. I would correct this problem by prohibiting the service company from providing
7 executive management for ULH&P. I also would require that the chief operating officer
8 for ULH&P must have his or her office in the CG&E/ULH&P service area and must
9 reside in that area.

10 In addition, I would require an authorized, direct employee of ULH&P (not an
11 employee of the service company) to investigate the cost and availability of comparable
12 services from unaffiliated vendors before ULH&P can request the service from Duke
13 Services. I would require this investigation to be made annually for any services
14 purchased from Duke Services, and I also would require ULH&P to maintain a record of
15 each of these investigations for at least five years.

16 **Q. Do you have other concerns with the proposed service company agreement?**

17 A. Yes, I have several other concerns. Generally, they can be grouped into three categories:
18 (1) whether the Commission should grant the Applicants' request for a waiver of the
19 affiliate pricing requirements of KRS 278.2207; (2) whether the service company should
20 be permitted to include a return on equity in the "costs" that it charges to ULH&P; and
21 (3) whether New Duke should be permitted to recover any of its corporate-level costs
22 from ULH&P either directly or indirectly.

1 ## Proposed Waiver of KRS 278.2207

2 **Q. Let's begin with your first category of issues. Before we go any further, please read**
3 **the relevant parts of KRS 278.2207.**

4 A. KRS 278.2207 concerns transactions between utilities and affiliates. Subsection (1)
5 reads: "The terms for transactions between a utility and its affiliates shall be in
6 accordance with the following." Paragraph (a) addresses utilities that sell services to
7 affiliates, which is not an issue in this case, as far as I can tell. Paragraph (b) concerns
8 services that a utility purchases from affiliates, and it reads: "Services and products
9 provided to the utility by an affiliate shall be priced at the affiliate's fully distributed cost
10 but in no event greater than market or in compliance with the utility's existing USDA,
11 SEC, or FERC approved cost allocation methodology."

12 Subsection (2) of the section allows a utility to ask the Commission to deviate
13 from these requirements "for a particular transaction or class of transactions." In such a
14 request, "the utility shall have the burden of demonstrating that the requested pricing is
15 reasonable. The commission may grant the deviation if it determines the deviation is in
16 the public interest."

17 In summary, then, section 278.2207 requires the utility to pay the lesser of cost or
18 market value for services it purchases from affiliates, unless the Commission grants a
19 waiver.

1 **Q. Do you understand that I am not asking you for a legal opinion or interpretation of**
2 **the statute?**
3 A. Yes, I understand that the Office of the Attorney General may raise legal issues
4 concerning the Applicants' waiver request. My testimony will address factual issues
5 associated with the requested waiver.

6 **Q. Have the Applicants requested a waiver?**
7 A. Yes, they have. The waiver request is in paragraph 29 of their Application. That
8 paragraph says that "the requested pricing is reasonable and in the public interest, for the
9 reasons discussed in testimony."

10 **Q. What testimony are they referring to?**
11 A. They appear to be referring to the testimony of Mr. Blackwell who addresses the affiliate
12 issues and sponsors the proposed agreements between ULH&P and various affiliates.

13 **Q. Is there anything in Mr. Blackwell's testimony that discusses the specifics of the**
14 **waiver or that shows the "requested pricing is reasonable and in the public**
15 **interest"?**
16 A. The only discussion of this issue that I found in Mr. Blackwell's testimony is on pages 4
17 and 5. There he explains why section 482 of the Internal Revenue Code "likely will
18 require the pricing of services provided by Duke Services to be adjusted to reflect the
19 market value of those services." He also explains that under the proposed agreement, the
20 "costs" that would be charged to ULH&P by Duke Services would include "a fair return
21 on equity."

1 **Q. Let's take these issues separately. First, is it reasonable to assume that section 482**
2 **of the Internal Revenue Code, 26 USC § 482, will require Duke Services to charge**
3 **its affiliates market value for the services it provides?**
4 A. No, it is not. Section 482 has been in the Internal Revenue Code, in a form almost
5 identical to its present form, since 1954.[5] In the 50 years that this has been the law, I am
6 not aware of a single instance where a utility's service company has been required to bill
7 its affiliate at market prices. Over the last 20 years, I have reviewed numerous service
8 company agreements and similar affiliated interest agreements in the energy,
9 telecommunications, and water utility industries and I have never before seen a concern
10 raised about section 482 of the Internal Revenue Code.
11 While I am not a tax expert, I did briefly review the Internal Revenue Service's
12 more than 90 pages of regulations interpreting this section (26 CFR §§ 1.482-0 to
13 1.482-8). I did not see anything in those regulations that relates to a utility holding
14 company or its service company. Since there are dozens, if not hundreds, of utility
15 holding companies and service companies, I would expect the IRS to make some
16 reference to them if this section were going to change the way they have been doing
17 business for decades. Incidentally, those IRS regulations were adopted in 1994 -- more
18 than ten years ago.

[5] Presently, section 482 reads as follows: "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxe s or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." When this section originally became part of the Internal Revenue Code in 1954 (as part of Public Law 83-591, specifically at 68A Stat. 162) the wording was identical, except the last sentence (about intangible property) was not included (it was added in 1986, Public Law 99-514, specifically at 100 Stat. 2562) and the first sentence referred to "the Secretary or his delegate."

1 **Q. Did you ask the Applicants if they had any additional information about the**
2 **applicability of section 482 to a utility holding company and service company?**
3 A. Yes, we did. In response to AG 2.8, Mr. Blackwell and Mr. Steffen state that they have
4 not been "notified by our outside auditors or by the Internal Revenue Service that a
5 service company cost sharing agreement would not meet the requirements of section
6 482." They also state that they are not aware "of any other public utility that uses a
7 service company that has been notified by an outside auditor or the IRS that a service
8 company cost sharing agreement would not meet the requirements of section 482."
9 Finally, they state that they are not aware of "any Private Letter Rulings, Revenue
10 Procedures, Court Rulings, or other documents from the IRS or relevant judicial
11 authorities that discusses whether a 'service company cost-sharing agreement' would
12 meet the requirements of section 482."

13 **Q. What do you conclude?**
14 A. I conclude that there is no basis for assuming that the Internal Revenue Service – for the
15 first time in more than 50 years – would require a utility holding company or service
16 company to bill affiliates using market values instead of actual costs.

17 **Q. Has Mr. Blackwell or any other witness from the Applicants provided any other**
18 **reason for deviating from the requirements of KRS 278.2207?**
19 A. No, they have not. I conclude, therefore, that there is no valid reason why their request
20 for a waiver should be granted. The Commission should require that any agreement
21 between ULH&P and any affiliate should comply with KRS 278.2207(1)(b) and be
22 "priced at the affiliate's fully distributed cost but in no event greater than market."

1 **Q. The statute also refers to services being priced "in compliance with the utility's**
2 **existing USDA, SEC, or FERC approved cost allocation methodology." Does that**
3 **have any bearing on this case?**
4 A. No, it does not. As I discussed earlier, with the repeal of the Public Utility Holding
5 Company Act of 1935, the Securities and Exchange Commission will no longer have
6 anything to do with utility holding companies, service companies, or affiliated
7 relationships. As I understand the holding company provisions of the new law, FERC's
8 jurisdiction will be limited to how any such agreements or relationships will affect
9 wholesale rates. Therefore, I do not believe that FERC will have the jurisdiction to
10 require holding companies to use certain agreements or allocation methods for state
11 jurisdictional purposes, any more than Kentucky could require FERC to use a certain cost
12 allocation method for federal jurisdictional purposes. In fact, the new law specifically
13 preserves state authority regarding the review and approval of cost allocation agreements,
14 stating: "Nothing in this section shall affect the authority of the [Federal Energy
15 Regulatory] Commission or a State commission under other applicable law."[6]

16 **Q. Mr. Steffen testifies that, even if they receive the waiver they requested, they will**
17 **only include actual costs in ULH&P's cost of service for ratemaking purposes**
18 **(Steffen Direct, pp. 10-11). Doesn't that make this whole issue pretty meaningless?**
19 A. No, it does not make it meaningless. As I discussed earlier, one of the major concerns
20 with a merger is to ensure that the operating utility's resources are used appropriately and
21 that it retains access to necessary capital. If ULH&P's resources are flowing to the
22 service company, it makes it that much harder for ULH&P to provide safe and reliable

[6] Section 1275(c) (Service allocation – effect on federal and state law).

1 service in Kentucky. Simply making a ratemaking adjustment, after the money is gone,
2 does little to allow ULH&P to meet its on-the-ground operating expenses, maintain and
3 upgrade its facilities, and make investments in growth and other new infrastructure. It is
4 important not only to get the ratemaking right, but also to ensure that cash is not flowing
5 to an affiliate when it should be staying in Kentucky.

6 In addition, having one set of expenses for book purposes and a completely
7 different set for ratemaking purposes could greatly complicate the ratemaking process. It
8 could be difficult to review service company expenses or otherwise ensure that ULH&P's
9 relationship with the service company is a reasonable one.

10 **Q. Earlier you stated that Mr. Blackwell defines the "costs" to be recovered by Duke**
11 **Services as including a return on equity. First, does the proposed agreement say**
12 **that Duke Services would be allowed to recover a return on equity capital from**
13 **ULH&P?**

14 A. No, it does not – at least not very clearly. The agreement says: "'cost,' as used in this
15 Agreement, means fully embedded cost, namely, the sum of (1) direct costs, (2) indirect
16 costs and (3) costs of capital." Attach. BFB-1, section 2.4. The agreement does not
17 define the term "costs of capital." Mr. Blackwell, however, states in his testimony:
18 "Costs of capital represent financing costs, including, but not limited to, interest on debt
19 and a fair return on equity." (Blackwell Direct, p. 5.)

20 **Q. Do you agree that a return on common equity capital should be an allowable cost**
21 **for recovery in a service company agreement?**

22 A. No, I do not. First and foremost, the return on common equity is an allowance for profit,
23 it is not a "cost" that can be easily identified or quantified. It is not accurate to say that

1 the service company will not make a profit, but then include an allowance for return on
2 common equity capital. That return is a profit, not a direct cost.
3 Second, if the parties really intend the term "costs of capital" to include a return
4 on equity, then it is very troublesome to have this term undefined in the agreement. We
5 all know how difficult it can be to determine an appropriate return on common equity
6 capital. There is no stated interest rate or other simple index or financial report that can
7 be used to determine the appropriate return. If the parties intend to allow Duke Services
8 to recover a return on equity capital, I would think that they would have a specific
9 formula or other mechanism for determining what that return should be. The fact that
10 there is no mention whatsoever of how to determine the return on equity is a further
11 indication that this is not a "cost" that is allowed to be charged to ULH&P.

12 **Q. What do you recommend?**

13 A. I recommend that the Commission deny the waiver request and require ULH&P to abide
14 by the requirements of KRS 278.2207(b) in all agreements that it enters into with
15 affiliates. I also recommend that its agreement with Duke Services (or whatever service
16 company is established) should not include return on equity capital as a cost to be
17 recovered by the service company.

18 **Recovery of Corporate-Level Costs**

19 **Q. Do you have any other concerns with the proposed service company agreement?**

20 A. Yes, I do. It appears that the service company agreement would apportion all of the
21 corporate-level costs of New Duke to ULH&P and the other subsidiaries of New Duke.
22 This includes costs for corporate advertising, lobbying and other political activities,

1 shareholder services, investor relations, executive compensation and transportation
2 (including a fleet of corporate aircraft), directors' fees – essentially all costs incurred by
3 New Duke.

4 **Q. Why does it concern you that a portion of these costs will be passed on to ULH&P?**
5 A. I am concerned because costs of this nature are neither necessary for, nor related to,
6 ULH&P's provision of safe and reliable service to its customers. The fact that New Duke
7 will have executives earning millions of dollars a year, and flying around the world to
8 survey their holdings, provides no benefit at all to ULH&P. By passing on a portion of
9 these costs to ULH&P, it removes needed financial resources from Kentucky while
10 providing no benefit to ULH&P or its customers.

11 **Q. But if New Duke can't recover its corporate-level expenses from its subsidiaries,**
12 **how would it recover them?**
13 A. Like any company, New Duke should recover its costs out of its income. The income to
14 a holding company like New Duke consists of dividend payments from its subsidiaries.
15 If the subsidiaries do not have sufficient earnings to pay enough in dividends for New
16 Duke to cover its expenses then, like any other company, New Duke will have to find a
17 way to reduce those expenses. But New Duke should not be able to recover its expenses
18 by simply turning them into an expense of its subsidiaries.

19 **Q. If there is extravagance at the corporate level, can't that be handled as a ratemaking**
20 **adjustment in future ULH&P rate cases?**
21 A. Certainly, if ULH&P is paying expenses (either for itself or affiliates) associated with
22 lobbying, public relations, luxury travel, and other unnecessary items, they should be

1 disallowed in a rate case. Capturing those costs at the corporate level, however, can be
2 very time-consuming and expensive. Moreover, that still does not address the
3 fundamental problem: these are not expenses related to ULH&P's provision of service;
4 they are really a dividend paid to the parent, disguised as an expense. The effect is to
5 turn a return on equity (profit) into an operating expense. Further, as I discussed earlier,
6 making a rate case adjustment does not address the outflow of capital from ULH&P to
7 affiliates; capital that is needed to ensure the provision of reliable service in Kentucky.

8 **Q. What do you recommend?**

9 A. I recommend that the Commission prohibit ULH&P from entering into any agreement
10 with affiliates that would require or permit ULH&P to pay expenses, either directly or
11 indirectly, associated with the operations of its ultimate corporate parent, New Duke.

12 Other Concerns with Proposed Service Company Agreement

13 **Q. Do you have any other concerns with the proposed service company agreement?**

14 A. Yes, I do. It appears to me that the proposed agreement (Attachment BFB-1) does not
15 appropriately consider the combined electric and gas operations of CG&E and ULH&P.
16 For example, costs associated with right of way administration do not have an allocator
17 relating to natural gas mains. Similarly, system planning, operations, and engineering
18 cost allocators make no mention of natural gas facilities.

19 Perhaps most troubling, the agreement is unclear as to how a "customer" will be
20 defined; specifically whether a combined gas/electric customer of ULH&P (or CG&E)
21 would be counted as one customer or two for cost allocation purposes. We requested a
22 clarification on this point during discovery and Mr. Blackwell responded as follows:

1 "Allocation factors used to allocate costs associated with both gas and electric operations
2 will include a combined gas/electric customer as two customers (one for gas and one for
3 electric). Allocation factors used to allocate costs associated with only gas or electric
4 operations will only include the gas or electric customer as one customer." AG 2.6(b).

5 **Q. What does this mean?**

6 A. This means that for customer costs that are common to both gas and electric operations –
7 functions like billing, metering, customer service, call center operations, and so on –
8 ULH&P's customers who receive both gas and electric service will each count as two
9 customers. Frankly, this makes no sense to me. The customer receives just one bill, has
10 one account number, can resolve any issues with just one call to the call center, and so
11 on. The impact on ULH&P and its rates, however, could be dramatic – effectively
12 doubling the amount of customer-related costs that ULH&P is allocated from the service
13 company.

14 **Q. What do you recommend?**

15 A. I recommend that the Commission prohibit ULH&P from entering into any agreement
16 with any affiliate that would count a ULH&P combined electric and gas customer as
17 being more than one customer.

18 Recommended Conditions Concerning Affiliated Transactions

19 **Q. Please summarize the specific conditions that would implement your**
20 **recommendations regarding affiliate transactions?**

21 A. I recommend that the Commission adopt the following conditions:

1 Condition 12. Prohibit any affiliate of ULH&P, other than CG&E, from
2 providing executive management for ULH&P.

3 Condition 13. Require that the chief operating officer for ULH&P have his or
4 her office in the CG&E/ULH&P service area, and must reside in that area.

5 Condition 14. Require an authorized, direct employee of ULH&P (not an
6 employee of the service company) to investigate the cost and availability of
7 comparable services from unaffiliated vendors before ULH&P can request the
8 service from Duke Services.

9 Condition 15. Require this investigation to be made annually for any services
10 purchased from Duke Services.

11 Condition 16. Require ULH&P to maintain a record of each of these
12 investigations for at least five years.

13 Condition 17. Require that any agreement between ULH&P and any affiliate
14 should comply with KRS 278.2207(1)(b) and be "priced at the affiliate's fully
15 distributed cost but in no event greater than market."

16 Condition 18. Prohibit ULH&P from entering into any agreement with Duke
17 Services (or whatever service company is established) that would include
18 return on equity capital as a cost to be recovered by the service company.

19 Condition 19. Prohibit ULH&P from entering into any agreement with
20 affiliates that would require or permit ULH&P to pay expenses, either directly
21 or indirectly, associated with the operations of its ultimate corporate parent,
22 New Duke.

23 Condition 20. Prohibit ULH&P from entering into any agreement with any
24 affiliate that would count a ULH&P combined electric and gas customer as
25 being more than one customer.

26 ## Quantification and Allocation of Synergy Savings

27 **Q. Have you reviewed the Applicants' estimate of the amount of synergy savings that**
28 **they could achieve from the merger, including their proposal to share a portion of**
29 **those savings with ULH&P's customers?**

30 A. Yes, I have reviewed their analysis and proposal, though not in the detail I would have
31 preferred due to time constraints in the schedule of this case. Further, as I am preparing
32 this testimony, I have not seen the synergy study that was presented to Duke's board of
33 directors in May 2005, that I discussed earlier. Thus, I am not able to say how the
34 information filed in this case differs from the information that was prepared internally at

1 Duke and that appears to represent a fundamentally different view of the level and types
2 of savings that can be achieved through this merger.

3 **Q. Please summarize your understanding of the Applicants' estimated synergy savings**
4 **from the merger, as they were filed in this case.**

5 A. The Applicants project that they will achieve gross savings in the regulated and shared
6 services areas (before costs to achieve the savings) totaling $1,330 million during the first
7 five years (Attachment TJF-2). They also project that they will incur $513 million of
8 expenses (not including $183 million in severance and other executive payments that the
9 Applicants will not attempt to recover from customers) to achieve these savings during
10 those five years (Attachment TJF-3). The result is net savings in the regulated and shared
11 services areas of $817 million. From this amount, they then deduct $10 million
12 associated with initiatives that Cinergy already had in progress concerning some of the
13 same areas where savings would occur. Finally, because fuel savings will be passed
14 through automatically to ULH&P customers (Ficke Testimony, p. 16), the Applicants
15 also deduct $40 million in estimated coal savings, leaving net savings of $767 million
16 during the first five years (Attachment AG 2.4-A).

17 **Q. How much of those savings are associated with the Applicants' regulated**
18 **operations?**

19 A. According to the Applicants, approximately $543 million of the non-fuel savings (71%)
20 would be allocated to their regulated operations (Attachment AG 2.4-A).

1 **Q. How much of those net savings do they allocate to ULH&P?**

2 A. ULH&P's share of the net, non-fuel savings is approximately $18.2 million (3.3%)
3 (Attachment AG 2.4-A and Ficke Testimony, p. 16).

4 **Q. How do the Applicants propose to share those $18 million in savings with ULH&P's**
5 **customers?**

6 A. The Applicants propose to provide ULH&P's customers with rate credits totaling $5.4
7 million, or approximately 29.7% of the net, non-fuel savings projected for ULH&P
8 during the first five years after the merger.

9 **Q. Do you agree with the Applicants' quantification and allocation of merger savings?**

10 A. No, I do not. There are several areas where I disagree with the Applicants' analysis.

11 **Q. Let's take this step by step. Do you agree with the Applicants' estimate that there**
12 **will be $1,330 million ($1,290 million excluding fuel) of gross savings in regulated**
13 **and shared services?**

14 A. No, I do not accept this figure. Of the $1,290 million in non-fuel savings, $906 million is
15 allocated by the Applicants to regulated operations (Attachment AG 2.4-A). The
16 Applicants told the public that overall merger savings are allocated approximately 50/50
17 between regulated and unregulated operations (meeting with investment analysts on
18 May 9, 2005). This would imply total company-wide savings of about $1.8 billion before
19 expenses and pre-merger initiatives. Mr. Flaherty indicates there would be gross savings
20 of $2.1 billion (Flaherty Testimony, p. 5), which would imply that regulated operations
21 are being allocated less than 50% of the savings.

22 Further, as I discussed earlier, a synergy savings analysis was presented to Duke's

1 board of directors on May 7, 2005. We have not yet been provided with that analysis.
2 However, from the minutes of the board meeting, it appears that the study found gross,
3 company-wide savings, before costs, of approximately{**begin confidential**
4 **end confidential**}. This implies a level of cost savings that is {**begin confidential**
5 **end confidential**}times higher than the amount used by Applicants in this case. That
6 would imply that regulated and shared services savings would be on the order of {**begin**
7 **confidential** **end confidential**}, not the $1.3 billion used by the Applicants.
8 Therefore, I cannot accept as reasonable the Applicants' filing which shows $1.3 billion
9 of regulated and shared services savings, before costs to achieve and pre-merger
10 initiatives.

11 **Q. Let's go to the next step. Whatever starting point we use, do you agree with the**
12 **magnitude of costs to achieve and pre-merger initiatives that Applicants develop?**
13 A. Yes, I can accept the Applicants' analysis showing costs to achieve of $513 million and
14 pre-merger initiatives of $10 million. I do not agree, however, that all of the costs to
15 achieve are appropriate for recovery from customers. Specifically, I do not believe that
16 Applicants should be allowed to charge the following types of costs to their regulated
17 utility customers:

18 19
- Retention costs: $25 million for keeping certain employees with the companies;

20 21
- Relocation costs: $10 million for moving certain employees between Duke and Cinergy;

22 23
- Regulatory process costs: $37 million for obtaining regulatory approvals of the merger;

24 25 26
- Internal/external communications: $23 million for public relations; shareholder communications, and other communications about the merger; and

1 • Transaction costs: $41 million paid to attorneys and advisors.
2
3 These costs total $136 million out of the $513 million in costs to achieve (about 26.5% of
4 the total), leaving $377 million as costs to achieve that are appropriately considered as an
5 offset to regulated and shared services savings. None of the $136 million in costs I
6 propose to exclude provide a direct benefit to consumers or are otherwise associated with
7 providing service to ULH&P's customers. I recommend, therefore, that none of the costs
8 I listed above should be included as offsets to the synergy savings.

9 **Q. Aside from the overall magnitude of the costs to achieve, do you have any other**
10 **concerns with the Applicants' analysis?**
11 A. Yes, I do. With the exception of information technology expenditures, the Applicants'
12 analysis assumes that all costs to achieve will be expensed, rather than capitalized. In
13 fact, though, Duke commissioned Ernst & Young to prepare, among other things, an
14 analysis of which costs to achieve would be expensed and which would be capitalized.
15 On April 15, 2005, Ernst & Young presented that analysis to Duke (it is contained in the
16 confidential documents that are part of Duke's Hart Scott Rodino filing, identified as
17 document 4(c)-P3). That analysis estimated that approximately 75% of costs to achieve
18 in the first year would be capitalized. The figure drops to 65% when change in control
19 costs are excluded (as the Applicants have done for purposes of their proposal in this
20 case).
21 Similarly, in the Applicants' public presentation to investment analysts on May 9,
22 2005, they showed that 60% of all costs to achieve would be capitalized (page 12 of the
23 presentation).

1 **Q. What did the Applicants assume in the analysis they presented in this case?**

2 A. We specifically asked the Applicants if they used the results of Ernst & Young's analysis,
3 or if they received any other guidance about capitalized expenditures in preparing their
4 analysis. Their response was that "Mr. Flaherty made no accounting related assumptions
5 around capitalization of costs to achieve. The costs to achieve simply represent amounts
6 to be expended in order to obtain the merger synergies." AG 2.11(b).

7 Thus, with the exception of information technology costs (which were divided
8 between expense and capital based on the nature of the project, AG 2.11(a)), all of the
9 costs to achieve were expensed, even though the Applicants had accounting advice
10 showing that at least 60% of those costs should be capitalized.

11 **Q. Is that the same way the Applicants determined the savings?**

12 A. No, it is not. For each element of savings, Mr. Flaherty's workpapers show the
13 development of a specific capitalization factor. For example, he shows that for New
14 Duke 53.9% of contract services savings, 66.9% of purchasing savings, and 88.8% of
15 inventory savings will be capitalized (Attachment CS 1.17-A, p. 10). For capitalized
16 savings, other than information technology, he uses a 13% revenue requirement rate.
17 That is, for each $100 in savings that are capitalized, he uses $13 as the actual savings in
18 annual revenue requirement.

19 In other words, the Applicants have capitalized a substantial share of the savings,
20 but they have not capitalized the costs to achieve those savings. This is a serious
21 mismatch that results in an over-estimation of the costs to achieve.

1 **Q. What is the magnitude of this problem?**

2 A. Let's start with the Applicants' estimate of $513 million of costs to achieve. Of that
3 amount, $225 million is information technology costs which already reflect a split
4 between expense and capital (Attachment CS 1.17-A, p. 246). That leaves $288 million
5 that should be divided between expense and capital but has not been. If we assume that
6 60% of that amount should be capitalized, that would mean $173 million should be
7 capitalized. Applying a 13% fixed charge rate for five years would mean that
8 approximately $113 million should be included as costs to achieve through five years, a
9 reduction of $60 million. Thus, the absolute maximum that should be included in costs to
10 achieve would be $453 million, not the $513 million used by the Applicants.

11 **Q. How does this relate to your earlier adjustment which reduced allowable costs to**
12 **achieve to $377 million?**

13 A. My adjustment did not affect information technology costs, so that would leave $152
14 million ($377 million allowable costs, of which $225 million is for information
15 technology) in other costs. Using the same methodology I just discussed would result in
16 $99 million being included in revenue requirement during the first five years, instead of
17 the full $152 million. The net effect of both adjustments, then, is an allowable level of
18 costs to achieve of $324 million ($225 million for information technology, plus $99
19 million for other costs).

20 **Q. Do you agree with Applicants that approximately 71% of the regulated and shared**
21 **services net savings should be allocated to the regulated utility companies?**

22 A. I do not have enough information to either agree or disagree with the Applicants'
23 allocation. We asked for the workpapers Mr. Blackwell used, both on paper (AG 1.2)

1 and in electronic form "with all formulas, references, and links intact" (AG 2.1). I have
2 reviewed those workpapers in some detail and I cannot find where those allocations are
3 developed. The electronic workpapers take as their starting point a certain amount of
4 costs that have been allocated to a particular company, but they do not show how that
5 allocation was developed. For purposes of this case, however, I am willing to accept the
6 Applicants' allocation of 71% of regulated and shared services net savings to the
7 regulated utilities.

8 **Q. The next step in the Applicants' analysis is to allocate the regulated net savings**
9 **among the operating utilities, including ULH&P. Do you agree with this process**
10 **that resulted in ULH&P being allocated 3.3% of the regulated savings?**
11 A. Once again, I do not have enough information to either agree or disagree with the
12 Applicants' allocation. We asked for the workpapers Mr. Blackwell used, both on paper
13 (AG 1.2) and in electronic form "with all formulas, references, and links intact" (AG
14 2.1). The workpapers that were provided do not show the basis for developing that
15 allocation. For purposes of this case, however, I am willing to accept the Applicants'
16 allocation of 3.3% of regulated utility net savings to ULH&P.

17 **Q. The final step in the Applicants' analysis is to allocate ULH&P's savings between**
18 **the utility and its customers. Do you agree with the Applicants that customers**
19 **should receive approximately 29.7% of ULH&P's net savings?**
20 A. No, I do not. Providing customers with less than one-third of the net savings does not in
21 any way represent a fair sharing of the savings that should result from the merger. The
22 Applicants make it sound as if they are the only ones facing any risk as a result of this
23 transaction. In fact, though, ULH&P's customers also face substantial risks to the

1 quality, safety, and reliability of the service they receive. The Applicants anticipate
2 making reductions in, for example, customer service personnel (reducing the work force
3 by 12%), electric transmission (7%), electric distribution (3%), and other areas that have
4 a direct bearing on the safety, reliability, and quality of service that customers receive
5 (Attachment CS 1.17-A, p. 29, and following pages).
6 This means that customers are being asked to bear substantial risks as a result of
7 this merger. Customers, in essence, are being asked to trust that New Duke will make the
8 right decisions about where and how it can reduce its work force, operating and
9 maintenance expenses, and capital expenditures. Given this level of risk, I do not
10 consider less than 30% of the net savings to be a reasonable share of savings for
11 customers.

12 Q. **In your opinion, what level of sharing would be reasonable?**
13 A. In my opinion, the appropriate level of sharing should be between 50% and 100% of the
14 Applicants' projected net savings. The Commission should decide where in that range
15 the savings should fall based on the Commission's perception of the robustness of the
16 Applicants' projections, including the Applicants' candor in providing relevant
17 information to the parties.

18 Q. **What is the overall effect of your recommendation on the level of synergy savings**
19 **for ULH&P?**
20 A. I have prepared Schedule SJR-1 to show the range of the level of savings that should be
21 used to reduce the rates of ULH&P's customers. Table 1 begins with the gross savings,
22 as filed by the Applicants in this case. Table 2 begins with my best guess of what the

1 "secret" synergies study prepared for Duke's Board contains and, therefore, that table is
2 Confidential.

3 **Q. Please explain Table 1.**

4 A. Table 1 begins with the Applicants' estimate of gross savings allocable to regulated and
5 shared services, excluding fuel cost savings, of $1,290 million. From this amount, I
6 subtract the level of costs to achieve that I recommend the Applicants should be allowed
7 to recover from utility customers, which is $324 million. (I show the detailed
8 development of this amount in Note 1 on the schedule.) I also subtract $10 million to
9 reflect the Applicants' estimate of the benefit from pre-merger initiatives at Cinergy.
10 Thus, the net savings allocable to regulated and shared services would be $956 million.

11 I then allocate 71% of this amount to the regulated utilities (this is the same
12 percentage that the Applicants allocated to the utilities). This results in $678.8 million in
13 savings for the utilities. ULH&P's share of these savings is 3.3% (again, the same figure
14 the Applicants use), resulting in net savings to ULH&P of $22.4 million over five years.
15 Finally, in the last column, I show the range of 50% to 100% of these savings, which is
16 the amount that should be used to reduce the rates of ULH&P's customers. This range is
17 $11.2 million to $22.4 million.

18 **Q. Does Table 2 follow the same format?**

19 A. Yes, it does. The methodology used in this table is identical to Table 1. The only
20 difference is the starting point -- which is my estimate of total regulated and shared
21 services savings of {**begin confidential** **end confidential**} that I developed
22 earlier. The result of this calculation would be to reduce the bills of ULH&P's customers
23 by a range of {**begin confidential** **end confidential**}.

1 **Q. Based on your review of these various approaches, what do you recommend?**

2 A. Based on my review of these options, I recommend that the Commission reflect synergy
3 savings for ULH&P's customers equal to at least $22.4 million. This is the amount of
4 synergy savings that would result from the Applicants' filing if costs to achieve are
5 adjusted as I recommend. In my opinion, it also represents a reasonable recognition of
6 the likely impact of the "secret" synergies study that Duke has not provided.

7 **Q. How do you propose to provide this benefit to ULH&P's customers?**

8 A. I propose to reflect this benefit as a credit on customers' bills beginning 12 months after
9 the merger closes. This will enable the Applicants to begin the process of integrating
10 their operations. Since they estimate that a majority of the costs to achieve will be
11 incurred in the first year, this will provide them with some time before rate credits must
12 begin.

13 Beginning 12 months after the merger closes, therefore, I would recommend that
14 ULH&P be required to reflect credits on its customers' bills totaling $5.6 million on an
15 annual basis. Using ULH&P's allocation between gas and electric, which has 13.58% of
16 the credit going to gas customers, this would result in annual credits to electric customers
17 of $4,839,500 and credits to gas customers of $760,500 per year. These credits would
18 remain in effect for a minimum of four years, regardless of whether ULH&P files a base
19 rate case during that period. That is, these credits would be guaranteed and would be
20 applied after whatever decision the Commission might make in future rate proceedings.

21 I also recommend that the credits should not expire automatically at the end of
22 this four-year period (five years after the merger closes), but should continue until the

1 next base rate case decision rendered after that date. The merger savings will not stop in
2 five years and neither should the rate recognition of those savings.

3 **Q. How would your proposal affect ULH&P's proposed amortization of the costs to**
4 **achieve?**

5 A. I would permit ULH&P to amortize the costs to achieve the merger over a five-year
6 period, with one important condition. If ULH&P files base rate cases during that five-
7 year period, it should not be permitted to include the unamortized amount in rate base.
8 Rather, the amortization of the costs to achieve will occur outside of a rate case, just as
9 the rate credits are being provided to customers outside of the rate case process. Under
10 no circumstances should ULH&P be allowed to include any of the costs to achieve in rate
11 base or otherwise recover them from customers after the five-year period expires.

12 **Q. What is the effect of your synergy savings proposal?**

13 A. The effect of my proposal is to make it the Applicants' responsibility to achieve the
14 savings they project they can achieve. Customers will receive a fair portion of those
15 savings, automatically through rate reductions based on the Applicants' projections. If the
16 Applicants produce more savings than they project, or have lower costs to achieve, then
17 they can retain the benefit. If they fail to live up to their projections, then the Applicants
18 – not ULH&P's customers – will bear the additional costs.

19 **Q. What should happen if shareholders do not approve the merger, or if the merger**
20 **fails to close for any other reason?**

21 A. If the merger does not close, then no rate credits would be issued. If that occurs,
22 however, the Commission also would need to ensure that none of the costs associated

1 with the failed transaction would be borne by ULH&P's customers. I recommend,
2 therefore, that the Commission adopt one further condition to reflect this; specifically:

3 Condition 21. If the merger does not close, prohibit ULH&P from including
4 in its regulated cost of service, in any fashion, any costs associated with any
5 aspect of the failed transaction.
6

7 Summary of Alternate Recommendations

8 **Q. Please summarize your alternate recommendations to the Commission.**

9 A. If the Commission rejects my primary recommendation (which is to deny the
10 Application), then I recommend that the Commission adopt 21 specific conditions.
11 Those conditions are designed to protect ULH&P and its customers from some of the
12 potentially serious, negative impacts of the merger. I also recommend that the
13 Commission adopt a mechanism, consistent with its legal authority, to automatically
14 enforce these conditions. That is, any violation of a condition should result in an
15 automatic penalty. In addition, I recommend that the Commission require ULH&P to
16 provide credits to customers totaling $22.4 million over five years.

17 Conclusion

18 **Q. Please summarize your conclusions and recommendations.**

19 A. My primary recommendation is that the Commission should deny the Joint Application
20 because Duke's lack of candor demonstrates that it does not have the requisite fitness to
21 own and operate a public utility in Kentucky. If the Commission rejects that
22 recommendation, then it needs to protect ULH&P and its customers, while also ensuring
23 that Kentucky receives its fair share of the benefits that the Applicants allege will result

1 from the merger. In either event, the Commission needs to ensure that if the merger does
2 not occur, ULH&P's customers will bear none of the costs associated with the failed
3 transaction.

4 **Q. Does your testimony reflect all issues that the Office of the Attorney General will**
5 **raise in this case?**

6 A. I have been advised by counsel that the Office of the Attorney General may raise issues
7 in its briefs or other pleadings that are not addressed in my testimony.

8 **Q. Does this conclude your direct testimony?**

9 A. Yes, it does, unless I am permitted to supplement my testimony if Duke's "secret"
10 synergies study and workpapers become available.

REDACTED

Synergy Savings (Excluding Fuel) to Customers of ULH&P
(x $1,000,000)

Table 1: Gross Savings as Filed by Joint Applicants

Category	Regulated & Shared Svcs	Regulated	ULH&P	Range of 50-100%
Gross Savings	1,290			
Costs to Achieve (1)	(324)			
Net Savings Subtotal	966			
Pre-Merger Initiatives	(10)			
Total Net Savings	956	678.8	22.4	11.2 to 22.4

Table 2: Gross Savings Estimated for "Secret" Synergies Study to Duke's Board

Category	Regulated & Shared Svcs	Regulated	ULH&P	Range of 50-100%
Gross Savings	[redacted]			
Costs to Achieve (1)	(324)			
Net Savings Subtotal	[redacted]			
Pre-Merger Initiatives	(10)			
Total Net Savings	[redacted]	[redacted]	[redacted]	[redacted]

Numbers that are white on black background are CONFIDENTIAL

Note:
(1) Adjusted costs to achieve allocated to regulated and shared services (x $1,000,000):

1.	As filed by Applicants	513	
	Adjustments		
2.	Employee retention costs	(25)	
3.	Employee relocation costs	(10)	
4.	Regulatory process costs	(37)	
5.	Communications costs	(23)	
6.	Transaction costs	(41)	
7.	Total adjustments	(136)	(sum lines 2-6)
8.	Recoverable costs to achieve	377	(line 1 - line 7)
9.	Less information tech. costs	(225)	(already reflects capital)
10.	Costs to be divided between expense and capital	152	(line 8 - line 9)
11.	Annual capitalization factor	0	
12.	Number of years	5	
13.	Capital recovery over 5 years	99	(product lines 10-12)
14.	Allowable costs to achieve	324	(-line 9 + line 13)

Commonwealth of Kentucky
Before the Public Service Commission

In the Matter of: Joint Application of Duke Energy Corporation, Duke Energy Holding Corp., Deer Acquisition Corp., Cougar Acquisition Corp., Cinergy Corp., the Cincinnati Gas & Electric Company, and the Union Light, Heat and Power Company for Approval of a Transfer and Acquisition of Control	)))))))	Case No. 2005-00228

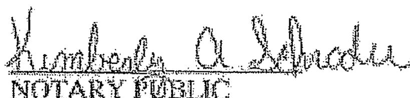
AFFIDAVIT OF SCOTT J. RUBIN

Commonwealth of Pennsylvania	)
	)
County of Snyder	)

Scott J. Rubin, being first duly sworn, states the following: The prepared Pre-filed Direct Testimony and the attached schedule constitute the direct testimony of Affiant in the above-styled case. Affiant states that he would give the answers set forth in the Pre-filed Direct Testimony if asked the questions propounded therein. Affiant further states that, to the best of his belief and knowledge, his statements made are true and correct. Further, Affiant saith not.

Scott J. Rubin

SUBSCRIBED AND SWORN to before me this 28th day of September, 2005.



NOTARY PUBLIC

My Commission Expires: Jan. 4, 2009