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**VIA OVERNIGHT MAIL**

February 28, 2008

Ms. Elizabeth O'Donnell  
Executive Director  
Kentucky Public Service Commission  
211 Sower Boulevard  
P.O. Box 615  
Frankfort, Kentucky 40602-0615

**RECEIVED**

FEB 29 2008

**PUBLIC SERVICE  
COMMISSION**

Re: Case No. 2007-477

Dear Ms. O'Donnell:

Enclosed please find an original and 12 copies of the Direct Testimony of Paul G. Smith and the Direct Testimony of Theodore E. Schultz on behalf of DE-Kentucky in the above captioned case.

Please date stamp and return the two extra copies of each testimony in the enclosed, self-addressed envelope.

If you have any questions, please do not hesitate to contact me at (513) 419-1847.

Sincerely,

Anita M. Schafer  
Senior Paralegal

cc: Parties of Record

**CERTIFICATE OF SERVICE**

I certify that a copy of the attached testimony of Paul G. Smith and Theodore E. Schultz, on behalf of Duke Energy Kentucky, Inc. has been served by UPS overnight mail to the following parties on this 28<sup>th</sup> day of February, 2008:

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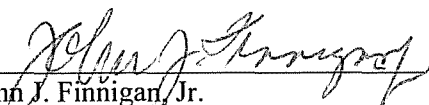
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COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

RECEIVED

FEB 29 2008

PUBLIC SERVICE  
COMMISSION

In the Matter of:

AN INVESTIGATION OF THE )  
ENERGY AND REGULATORY ISSUES )  
IN SECTION 50 OF KENTUCKY'S 2007 )  
ENERGY ACT )

CASE NO. 2007-00477

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DIRECT TESTIMONY OF

PAUL G. SMITH

ON BEHALF OF

DUKE ENERGY KENTUCKY, INC.

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February 29, 2008

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**I. INTRODUCTION AND PURPOSE**

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

2 A. My name is Paul G. Smith and my business address is 139 East Fourth Street, Cincinnati,  
3 Ohio 45202.

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

5 A. I am employed by the Duke Energy Corporation (“Duke Energy”) affiliated companies as  
6 Vice President, Rates – Ohio and Kentucky.

7 **Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL**  
8 **QUALIFICATIONS.**

9 A. I received a Bachelor of Science in Industrial Management Degree from Purdue  
10 University and a Master of Business Administration Degree, with Honors, from the  
11 University of Chicago Graduate School of Business. I am a Certified Public Accountant  
12 (“CPA”) in the State of Ohio and a member of the American Institute of Certified Public  
13 Accountants. I am also a member of the Edison Electric Institute’s Economic Regulation  
14 and Competition Committee, and Budgeting and Financial Forecasting Committee.

15 **Q. PLEASE SUMMARIZE YOUR WORK EXPERIENCE.**

16 A. Upon graduation from Purdue University in 1982, I was employed by the CPA firm of  
17 Touche, Ross & Co. as a member of the audit staff in their Chicago office. From 1984 to  
18 1987, I was employed by the CPA firm of Crowe, Chizek & Co. as a member of the  
19 commercial audit and tax staff in their Indianapolis office. Since 1987, I have held  
20 various positions with PSI Energy, Inc., Cinergy Services, Inc., and Duke Energy Shared  
21 Services, Inc., including responsibilities in Rates and Regulation, Budgets and Forecasts,  
22 Investor Relations, and Corporate Development as well as the International Business

1 Unit. From March 1998 to July 1999, I was Distribution Price Control Program Manager  
2 at Midlands Electricity, the regional electric company in the United Kingdom of which  
3 Cinergy Corp. ("Cinergy") previously held a 50% equity ownership. From March 2005  
4 to March 2006, I did strategic planning and project management work. I was appointed  
5 to my current position as Vice President, Rates in April 2006.

6 **Q. PLEASE DESCRIBE YOUR DUTIES AS VICE PRESIDENT, RATES.**

7 A. As Vice President, Rates, I am responsible for the regulatory accounting and filings, cost  
8 of service and rate design for Duke Energy Ohio, Inc. ("DE-Ohio"), formerly known as  
9 The Cincinnati Gas & Electric Company ("CG&E"), and Duke Energy Kentucky, Inc.,  
10 ("DE-Kentucky") formerly known as The Union Light, Heat and Power Company  
11 ("ULH&P").

12 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE KENTUCKY PUBLIC**  
13 **SERVICE COMMISSION?**

14 A. Yes. I have testified before the Kentucky Public Service Commission ("Commission") on  
15 several occasions on behalf of DE-Kentucky. Most recently, I provided testimony in DE-  
16 Kentucky's electric rate case, Case No. 2006-00172.

17 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

18 A. The purpose of my testimony is to discuss DE-Kentucky's position regarding: (1)  
19 modifying rate structures and cost recovery to better align the financial interests of the  
20 utility with the goals of achieving energy efficiency and lowest life-cycle energy costs to  
21 all classes of customers; and (2) eliminating impediments to the consideration and  
22 adoption by utilities of cost-effective demand-management strategies for addressing  
23 future demand prior to Commission consideration of any proposal for increasing

1 generating capacity. These are two of the four issues raised by Section 50 of Kentucky's  
2 2007 Energy Act, which the Commission asked Parties to address.<sup>1</sup>

3 **II. DISCUSSION**

4 **Q. PLEASE EXPLAIN DE-KENTUCKY'S RECOMMENDATION REGARDING**  
5 **MODIFYING RATE STRUCTURES AND COST RECOVERY TO BETTER**  
6 **ALIGN THE FINANCIAL INTERESTS OF THE UTILITY WITH THE GOALS**  
7 **OF ACHIEVING ENERGY EFFICIENCY.**

8 A: First, DE-Kentucky recommends that the Commission should be able to implement  
9 alternative regulatory ratemaking authority. DE-Kentucky also recommends that the  
10 Commission clarify its existing ratemaking approval authority, specifically with respect  
11 to general tracker approval, which is useful in implementing regulatory initiatives,  
12 outside of a comprehensive rate case filing. DE-Kentucky also recommends a change to  
13 the current Fuel Adjustment Clause ("FAC") regulation regarding cost recovery for  
14 planned versus forced outages to allow opportunities for utilities to take advantage of  
15 renewable resources.

16 **Q. PLEASE EXPLAIN DE-KENTUCKY'S RECOMMENDATION REGARDING**  
17 **ALTERNATIVE REGULATORY AUTHORITY.**

18 A. It is well recognized that the Commission, as a creature of statute, is limited in its  
19 authority to that provided by the General Assembly as set forth in the Kentucky Revised  
20 Statutes. Many State Utility Commissions, such as those in Ohio and Indiana, have broad  
21 statutory authority and the flexibility to consider innovative utility programs and service  
22 offerings for customers through alternative regulatory authority. DE-Kentucky believes

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<sup>1</sup> DE-Kentucky participates in the Testimony of Witness Lonnie E. Bellar filed by the Joint Parties for the remaining two issues.

1 that this Commission should have additional regulatory flexibility to consider, adopt and  
2 approve alternative regulatory mechanisms and procedures that are in the public interest.  
3 Indiana Statutes, Title 8, Article 1, Chapter 2.5, provide an excellent regulatory model for  
4 “alternative” regulatory authority recognizing that “traditional commission regulatory  
5 policies and practices, and certain existing statutes are not adequately designed to deal  
6 with an increasingly competitive environment for energy services and that alternatives to  
7 traditional regulatory policies and practices may be less costly.”<sup>2</sup>

8 DE-Kentucky believes that the additional flexibility of alternative regulatory  
9 authority would be beneficial to all stakeholders and in the best interests of customers,  
10 utilities, and the public, to ensure continued availability of safe, adequate, efficient, and  
11 economical energy service. This alternative regulatory authority should also explicitly  
12 vest the Commission with general regulatory tracker approval authority.

13 **Q. PLEASE EXPLAIN DE-KENTUCKY’S SUGGESTION THAT THE**  
14 **COMMISSION SHOULD HAVE GENERAL TRACKER APPROVAL**  
15 **AUTHORITY.**

16 A. DE-Kentucky believes that the Commission should recommend to the General Assembly  
17 that the Commission be vested with the authority to review and approve alternative  
18 modes of regulatory ratemaking and cost recovery for utilities, including a general tracker  
19 approval authority. This general tracker approval authority would be useful for  
20 implementing innovative initiatives including reliability investments, energy efficiency,  
21 and economic development. While DE-Kentucky believes that the Commission currently  
22 has the ability to approve tracking mechanisms in the context of a general rate case, and  
23 has argued as such, not all stakeholders agree. The Commission should recommend to

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<sup>2</sup> Burns Ind. Code Ann. § 8-1-2.5-1



1 the General Assembly that any ambiguity in statutory powers of the Commission be  
2 clarified such that it is clear that the Commission has broad regulatory and ratemaking  
3 authority so the Commission may continue to approve such programs and tracking and  
4 cost recovery mechanisms to the benefit of utilities and all customers.

5 **Q. PLEASE EXPLAIN HOW SUCH AUTHORITY IS BENEFICIAL TO ALL**  
6 **STAKEHOLDERS.**

7 A. The ability to approve, and for utilities to implement, discrete cost recovery and tracking  
8 mechanisms is beneficial to all stakeholders and ultimately reduces costs and customer  
9 rate shock. Tracking mechanisms permit a utility to recover specific costs in a timely  
10 fashion. These mechanisms provide revenue certainty and security for utilities and  
11 encourage the investment in reliability. Riders are beneficial to customers as well. They  
12 lessen the frequency of general base rate cases, and due to the timely recovery of costs,  
13 would likely lessen the revenue requirement adjustment when a utility does file a base  
14 rate case. Base rate cases are expensive both for the utility to develop and for customers  
15 once those costs are folded into the final approved rate adjustment. Spreading the  
16 adjustments out over time through a cost recovery or tracking mechanism is consistent  
17 with the principle of gradualism lessening the rate shock to customers, an unfortunate  
18 consequence of any rate adjustment. The riders are generally symmetrical, such that if the  
19 costs covered by the tracking mechanism directly produce any expense reductions, these  
20 savings are also passed along to customers through the tracking mechanism. Moreover,  
21 the riders lessen the need to seek deferrals for such investments.

22 By allowing utilities to implement rate recovery trackers or riders, utilities may  
23 seek annual adjustments to account for increased costs, subject to Commission review.

1 The recovery permitted under the riders would then be folded into the base rate structure  
2 and reset when the utility does file its base rate case.

3 Due to the difference in opinions about the extent of the Commission's existing  
4 regulatory authority to consider and approve discrete recovery mechanisms, the  
5 Commission should recommend to the General Assembly that it make this authority  
6 abundantly clear.

7 **Q. PLEASE PROVIDE A PRACTICAL EXAMPLE OF HOW A GENERAL RIDER**  
8 **APPROVAL AUTHORITY WOULD BE BENEFICIAL.**

9 A. One example of such an initiative is DE-Kentucky's Accelerated Main Replacement  
10 Program ("Rider AMRP"), currently facing appeal. As this Commission is aware, Rider  
11 AMRP was approved in DE-Kentucky's 2001 and 2005 general rate cases, and  
12 established a tracking formula as part of DE-Kentucky's filed schedule of rates. As  
13 approved, Rider AMRP is adjusted annually and used to calculate a surcharge on  
14 customers' bills to allow DE-Kentucky to recover its investment and costs to replace its  
15 aging gas distribution system in a timely and cost effective manner. Rider AMRP allows  
16 DE-Kentucky to invest in its distribution system thereby increasing reliability for  
17 customers, and spreading cost increases out over time, rather than through a one-time  
18 significant cost increase during a rate case, which may include carrying costs, or through  
19 multiple consecutive and expensive rate cases over time. The rider affords the utility  
20 timely recovery of costs while reducing the rate shock to customers, which would occur  
21 if the entirety of the distribution system replacement were included in a single rate case  
22 or multiple consecutive rate cases. The main replacement program reduces the  
23 Company's maintenance expense and these savings are passed along to customers

1 through the tracking mechanism.

2 The approval of Rider AMRP as a cost tracking and recover mechanism was the  
3 subject of an appeal filed by the Attorney General, who disputed the Commission's  
4 statutory authority to approve this sort of mechanism.<sup>3</sup> Under this restrictive  
5 interpretation of Kentucky's regulatory model, utilities are limited in their ability to  
6 receive timely cost recovery of reliability investments. Without this annual surcharge  
7 mechanism, DE-Kentucky's alternative would be to recover these costs through filing  
8 multiple general rate cases over the ten-year span of the AMRP. A general rate case is a  
9 time-consuming and expensive undertaking, which entails a comprehensive review of all  
10 aspects of a utility's finances. The costs of conducting these general rate cases will be  
11 passed on to DE-Kentucky's customers, resulting in higher utility bills. Moreover, such a  
12 process is an inefficient use of resources for the utility, other stakeholders and this  
13 Commission.

14 **Q. PLEASE PROVIDE A PRACTICAL EXAMPLE OF HOW ALTERNATIVE**  
15 **REGULATORY APPROVAL AUTHORITY IS BENEFICIAL?**

16 A. Another example of how alternative regulatory authority could be beneficial would be in  
17 the interest of economic development. Under the current regulatory model, it has now  
18 become uncertain whether the Commission has the ability to approve service offerings  
19 beyond more traditional rate classifications. One such example is the ability to approve  
20 classifications based upon economic development needs. In 2004, the Commission  
21 approved such an economic development incentive via a tariffed service offering  
22 designed to help entice new customers to locate in the commonwealth and in particular,

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<sup>3</sup> *Commonwealth of Kentucky v. Kentucky Public Service Commission et al.*, Civil Action No. 06-CI-269, (Aug. 1, 2007)(Opinion and Order).

1 DE-Kentucky's service territory. Such incentives, not only add new customers to the  
2 utility's service territory thereby spreading the utility's cost of service to more entities,  
3 they add tax base to the communities, and fuel the creation of jobs.

4 Like the Rider AMRP example I discussed above, the Commission's authority to  
5 approve economic development incentives to a class of new customers was challenged.  
6 The Franklin Circuit Court upheld the Commission's approval of the economic  
7 development rates in Case Number 05-CI-00648. However, on February 1, 2008, the  
8 Kentucky Court of Appeals reversed the Franklin Circuit Court and found the  
9 Commission's approval of economic development rates to be unlawful, leaving the  
10 Commission's ability to approve these types of service offerings in question.<sup>4</sup>

11 Alternative regulatory programs such as DE-Kentucky's Rider AMRP and  
12 economic development service offerings are in the public interest in that they are  
13 beneficial to customers, the utility, and the Commonwealth. The Commission should  
14 recommend that the General Assembly adopt an alternative regulatory model similar to  
15 that in the neighboring state of Indiana so that public interest may be better served  
16 through innovative service offerings, which current regulatory authority may not permit.

17 **Q. PLEASE EXPLAIN DE-KENTUCKY'S RECOMMENDATION FOR COST**  
18 **RECOVERY FOR PLANNED VERSUS FORCED OUTAGES.**

19 A. DE-Kentucky believes that the existing distinction in FAC regulation, which disallows  
20 cost recovery for forced outages should be eliminated. An unintended consequence of  
21 this distinction is that the purchase of renewable resources is discouraged because  
22 currently those resources tend to incur a higher rate of forced outages, the replacement

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<sup>4</sup> *Commonwealth of Kentucky v. The Public Service Commission of Kentucky et al.*, Case No. 2006-CA-001652, (Opinion)(February 1, 2008).

1 power for which is not recoverable. This effectively prevents utilities from considering  
2 the impact on the carbon footprint and availability of renewable resources in purchasing  
3 capacity and energy on the market. Therefore, this barrier should be removed entirely, or  
4 at least be reevaluated such that a utility is not penalized if it chooses to purchase a  
5 renewable resource that may experience a higher rate of unplanned or forced outages.

6 **Q. PLEASE EXPLAIN DE-KENTUCKY'S RECOMMENDATIONS FOR**  
7 **ELIMINATING IMPEDIMENTS TO THE CONSIDERATION AND ADOPTION**  
8 **BY UTILITIES OF COST-EFFECTIVE DEMAND-MANAGEMENT**  
9 **STRATEGIES FOR ADDRESSING FUTURE DEMAND PRIOR TO**  
10 **COMMISSION CONSIDERATION OF ANY PROPOSAL FOR INCREASING**  
11 **GENERATING CAPACITY.**

12 A. DE-Kentucky recommends that the General Assembly reevaluate and restructure the  
13 appellate process for Commission Orders, bypassing the Franklin Court of Appeals, to  
14 provide a quicker resolution of regulatory disputes on appeal.

15 **Q. PLEASE DESCRIBE DE-KENTUCKY'S RECOMMENDATION TO IMPROVE**  
16 **THE CURRENT APPELLATE PROCESS FOR THE COMMONWEALTH OF**  
17 **KENTUCKY.**

18 A. DE-Kentucky believes that all stakeholders would benefit from a restructuring of the  
19 appellate process and that that the Commission should consider making such a  
20 recommendation in its report to the General Assembly. Under the current model, appeals  
21 from Commission Orders, start anew in the Franklin County Circuit Court, and must  
22 progress through the entire appellate system before a final decision is reached at the  
23 Kentucky Supreme Court level. DE-Kentucky believes that appeals of Commission

1 Orders should bypass the first stage at the Franklin County Circuit Court and become a  
2 direct appeal to the Appellate Court. This proposed restructuring would be beneficial to  
3 all stakeholders, including the Commonwealth in that it would ultimately reduce the time  
4 and expense incurred to achieve finality to Commission decisions. Further, there would  
5 be a greater regulatory certainty for stakeholders because it would lessen the possibility  
6 for conflicting decisions by eliminating one level of the current appellate process. The  
7 restructuring would also serve to reduce the burden placed upon the already overextended  
8 resources of the Circuit Court.

9 **III. CONCLUSION**

10 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY IN THIS**  
11 **PROCEEDING?**

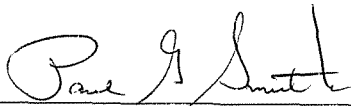
12 **A. Yes.**

13

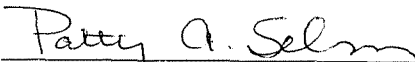
**VERIFICATION**

State of Ohio            )  
                                  )        SS:  
County of Hamilton    )

The undersigned, Paul G. Smith, being duly sworn, deposes and says that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his knowledge, information and belief.

  
\_\_\_\_\_  
Paul G. Smith, Affiant

Subscribed and sworn to before me by Paul G. Smith on this 19 day of February, 2008.

  
\_\_\_\_\_  
NOTARY PUBLIC

My Commission Expires: 9-15-2009

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

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FEB 29 2008  
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In the Matter of: )  
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DIRECT TESTIMONY OF  
THEODORE E. SCHULTZ  
ON BEHALF OF DUKE ENERGY KENTUCKY, INC.

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February 29, 2008



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1 **I. INTRODUCTION AND PURPOSE**

2 **Q. PLEASE STATE YOUR NAME AND ADDRESS,**

3 A. My name is Theodore E. Schultz, and my business address is 526 South Church Street,  
4 Charlotte, North Carolina.

5 **Q. PLEASE STATE YOUR JOB POSITION AND DUTIES.**

6 A. I am Vice President – Energy Efficiency for Duke Energy Corporation (“Duke Energy”)  
7 the ultimate parent company of Duke Energy Kentucky, Inc. (“DE-Kentucky” or the  
8 “Company”). I am responsible for leading energy efficiency initiatives across all retail  
9 markets served by Duke Energy, including DE-Kentucky’s service territory. I am also  
10 responsible for Duke Energy’s customer strategy and the development and  
11 implementation of new products and services for the retail market.

12 **Q. PLEASE SUMMARIZE YOUR EDUCATION.**

13 A. I graduated from Syracuse University in 1987 with a Master’s Degree in Business  
14 Administration. I also earned a Bachelor of Science Degree in Business Administration  
15 from Albany University in Albany, New York.

16 **Q. PLEASE DESCRIBE YOUR BUSINESS BACKGROUND AND EXPERIENCE.**

17 A. Prior to joining Duke Energy, I worked for Energy East (New York State Electric and  
18 Gas) from 1983 to 1997. While at Energy East, I was promoted to various positions of  
19 increasing responsibility in the areas of planning and information technology, and was  
20 director of information technology when I left to join Duke Energy. I joined Duke  
21 Energy in 1997 as manager of strategic business  
22 development and became a director in our eBusiness area in 1999. In 2002, I joined  
23 Duke Power’s customer sales, service and marketing group becoming Vice President –

**THEODORE E. SCHULTZ DIRECT**

1 Marketing in 2003 and Vice President – Large Business Customers in 2004. Following  
2 the merger with Cinergy Corp. in 2006, I was named Vice President – Customer Strategy  
3 and Planning before being named to my current position in October 2006.

4 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

5 A. The purpose of my testimony is to discuss DE-Kentucky’s position regarding Section 50  
6 of Kentucky’s 2007 Energy Act (“Section 50”), which the Kentucky Public Service  
7 Commission (“Commission”) has asked Parties to address. To the extent DE-Kentucky  
8 agrees with other Kentucky utilities on some of the issues raised by Section 50, the  
9 Company has joined in the filing of the Joint Testimony of Witness Lonnie E. Bellar.  
10 However, through my testimony, I discuss DE-Kentucky’s position with respect to  
11 “modifying rate structures and cost recovery to better align the financial interests of the  
12 utility with the goals of achieving energy efficiency and lowest life-cycle energy costs to  
13 all classes of rate payers.” In my testimony I: (1) discuss current challenges with  
14 achieving and implementing energy efficiency and the need for a new regulatory model;  
15 (2) recommend changes to the current regulatory model for demand side management in  
16 Kentucky; and (3) I describe key characteristics of an improved regulatory approach to  
17 energy efficiency.

18 **II. CHALLENGES UNDER CURRENT REGULATORY MODELS**

19 **Q. WHAT ARE THE CHALLENGES FACING ENERGY EFFICIENCY**  
20 **PROGRAMS UNDER CURRENT REGULATORY MODELS?**

21 A. While the existing regulatory models present a solid foundation for energy efficiency  
22 offerings, there are many challenges to implementing cost-effective energy efficiency  
23 programs, and achieving widespread customer participation.

THEODORE E. SCHULTZ DIRECT

1           First, most customers do not have the data, time or desire to evaluate efficiency  
2 options. They perceive energy efficiency alternatives as higher-priced, complicated, or  
3 unwelcome interferences with their lifestyle or business. For most of these customers,  
4 energy is a small portion of the household or business budgets and they view energy as an  
5 abundant, low-cost, and readily available commodity. As a result, other lifestyle or  
6 competitive issues typically take priority over customers' considerations to conserve  
7 energy.

8           Second, many customers lack the capital to invest in energy efficiency. This  
9 leads to customer decisions based on a lower initial capital cost as opposed to total  
10 lifecycle cost of a more efficient option or prolonging a replacement decision as long as  
11 possible.

12           Lastly, most customers are not aware of the positive impact their individual  
13 behaviors can have on the welfare of others on such issues as climate change or national  
14 energy independence. Although there are signs of an emerging social consciousness with  
15 regard to energy, few customers are currently willing to pay more to participate.

16           These challenges serve to limit customer participation in energy efficiency  
17 programs, regardless of who develops, markets, or administers the programs. DE-  
18 Kentucky believes that if we are to achieve widespread adoption of all cost-effective  
19 energy efficiency, these challenges must be addressed with a new approach to energy  
20 efficiency.

1 **Q. PLEASE EXPLAIN AN APPROACH TO ENERGY EFFICIENCY THAT CAN**  
2 **ADDRESS THESE CHALLENGES.**

3 A. A new approach that recognizes energy efficiency resources as being as valuable as  
4 energy production resources and aligns the interests of customers, the environment and  
5 utility shareholders, can overcome the challenges to widespread adoption. This approach  
6 will drive innovation and investment to deliver cost-effective energy efficiency programs  
7 that provide real value to customers. As a resource, energy efficiency can provide more  
8 value to customers through lower bills and an emissions free option to meet customer  
9 demand.

10 Utilities are uniquely positioned to lead this approach. They have the expertise,  
11 infrastructure, and customer relationships to be leaders in delivering cost-effective energy  
12 efficiency. What is missing is the proper incentive for utilities to take the next step and  
13 develop energy efficiency initiatives that will stimulate investment and innovation in  
14 energy efficiency to facilitate widespread customer participation. These initiatives will  
15 produce quality resources that are included in the Company's integrated resource plan  
16 ("IRP") with energy efficiency ultimately becoming part of a utility's standard service  
17 offer.

18 **III. RECOMMENDED CHANGES TO CURRENT REGULATORY MODEL**  
19 **FOR DEMAND SIDE MANAGEMENT**

20 **Q. WHAT CHANGES DOES DE-KENTUCKY RECOMMEND FOR THE**  
21 **CURRENT DEMAND SIDE MANAGEMENT STATUTORY MODEL?**

22 A. While the current Kentucky demand side management statute, KRS 278.285, presents a  
23 good foundation for energy efficiency offerings, DE-Kentucky believes that additional

**THEODORE E. SCHULTZ DIRECT**

1 flexibility needs to be incorporated into the statute to align stakeholder interests and  
2 expand energy efficiency as a resource to meet growing customer demand for energy. To  
3 accomplish this goal, DE-Kentucky suggests that the Commission recommend that the  
4 General Assembly amend the current DSM statute to permit the electric distribution  
5 utility to receive compensation or cost recovery including but not limited to, lost  
6 revenues, shared savings, and compensation based upon capitalization of a percentage of  
7 avoided costs achieved by or associated with all energy efficiency programs. In addition,  
8 utilities should be able to implement a tracking mechanism with an annual adjustment to  
9 take advantage of the feedback received from customers, new technologies and  
10 new/innovative program ideas.

11 **IV. PROPOSED NEW REGULATORY MODEL**

12 **Q. PLEASE BRIEFLY DESCRIBE WHAT THE COMPANY ENVISIONS AS A**  
13 **NEW REGULATORY APPROACH.**

14 A. Although simple in concept, the proposed approach to energy efficiency, fundamentally  
15 changes both the way energy efficiency is perceived and the role of the utility in  
16 achieving such energy efficiency. Energy efficiency should be looked at from a long-  
17 term supply side management perspective with a focus on value to the customer. The  
18 goal of this new energy efficiency approach is to achieve all cost-effective reductions in  
19 electricity in a way that enhances customer satisfaction and ensures the utility is  
20 financially whole relative to the generation alternative.

21 In order to encourage utilities to become leaders in producing capacity and energy  
22 by “saving” watts, DE-Kentucky believes that utilities should be compensated through  
23 the amortization of and a return on a percentage of the costs avoided by saving watts.

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1 Not only will this produce savings for customers, but also creates the proper incentive for  
2 utilities to invest in energy efficiency. Customers will only pay for capacity and energy  
3 savings actually realized by customers. In other words, customers will not pay for energy  
4 savings that a utility does not achieve. From this revenue stream, the utility will pay for  
5 marketing, administration, program incentives and measurement and verification costs.

6 In addition, energy efficiency programs should be flexible to assist customers to  
7 address rising energy prices in the near term in a manner that provides value from our  
8 customer's perspective. However, a long-term focus is also needed. Ultimately, DE-  
9 Kentucky plans to build energy efficiency into standard service offerings making it part  
10 of a customer's everyday life without having to sacrifice the comfort and convenience of  
11 electricity use.

12 **Q. WHAT ARE THE PRIMARY DIFFERENCES BETWEEN DE- KENTUCKY'S**  
13 **NEW APPROACH AND OTHER MORE TRADITIONAL REGULATORY**  
14 **MODELS FOR ENERGY EFFICIENCY?**

15 A. There are three significant differences between the traditional models and the new model.  
16 First, under traditional approaches to energy efficiency, the utilities  
17 are compensated for their marketing, administration, program incentives and  
18 measurement and verification expenses regardless of the energy efficiency impacts (kWh  
19 and kW savings) they achieve. As a result, the customer assumes the risk of not  
20 achieving the energy efficiency impacts or the risk of achieving them at a higher unit cost  
21 than planned.

22 Under the new approach, the burden of achieving results is shifted to the utility.  
23 The utility only gets paid for the energy efficiency results it delivers, *i.e.*, the energy

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1 efficiency impacts (kWh and kW) realized by customers. These results should be  
2 transparent and verifiable by an independent third-party. Customers would not pay for  
3 energy efficiency resources that are not delivered. The result is those resources that are  
4 delivered are more reliable in the IRP process.

5 Second, if the energy efficiency resource produces results over a 10-year useful  
6 life, the new approach pays the utility for the results over the 10-year period. This  
7 requires the utility to be accountable for the results over the resource's useful life in a  
8 manner similar to a supply-side resource.

9 Third, past experience has shown traditional energy efficiency approaches do not  
10 provide the needed flexibility to quickly adjust product offerings, incentives, and  
11 marketing focus as customer needs, markets, and technologies change. Customers should  
12 not be turned away from participating in an energy efficiency program based on pre-set  
13 limits to program funding and participation if we are truly focused on delivering all cost-  
14 effective energy efficiency to customers.

15 **Q. WHY IS FLEXIBILITY IN PROGRAM OFFERINGS IMPORTANT?**

16 A. Utilities need to be able to make program changes and reallocate resources among  
17 programs over the lives of the programs to optimize results for both customers and the  
18 utility. Utilities need to be adaptable to changes in technology in order to take advantage  
19 of innovative new service offerings such as smart grid technology, conservation, and  
20 demand response initiatives. This flexibility is crucial to the success of the undertaking,  
21 particularly given the innovative nature of the effort and the need to make timely and  
22 responsive changes as a utility gains experience working with customers to figure out  
23 how to provide the most value.

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1 **Q. WHY IS PROVIDING VALUE TO CUSTOMERS IMPORTANT?**

2 A. DE-Kentucky believes energy efficiency initiatives should focus on providing value to  
3 customers. Continuing to operate under the current model will likely result in future  
4 participation in energy efficiency programs and ultimate results far below the potential  
5 we believe is achievable. The objectives of the approach outlined are the creation of  
6 value for customers, an environmentally better alternative to meet customer demand, and  
7 an incentive for the utility to achieve all cost-effective energy efficiency.

8 In order to realize strong gains in energy efficiency program participation,  
9 the concept of getting paid based solely on results delivered encourages utilities to create  
10 real value for customers and be rewarded for the value delivered. It requires a deep  
11 understanding of customers' needs and price sensitivity to deliver energy efficiency  
12 offers that customers will appreciate and understand. Because the utility is paid based on  
13 verified watts saved, this regulatory model provides the necessary incentive to the utility  
14 to produce quality energy efficiency results that can be incorporated as a reliable resource  
15 in the utility's IRP.

16 **Q. PLEASE BRIEFLY EXPLAIN DE-KENTUCKY'S RECOMMENDATIONS**  
17 **REGARDING CUSTOMER PARTICIPATION IN ENERGY EFFICIENCY**  
18 **CONSERVATION AND DEMAND RESPONSE OFFERINGS?**

19 A. All major customer classes should participate in and pay for all conservation and  
20 demand response programs. Consistent with KRS 278.285(1)(k), measurable and  
21 verifiable energy and demand savings should be included as a component of the  
22 utility's IRP because effective energy efficiency measures reduce the need to build more  
23 generation or buy more power benefiting all customers.

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1           Although DE-Kentucky believes that all customers benefit from all energy  
2 efficiency programs, the Company does not necessarily oppose an opportunity for the  
3 larger commercial and industrial customers, who have undertaken significant  
4 conservation initiatives on their own in an effort to reduce their cost of energy, the ability  
5 to opt-out of the utility's conservation offerings. In order to opt-out, large commercial  
6 and industrial customers should be required to self-certify to the Commission that they  
7 have undertaken energy efficiency projects or measures at their sites within the last three  
8 years. This strikes a reasonable balance between the legitimate concern of the largest  
9 commercial and industrial customers and the utility's desire to significantly increase  
10 energy efficiency for all customer classes.

11           Although some customers have undertaken initiatives to reduce their cost of  
12 energy, there is still a significant opportunity to improve the operation of the utility  
13 system and provide additional value to customers through demand response programs.  
14 These programs must be evaluated on a utility system basis, in other words no customer  
15 can implement these programs on their own; therefore all customers should be eligible  
16 for and required to pay for demand response programs.

17           As for the revenues associated with conservation programs, DE-Kentucky  
18 believes that there should not be any cross-subsidy between the customer classes.  
19 Residential customers pay for residential conservation programs and all other non-  
20 residential customers should pay for non-residential conservation programs. This is  
21 similar to how the current demand side management statute proposes costs be allocated  
22 among classes.

V. CONCLUSION

1

2 Q. DOES THIS CONCLUDE YOUR PREFILED DIRECT TESTIMONY?

3 A. Yes.

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**VERIFICATION**

STATE OF NORTH CAROLINA        )  
  )        SS:  
COUNTY OF MECKLENBERG        )

The undersigned, Theodore E. Schultz, being duly sworn, deposes and says that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his knowledge, information and belief.

Theodore E. Schultz  
Theodore E. Schultz, Affiant

Subscribed and sworn to before me by Theodore E. Schultz on this 19<sup>th</sup>  
day of February, 2008.

Diane M. Wilkinson  
NOTARY PUBLIC

My Commission Expires:

