COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.	)	
	)	
V.	)	Case No. 2017-00477
	)	
KENTUCKY UTILITIES COMPANY, LOUISVILLE	)	
GAS AND ELECTRIC COMPANY, KENTUCKY POWER	)	
COMPANY AND DUKE ENERGY KENTUCKY, INC.	)	

DIRECT TESTIMONY OF

STEPHEN G. DE MAY

ON BEHALF OF

DUKE ENERGY KENTUCKY, INC.

January 26, 2018

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I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

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

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

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

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

My professional work experience began in 1986 with the public accounting firm of Price Waterhouse (now PricewaterhouseCoopers) and, subsequently, Deloitte, Haskins and Sells (now Deloitte & Touche), where my work focused on tax accounting and consulting for a variety of clients. In 1990, I joined Crescent Resources, Inc., a then wholly-owned real estate development subsidiary of Duke Power Company (a predecessor company to today's Duke Energy) where I was responsible for real estate accounting and finance. In 1994, I moved to the Treasury and Corporate Finance Department where I have held, except for a two-year period of time, various positions of increasing responsibility. The two-year exception was for the majority of 2004 and 2005, during which time I had the lead responsibility for developing and managing Duke Energy's energy and regulatory policies. I was named Treasurer in November 2007 and led the Investor Relations function for Duke Energy from October 2009 through June 2012. Upon closing of the merger with Progress Energy, I was named Vice President and Treasurer. In 2015, I was promoted to my current position as Senior Vice President Tax and Treasurer.

Q. PLEASE SUMMARIZE YOUR RESPONSIBILITIES AS SENIOR VICE PRESIDENT, TAX AND TREASURER.

A. As Senior Vice President, Tax and Treasurer, I have overall responsibility for corporate tax compliance, planning, and accounting for Duke Energy. The Duke Energy Tax Department prepares and files federal, state, and local income, sales and use, excise, and property tax returns for Duke Energy. The department also files tax returns for various joint ventures if Duke Energy is the designated tax matters partner.

The Tax Department maintains and reconciles Duke Energy's tax accounts and manages audits with the Internal Revenue Service and state and local tax authorities. Additionally, the Tax Department is responsible for the reporting and disclosure of tax-related matters, to the extent required.

In my role as Treasurer, I am also responsible for treasury related services to Duke Energy and its subsidiaries, including Duke Energy Kentucky. I monitor trends in the investment markets and maintain key relationships with debt investors, analysts, and financial institutions. Under my supervision, the Treasury Department arranges and executes all capital raising and liquidity transactions, including credit facilities and commercial paper, debt securities, preferred and hybrid securities, and common stock, as well as daily cash management for Duke Energy and its subsidiaries. My responsibilities include managing Duke Energy's and its subsidiaries' credit ratings and interactions with the major credit rating agencies, commercial banks, and the capital markets.

Q. HAVE YOU PREVIOUSLY PROVIDED TESTIMONY BEFORE THE KENTUCKY PUBLIC SERVICE COMMISSION?

A. Yes. I previously provided testimony on behalf of Duke Energy Kentucky in Case No. 2009-00202, in support of its last natural gas base rate case.

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

A. My testimony is in response to the January 5, 2018 Order issued by the Kentucky Public Service Commission (Commission) to provide testimony in support of the Company's position regarding the substance of the Complaint filed in this proceeding on December 21, 2017. In doing so, I first discuss the key components of the recently enacted Tax Cuts and Jobs Act (Tax Act)[1] and its overall impact on the rates (in the short-term and long-term) of Duke Energy Kentucky. I explain the requirements of the Tax Act both in terms of the change in the federal corporate tax rate, changes in the treatment of bonus depreciation, and other deductions, as well as the law's requirements for the treatment of excess Accumulated Deferred Income Taxes (ADITs). I then describe the impact of the Tax Act as it relates to Duke Energy Kentucky if the Commission requires immediate pass through of only the benefits under the Tax Act, (to the exclusion of other provisions of the Tax Act) in isolation and without regard to the utility's current financial position and other relevant factors. I then discuss and support the Company's proposal for customers to share in the benefits created as a result of the Tax Act.

II. OVERVIEW OF THE TAX ACT

Q. PLEASE BRIEFLY DESCRIBE THE TAX ACT.

A. On December 22, 2017, President Donald Trump signed the Tax Act into Law. This legislation represents the most significant revision to the Federal Tax Code in the last thirty years. The voluminous Tax Act brings comprehensive change to the individual, corporate and international tax law. The headline change to the

[1] Tax Cuts and Jobs Act, H.R. 1, Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017).

corporate tax code is a reduction of the statutory corporate tax rate from 35% to 21%, but this reduction in rate is accompanied by many other provisions that serve to broaden the tax base and to "pay for" the effect of the 21% tax rate. Most provisions of the Tax Act take effect beginning January 1, 2018.

Q. WHAT WAS THE PURPOSE BEHIND THE PASSAGE OF THE TAX ACT?

A. The purpose of the Tax Act was to stimulate business investments, create jobs and grow the economy. An expectation that the financial health of the Company be unharmed by tax reform is consistent with these policy objectives and serves as a theme of my testimony.

Q. WHAT ARE THE KEY PROVISIONS OF THE TAX ACT AS IT RELATES TO DUKE ENERGY KENTUCKY?

A. Most changes to the corporate tax code apply to all U.S. corporations equally; while a limited set of others affect regulated utilities uniquely. For utilities in general, and Duke Energy Kentucky in particular, the key provisions of the Tax Act that will affect customer rates are as follows: (1) reduction of the corporate tax rate from 35 percent to 21 percent; (2) retention of net interest expense deductibility; (3) elimination of bonus depreciation; (4) elimination of the manufacturing deduction; and (5) normalization of excess accumulated deferred income taxes (ADITs) resulting from the Tax Act.

Q. PLEASE SUMMARIZE HOW THESE KEY PROVISIONS COULD IMPACT DUKE ENERGY KENTUCKY AND CUSTOMER RATES.

A. REDUCTION IN CORPORATE TAX RATE: The new statutory income tax rate of 21% represents a 40% reduction from the previous rate of 35%. This will lower a key component of cost of service, i.e., income taxes. In combination with the elimination of bonus depreciation (see below), a lower corporate tax rate will slow the accumulation of deferred income taxes and have an increasing effect on rate base, thereby causing an effect that is opposite to the lower cost of service effect.

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

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

MANUFACTURING DEDUCTION: Prior to the Tax Act, domestic manufacturers were granted a tax deduction based on a certain percentage of qualifying manufacturing income, and the production of electricity qualified for this tax benefit. In order to avail itself of this deduction, a corporation had to be in a taxable income position—this was often not the case recently for most regulated utilities because of the impact of bonus depreciation. Unfortunately, the elimination of bonus depreciation for utilities in the Tax Act coincided with the elimination of this tax deduction for all manufacturers, which is directionally detrimental to customer rates.

EXCESS DEFERRED INCOME TAXES: At the end of 2017, Duke Energy Kentucky has a significant net deferred tax liability, booked at a 35% corporate tax rate and driven overwhelmingly by accelerated and bonus depreciation of fixed assets for tax purposes. Because a deferred tax liability represents taxes collected from customers but not yet paid to taxing authorities, and because the ultimate payment of these taxes will now occur at a 21% corporate tax rate (down from 35%), the balance of deferred tax liability must be remeasured. The resulting "excess" deferred tax balance becomes a regulatory liability. The Tax Act requires that excess deferred taxes generally associated with property, and specifically connected to the accelerated depreciation of property, must be normalized into customers rates in a highly-prescribed manner that mimics the remaining life of the underlying assets. These are known as "protected" excess deferred taxes. All other excess deferred taxes may be treated by the commission like any other regulatory liability in the rate-setting process. If *all* excess deferred tax liability balances are normalized for rate-setting purposes, the impact to the company would be neutral to pre-Tax Act cash flow even as customers will realize a rate benefit over time.

Mr. Wathen discusses the Company's estimation of these impacts in his testimony.

Q. PLEASE DISCUSS THE CONCEPT OF BONUS DEPRECIATION.

A. Bonus depreciation is an enhanced form of accelerated depreciation for tax purposes. Congress has used bonus depreciation for well over a decade to encourage capital investment, at varying times renewing the provision just as it is set to expire and modifying the degree to which depreciation in the first year (the "bonus") could be claimed. Prior to the Tax Act, existing bonus depreciation laws were scheduled to sunset in 2021, but could very well have been extended as in years past. In 2017, prior to the Tax Act, bonus depreciation was 50%--this means that corporate taxpayers could depreciate 50% of capital placed in service in the first year *in addition to* a normal level of tax depreciation (MACRS) on the remaining 50%.

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

Q. PLEASE DISCUSS THE CONCEPT OF ACCUMULATED DEFERRED INCOME TAXES (ADIT)

A. Many timing differences exist between when income taxes are collected from customers in rates and when the company pays those taxes in cash to the IRS. Sometimes the taxes are paid sooner than when they are collected from customers (which creates a deferred tax asset on the company's books), and sometimes they are paid later (creating a deferred tax liability). Deferred taxes balances, therefore, result from book/tax timing differences between the recognition of income and expenses. All deferred tax balances, whether they are assets or liabilities, reverse over time and converge to zero over the life of the underlying item giving rise to the deferred tax balance.

To illustrate, see the table below. In this example, I assume the Company invests $1,000 in an asset with a useful life of ten years. Because the useful life is ten years, the initial cost of the asset will be spread out evenly over the ten-year period such that the depreciation expense for book purposes is $100 per year. Another assumption in this example is that the Company is allowed to accelerate the depreciation of the investment over a much shorter life for tax purposes—five years in my example (the IRS provides tables that are used to calculate the annual tax depreciation expense).

In this example, Duke Energy Kentucky is allowed to depreciate $200 of its investment for calculating its current year tax liability, but only $100 for calculating its book tax expense. Because of that difference, the Company's income taxes paid is $35 less (at the 35 percent tax rate) than it would have been using the useful life as the basis for calculating taxes. In the example below, it shows that by end of year six the Company will have fully depreciated its investment for tax purposes but is still recording depreciation expense for book purposes. The benefit to the Company and customers is apparent in the "accumulated" column. The figures in this column represent cash available to the Company from what amounts to a zero-cost loan from the government. This balance benefits customers by providing an offset to rate base.

Table 1

	Depreciation Expense			Deferred Tax	
Year	**Per Books**	**Per Tax**	**Difference**	**Current Year**	**Accumulated**
1	$100	$200	$100	$35	$35
2	100	320	220	77	112
3	100	192	92	33	145
4	100	115	15	5	150
5	100	115	15	5	155
6	100	58	(42)	(15)	140
7	**100**	-	**(100)**	**(35)**	**105**
8	100	-	(100)	(35)	70
9	100	-	(100)	(35)	35
10	100	-	(100)	(35)	0
	$1,000	$1,000	$0	$0	$0

Q. HOW DOES THE TAX ACT ADDRESS THE ACCOUNTING TREATMENT OF EXCESS ADITS?

A. Because of the passage of the Tax Act, the deferred tax assets and liabilities on the Company's books as of December 31, 2017, which were established at a rate of 35 percent, will be revalued at a rate of 21 percent creating "excess" ADITs.

Under the Tax Act, the protected excess ADIT reserve may be reduced with a corresponding reduction in the revenue that the utility collects from ratepayers no more rapidly than the reserve would be reduced under the Average Rate Assumption Method (ARAM).[2]

III. IMPACT OF THE TAX ACT

Q. PLEASE EXPLAIN THE IMPACTS OF THE TAX ACT ON DUKE ENERGY KENTUCKY AND ITS CUSTOMERS?

A. As I previously stated, the key components of the Tax Act reduce the corporate tax rate, eliminate bonus depreciation, and cause the revaluation of tax assets and liabilities and the normalization of certain specified balances. These provisions will impact Duke Energy Kentucky in several ways. First, the lower federal statutory tax rate would have the effect of reducing the amount of federal income tax expense that the Company must collect through rates. The revenue requirement would also he lowered through the amortization and normalization of

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[2] AVERAGE RATE ASSUMPTION METHOD.—The average rate assumption method is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under such method, during the time period in which the timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying—

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by (ii) the amount of the timing differences which reverse during such period.

(ii) the amount of the timing differences which reverse during such period.

excess deferred income taxes. At the same time, the lower tax rate, the elimination of bonus depreciation and the amortization of excess ADIT balances will increase the Company's rate base, driving a higher revenue requirement starting right away and continuing over time.

Q. PLEASE EXPLAIN HOW THE CHANGES IN THE TAX ACT WILL ACTUALLY CAUSE DUKE ENERGY KENTUCKY'S RATE BASE TO GROW FASTER THAN IT WOULD ABSENT TAX REFORM.

A. Duke Energy Kentucky witness Don Wathen further explains this in his direct testimony. In summary, the lower corporate tax rate and the elimination of bonus depreciation have the effect of reducing the tax depreciation and the resulting ADIT going forward. ADIT acts as a reduction to rate base as part of the rate-making process, and this offsetting effect will be lower than it otherwise would be at the former 35 percent rate. Thus, rate base will be higher going forward.

Q. IN ITS DECEMBER 27, 2017 ORDER, THE COMMISSION DIRECTED EACH UTILITY TO "RECORD A DEFERRED LIABILITY STARTING JANUARY 1, 2018, TO REFLECT BOTH THE REDUCED FEDERAL CORPORATE TAX RATE EXPENSE OF 21 PERCENT AND THE EXCESS DEFERRED ACCUMULATED INCOME TAXES TO BE RETURNED TO RATEPAYERS OVER THE NEXT 20 YEARS." HAS DUKE ENERGY KENTUCKY DONE THIS?

A. Yes. At the time of this testimony, such deferrals are based on estimates and reasonably approximate actual levels. The Company performed this estimation and conducted an analysis in determining the regulatory liability as directed by this Commission. This analysis is covered in the testimony of witness Don Wathen.

Q. HAS DUKE ENERGY KENTUCKY ATTEMPTED TO QUANTIFY THE INITIAL IMPACT OF THE TAX ACT?

A. Yes. The Tax Act is complex and the law was only enacted at the end of 2017. Determing the actual impacts of the entire legislation will take some time, but the Company has an ability to estimate the impacts with reasonable accuracy. At a high-level, the Company has performed estimates on the change in the federal tax rate. Mr. Wathen discusses these impacts in his testimony.

Q. IS IT REASONABLE THAT CUSTOMERS SHOULD BENEFIT FROM THE CHANGES IN THE COMPANY'S COST TO SERVE AS A RESULT OF THE TAX ACT?

A. Yes, customers should benefit, and they will. And it is incumbent on the Commission to ensure that customers receive and the utility is providing reliable service at reasonable rates. But without the thoughtful consideration of the Commission of all aspects of the Tax Act, the Company could be adversely affected by the legislation, particularly through a material reduction of much-needed cash flow.

As this Commission is well aware, utilities are one of the most capital intensive industries in the country, and that in part, is why utilities are heavily regulated. The Company invests in infrastructure not because of federal tax policy, but because it is critical, necessary and often legally required that it does so. Our obligation to serve requires the financial wherewithal to support our commitments to our customers on a reliable and cost-effective basis. Credit quality drives access to affordable capital and for this reason it is in the best interest of customers to prevent a weakening of the Company's cash flow and credit quality from pre-Tax Act levels.

Adjusting utility rates solely to account for the impact of the reduction in the federal corporate tax rate and the flow back of excess ADITs is not appropriate. The Commission should also take into account all other impacts of the Tax Act as well as other non-tax inputs that could affect rates. The Tax Act represents a unique opportunity to deliver savings to customers, but as with all ratemaking actions, the interests of customers and the Companies must be balanced.

While it may be appropriate for the Commissions to consider whether a regulated utility's existing rates charged to its customers are potentially "excessive," given that certain costs (namely federal taxes) will be reduced, as is the case in this proceeding, the overall guiding principle is, and should continue to be, whether the regulated utility's rates as a whole, given all changes that may have occurred since those rates were last set, remain just and reasonable. If, upon examination of all facts and circumstances impacting the utility, the Commission determines that the Company's rates are excessive or unreasonable, then the rates should be adjusted.

Q. DOES THE COMMISSION NEED TO ACT QUICKLY TO REQUIRE DUKE ENERGY KENTUCKY TO REDUCE ITS BASE GAS AND ELECTRIC RATES TO ACCOUNT FOR THE CHANGES IN THE FEDERAL CORPORATE TAX RATE AND THE EXCESS ADIT TO MAKE SURE CUSTOMERS RECEIVE THE BENEFITS OF THE TAX ACT?

A. No. The Commission has directed utilities to create the necessary accounting entries to preserve the impact of the Tax Act.

Q. WHAT IS DUKE ENERGY KENTUCKY SUGGESTING TO THE COMMISSION WITH RESPECT TO THIS COMPLAINT PROCEEDING?

A. In determining that customers are receiving and utilities are providing reliable service at reasonable rates, the Commission should ensure that the result of the current Duke Energy Kentucky rate proceeding is a rate outcome that is reasonable and that the Commission's final order does not unfairly harm either customers or the utility.

To the extent Duke Energy Kentucky already has riders, or other surcharge mechanisms in place that automatically adjust for costs (including taxes) outside of a base rate case, customers will automatically experience those savings in the normal course of operation of those riders. Further, the Tax Act is clear on the treatment of excess ADITs that are tied to property, and those must be reversed over the life of those assets. Similarly, to the extent there are unprotected excess ADITs, the Commission should take the opportunity now, to consider opportunities that will provide a longer-term benefit to customers and the utility and not harm either customers or the Company's financial condition. As further explained by Mr. Wathen, the most appropriate way to address all of these issues is through a base rate case. Nonetheless, Duke Energy Kentucky agrees that the impacts of this Tax Act should not be unnecessarily or unreasonably delayed. Therefore, the Company is proposing a fair and reasonable solution to address all of the impacts of the Tax Act in a reasonable time.

The heart of this complaint proceeding is the allegation that due to the passage of the Tax Act, the named utility defendants are no longer charging a reasonable rates.[3] The Company urges the Commission to look beyond the just the reductions in tax expense afforded under the Tax Act and to focus on bigger picture of Tax Act as it relates to the reasonableness of the utility's rates. This approach is beneficial for both customers and the utilities and necessarily includes consideration of both the immediate and longer term impacts of the Tax Act, the current financial condition of the utility, and an appreciation of what the impact of a sudden reduction in utility rates will have on the quality of service the utility is providing. This is particularly important in the situation where the utility is already under earning, not only on its authorized rate of return, but below the range of a reasonable rate of return.

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[3] Complaint at 2.

Q. COULD DUKE ENERGY KENTUCKY'S FINANCIAL CONDITION COULD BE HARMED IF THE COMMISSION REQIRES AN IMMEDIATE REDUCTION IN ITS RATES AS A RESULT OF THE TAX ACT.

A. Yes. The issue for Duke Energy Kentucky is simple. The implementation of the Tax Act has the potential to adversely affect the Company's cash flow needed to fund ongoing operations and new infrastructure investments. An unmitigated cash flow shortfall could force the Company to rely excessively on third-party capital to fund itself, to the ultimate detriment of its financial condition.

As further discussed by Mr. Wathen, Duke Energy Kentucky is already in the midst of a base electric rate case where the Company has demonstrated that its revenues are already insufficient to provide recovery of its reasonable costs and earn a reasonable return. This deficiency is greater than the anticipated reduction in expense as a result of the Tax Act. Adjusting the Company's rates downward in isolation for just the reduction in the Federal corporate tax rate will make an undesirable situation worse from an overall cash flow perspective.

Similarly, for gas operations, as Mr. Wathen explains, Duke Energy Kentucky has not had a gas base rate case in nearly eight years. The financial condition of the Company's gas operations is not the same as it was immediately following its last base rate case.[4] Indeed, intervening events have precluded the Company from filing rate cases through negotiated stay-outs, and balancing the timing of other rate increases to its customers. As demonstrated by Mr. Wathen, the Company's natural gas rates are already unreasonable in that they are not adequately compensating the Company for its cost of providing service and ability to earn authorized reasonable return on its invested capital.

Duke Energy Kentucky has worked hard over the years to keep customers' rates well below the national average. The Company has accomplished this while providing safe, reliable and increasingly clean energy. These Federal tax law changes provide the Commission an opportunity to help reduce and smooth out customer rates over the short- and longer-term, while maintaining the utility's ability to provide safe, reliable and affordable rates. Keeping with this strong tradition, and as further described by Mr. Wathen, Duke Energy Kentucky proposes both near- and longer-term solutions that will lower customer bills immediately and help off-set future rate increases.

Q. PLEASE SUMMARIZE HOW THE COMPANY IS PROPOSING THE COMMISSION BALANCE INTERESTS IN ACHIEVING IMMEDIATE BENEFIT FOR CUSTOMERS WITHOUT CREATING AN ADVERSE FINANCIAL IMPACT ON DUKE ENERGY KENTUCKY.

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[4] As part of the settlement of Case No. 2009-00202, Duke Energy Kentucky agreed to an 18-month natural gas base rate case stay-out. By Order dated October 28, 2011, part of the settlement in Case No. 2011-00124, the Commission approved a two-year electric and natural gas base rate case stay-out. On February 2, 2016 in Case No. 2015-00210, the Commission approved a settlement that included a one-year base rate case stay-out for gas rates.

A. As I explained above, the Tax Act creates multiple complex issues that impact the utility's over-all cost of service, both in the short-and-long-term. While the change in the statutory federal tax rate will certainly impact the Company's revenue requirement, that reduction alone does not offset all other increases that the Company has experienced since its last base rate proceedings, nor those that will now result in the future due to the other changes resulting from the Tax Act, as I previously described. The Commission has a unique opportunity to use its rate-making authority to address these issues in a fair and balanced way that can provide both immediate benefits to customers, preserve the short-and-long-term financial integrity of the utility, and perhaps have a meaningful impact on customer rates in the future as well.

Mr. Wathen explains the Company's proposal in greater detail as well as other strategies that the Commission could consider. In summary, the Company's proposal is threefold. First, the Company is proposing that the Commission evaluate the impacts of the Tax Act in the context of the already pending base electric rate case. Second, for gas operations, the Company is proposing that since its current earnings are already significantly insufficient to permit it to earn a reasonable return that no immediate reduction in rates occurs. Rather, the Company is proposing that to the extent the Company's earnings improve between now and when the Commission approves new base rates, that the Company will implement a Tax Act earnings sharing mechanism that will flow back to customers any natural gas operations earnings over 9.7 percent until new base rates are approved for the Company's natural gas operations in a base rate case. The Company commits to file a natural gas base rate case before the end of 2018 through which the impact of the Tax Act will be addressed going forward. Finally, to the extent the Company has riders and surcharge mechanisms for its gas and electric operations already in place that adjust for taxes, customers will receive the impact of the change in the federal tax rate during the ordinary course of those rider adjustments.

Q. WHY IS IT REASONABLE FOR THE COMMISSION TO BALANCE THE INTERESTS IN MAINTAINING THE FINANCIAL INTEGRITY OF THE UTILITY WITH THAT OF CUSTOMERS?

A. This proposal is reasonable in that it ensures that the Company is able to earn a fair, just and reasonable rate of return notwithstanding the impacts of the Tax Act and all other upward pressure on rates that the Company has experienced since its last base rate case proceedings. The Company is already creating the deferrals for the ADIT liabilities. The issue for the amortization of these assets is not so much a question of how, just when. Allowing the Company to delay implementing the rate adjustments that put downward pressure on its rates and rate base until such time as the Commission has the opportunity to fully consider all costs that are providing upward pressure will enable Duke Energy Kentucky to maintain its financial condition and not risk a creditworthiness concern.

IV. CONCLUSION

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

A. Yes.

VERIFICATION

STATE OF NORTH CAROLINA)
) **SS:**
COUNTY OF MECKLENBURG)

The undersigned, Stephen G. De May, SVP, Tax and Treasurer, being duly sworn, deposes and says that he has personal knowledge of the matters set forth in the foregoing testimony and that it is true and correct to the best of his knowledge, information and belief.

S.G. De May
Stephen G. De May Affiant

Subscribed and sworn to before me by Stephen G. De May on this 22 day of January 2018.

Natalie W. Polk
NOTARY PUBLIC

My Commission Expires: 4-29-2018