Large Filing Separator Sheet

Case Number: 08-709-EL-AIR
08-710-EL-ATA
08-711-EL-AAM

Date Filed: 7/25/2008

Section: 1 of 6

Number of Pages: 200

Description of Document: Application
Volume 4, 5 & 6
Schedule S-4.2
Part 1 of 3

BEFORE THE

PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Duke Energy Ohio, Inc. For an Increase in Electric Rates	))))	Case No. 08-709-EL-AIR
In the Matter of the Application of Duke Energy Ohio, Inc. For Tariff Approval	))))	Case No. 08-710-EL-ATA
In the Matter of the Application of Duke Energy Ohio, Inc. for Approval To Change Accounting Methods	)))	Case No. 08-711-EL-AAM

VOLUME 4

SCHEDULE S-4.2
(PART 1 OF 3)

July 25, 2008

Duke Energy Ohio
Cause No. 08-709-EL-AIR

Management Policies, Practices & Organization of
Duke Energy Corporation

Schedule S-4.2

Volume 1 of 3

VOLUME 1 of 3

Page Nos.

VOLUME 2 of 3

VOLUME 3 of 3

DUKE ENERGY
DUKE ENERGY OHIO
SUMMARY OF MANAGEMENT POLICIES, PRACTICES AND ORGANIZATION
ACCOUNTING DEPARTMENT
SFR Reference: Chapter II(B)(9)(b)(ii,iv),Chapter II(B)(9)(e)(vii)

I. Policy and Goal Setting

The Corporate Controller's Department sets policies, as necessary, to comply with Financial Accounting Standards Board (FASB), Security Exchange Commission (SEC), Public Company Accounting Oversight Board (PCAOB), and Federal Energy Regulatory Commission (FERC) requirements. These policies are generally developed within the department, taking into account department and enterprise practices, industry standards and requirements, and processes developed through past experience. Policies and practices documents employed by management are available to the general employee population through department web sites on the Duke Energy's intranet.

The Midwest Accounting Group is primarily responsible for the books and records of Midwest operations including The Cincinnati Gas & Electric Company and Cinergy Corp. This group supports the corporate policies developed by the Corporate Controller's Department through department directives, procedures and practices. The groups that report to the Corporate Controller, including Midwest Accounting, sets goals designed to support the financial and administrative goals of the Corporate Controller's Department which are aligned to support the Company's strategic and business plans. The goal setting process is a joint effort of the Senior Vice President & Controller (Corporate Controller), business unit Vice Presidents, Directors and Managers of the Department. Progress toward achieving the established goals is reviewed as required.

II. Strategic Planning

Senior Management has the primary responsibility for establishing the Company's strategic plan. As mentioned in Section I, Policy and Goal Setting, the Corporate Controller's Department goals are designed to align with the Company's strategic and business plans.

The Corporate Controller's Department participates in the corporate planning process through input and suggestions given to the Group Executive &Chief

Financial Officer, and through Corporate Controller Department participation on corporate teams established for this purpose.

III. Organizational Structure

The Company's accounting operations are centralized and led by the Corporate Controller. Reporting directly to the Corporate Controller are the Vice President, Franchised Electric & Gas Accounting, Vice President Non-Regulated Accounting, Vice President, Duke Energy International Accounting, General Manager, Corporate Accounting, General Manager, Closing and Consolidation, General Manager, Accounting Research, and General Manager, Financial Controls.

The Midwest Accounting Group is under the direction of the Director of General Accounting- Midwest who reports to the Vice President, Franchised Electric & Gas. Also reporting to the Vice President, Franchised Electric & Gas are the Director of General Accounting- Carolinas, Director of Asset Accounting, Director of Derivative and Revenue Accounting, Director, Wholesale Accounting, Director Internal Controls, and the Accounting Manager responsible for reporting the consolidated financial results for Franchised Electric & Gas.

An organizational chart of the Department is attached as Exhibit CO-1.

IV. Responsibilities

The Franchised Electric & Gas Accounting group is responsible for ensuring the integrity of the regulated businesses' accounting books and records; providing accounting-related information to support Duke Energy's regulatory initiatives and assure that the organization's reporting documents are in compliance with generally accepted accounting principles and practices and established governmental standards set by regulators, such as the Securities and Exchange Commission (SEC), the Federal Energy Regulatory Commission (FERC) and the Utility Regulatory Commissions of Ohio, Indiana, Kentucky, North Carolina and South Carolina.

The duties of the Midwest and Carolinas General Accounting groups include:

- Close the books on a monthly basis and analyze financial results;
- Coordinate and prepare filings with regulators including FERC Form 1, FERC Form 2 and FERC Form 3Q or others as required;
- Support the company's regulatory activities including assistance in preparing accounting-related testimony, exhibits and discovery request and coordination of regulatory audits;

- Assist in preparing accounting-related data in support of corporate initiatives and activities;
- Initiate and monitor quarterly due diligence reviews to ensure adequate external financial disclosures; and
- Establish financial controls and test for compliance with Sarbanes\Oxley 404 requirements;

The duties of the Fixed Assets group include:

- Maintain continuing property, fuel and emission allowance records (Asset valuation, depreciation, AFUDC, capital recovery, etc.);
- Establish asset accounting policies;
- Provide guidance on capital versus expense accounting;
- Perform construction and retirement work order accounting;
- Determine appropriate strategies for book depreciation and AFUDC;
- Establish financial controls and test for compliance with Sarbanes-Oxley requirements;
- Prepare and analyze capital expenditure, fuel and emission allowance reports for management use; Prepare rate case exhibits and testimony.

The duties of the Derivative and Revenue Accounting group include:

- Record revenues, primarily utility related, for the business units;
- Completes accounting control functions for utility revenue process to ensure data integrity;
- Provides internal management reporting and analysis for revenue results; and
- Provide billing and collection services for miscellaneous utility and certain non-utility services.

The specific duties of the Wholesale Accounting group include:

- Provide accounting and settlement function for power and gas transactions;
- Provide accounting and invoicing for jointly owned facilities and network point to point transmission;
- Post Analysis Cost Evaluation (PACE) modeling;
- Report and analyze product line profitability;
- Maintain fuel clause, revenue sharing and other regulatory calculations; and
- Support regulatory fuel clause and revenue sharing audits

The duties of the Consolidated Financial Reporting group include:

- Consolidate Carolinas and Midwest financial data to report results for Franchised Electric & Gas;
- Coordinate data gathering for 10Q/10K filings for Duke Energy Corp
- Coordinate updates of key financial messages for Investor Relations

The Non-Regulated Accounting group is responsible for power and gas accounting settlements, Coal and emission allowance accounting/settlements, financial reporting and risk analysis and reporting. Detail responsibilities are separately documented.

The Duke Energy International Accounting is responsible for the books and records, financial reporting, and all other accounting-related aspects of non-US operations.

The Corporate Accounting group is responsible for corporate level benefits accounting, stock based compensation accounting, captive insurance accounting, derivative accounting, parent company accounting, reserves and accruals, monthly cashflow rollforwards, income and balance sheet variance analysis and reporting for the Duke Other segment.

The Close and Consolidation group is responsible for supporting the enterprise-wide consolidation of balance sheets and income statements, facilitating intercompany tranactions reconciliation and elimination processes, manage the monthly close and reporting tasks, and manage non-routine transactions and non-routine SEC reporting that involve multiple business units and/or corporate areas.

The Accounting Research group is responsible for providing assistance to the corporate and business unit personnel on resolution of accounting and reporting issues related to generally accepted accounting principles (GAAP), SEC reporting, and other regulatory matters. This group also provides implementation assistance and periodic training to corporate and business unit personnel on new accounting pronouncements and reporting matters and review significant accounting conclusions developed by the business units.

The Reporting and Analysis group is responsible for preparing and filing all SEC periodic reports and financial statements (Form 10-K, 10-Q, etc), preparing certain monthly financial reports to executive management and the Board of Directors of Duke Energy and financial statement analysis.

The Financial Controls group is responsible for leading enterprise efforts to enhance internal controls, including the development and enhancement of corporate control policies and compliance with sections of the Sarbanes-Oxley Act of 2002 related to internal controls and disclosure controls. Detail responsibilities are separately documented.

V. Practices and Procedures

The Corporate Controller's Department's practices and procedures comply with Duke Energy policies and procedures located on the Company's intranet. These policies including those established by the Corporate Controller's Department as noted in Section I, Policy and Goal Setting of this document, help ensure consistency across the enterprise. Policies and procedures are reviewed and updated as necessary to reflect new or modified accounting pronouncements and regulatory requirements, and to provide additional clarity. Copies of these key Internal Controls and Financial Controls policies are attached as Exhibit CO-2.

As part of Duke Energy's due diligence process with respect to its SEC filed financial statements, senior management and certain key management employees are required to sign a quarterly certification representing that there are no material weaknesses in internal controls or any material misstatements in the financial statements of the company.

VI. Decision Making and Control

Overall direction on the broad concepts for reflecting accounting and financial information is provided by the Corporate Controller. With few exceptions, personnel at all levels are provided general supervision and granted latitude to make daily decisions, plan activities, coordinate personal schedules and travel as required to perform their core functions.

The decision making process for the Corporate Controller's Department revolves primarily around the proper disclosure of accounting and financial data to satisfy external regulations and requirements. Department personnel research accounting issues as needed and formulate preliminary decisions which are communicated through the management hierarchy, as appropriate, for concurrence.

Control of individual purchasing activities and access to cash disbursements and reimbursements are strictly controlled in accordance with the Duke Energy Approval of Business Transactions policy and resulting delegations of authority (DOA approval levels). For most transactions, DOA approval levels are captured in the various procurement and payable systems and are electronically verified to ensure compliance with established limits.

To provide greater controls and review of financial documents to be filed externally, the Corporate Controller's Department circulates drafts of each filing for comments from internally affected departments and externally from the Company's independent auditors. In addition, a due diligence process is performed each quarter to ensure that the Financial Statements include the most current and appropriate financial disclosures.

In addition to the internal reviews and controls associated with making accounting changes, compliance with certain accounting policies and procedures is monitored by the Audit Services Department, independent auditors, and/or regulators.

VII. Internal and External Communication

Periodic staff meetings are held by the Corporate Controller and each group that reports to the Corporate Controller to provide a sharing of events which have transpired and/or are planned that affect accounting operations, to provide updates on the progress of projects at various stages of completion and to discuss personnel, policies and practices. Those items and events affecting the operations of the department are communicated to employees as appropriate. Electronic mail is used extensively, along with internal departmentally shared network drives to exchange both formal and informal communication.

Frequent communication is also required with other departments within the Company including, Legal, Rate, Tax, Human Resources, Risk Management, Budgets & Forecasts and Treasury in the form of oral or written requests to gain information/knowledge on certain issues to be considered when preparing external documents. These departments frequently request information from the Corporate Controller's Department as well.

The Corporate Controller and staff communicate with other utilities on accounting issues which may impact the utility industry. As needed, contact with other utilities is made by phone to obtain these companies' external reports such as Annual Reports or Form 10-Ks and also to discuss accounting methods or procedures. In addition, the Corporate Controller's Department periodically responds in written format to regulatory agencies' and authoritative accounting bodies' proposed accounting changes.

Frequent contact is maintained with independent auditors during their review of financial statements and documents. Occasional contacts are also made with outside legal and actuarial experts, as well as state and federal regulatory agencies, concerning audits for prescribed accounting and records supporting rate case issues.

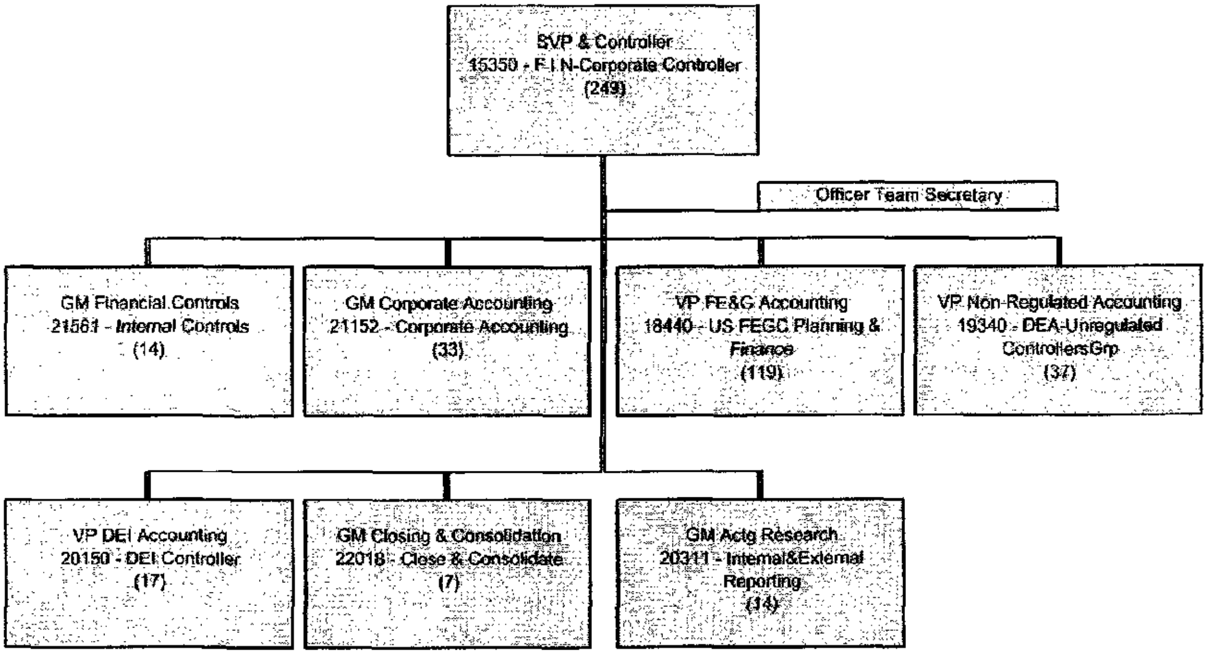
VIII. Goal Attainment and Qualification

Performance measures are established annually and approved by the Duke Energy Compensation Committee. These performance measures include items that are critical to the enterprise as well as departmental items that support and align with enterprise measures. Enterprise measures may include EBIT, ROE, etc. Departmental measures may include items such as timely and accurately closing the books and reporting financial results, and timely response to data request. Actual performance against these measures is tracked and reported to all employees.

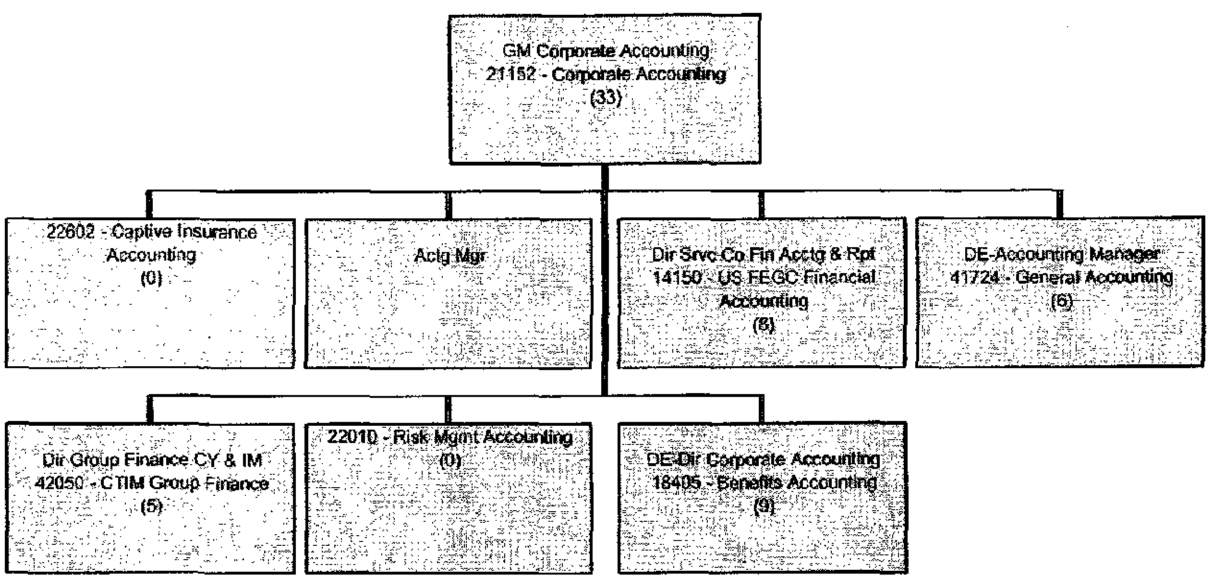
In addition, employees receive annual performance reviews to measure and report progress toward individual goals and performance against expectations.

DUKE ENERGY CORPORATION MANAGEMENT STRUCTURE

Senior Vice President & Controller



General Manager Corporate Accounting



DUKE ENERGY CORPORATION MANAGEMENT STRUCTURE

Director Group Finance, CY&IM

- Dir Group Finance CY & IM
  42050 - CTIM Group Finance
  (5)
  - 20419 - Duke Net Accounting&Reporting (0)
  - DE-Sr Business Analyst
  - DN-Sr Accounting Assistant
  - DN-Accountant II
  - DukeNet - Finance Manager
  - DE-Strategic Business Cnsl

Vice President FE&G Accounting

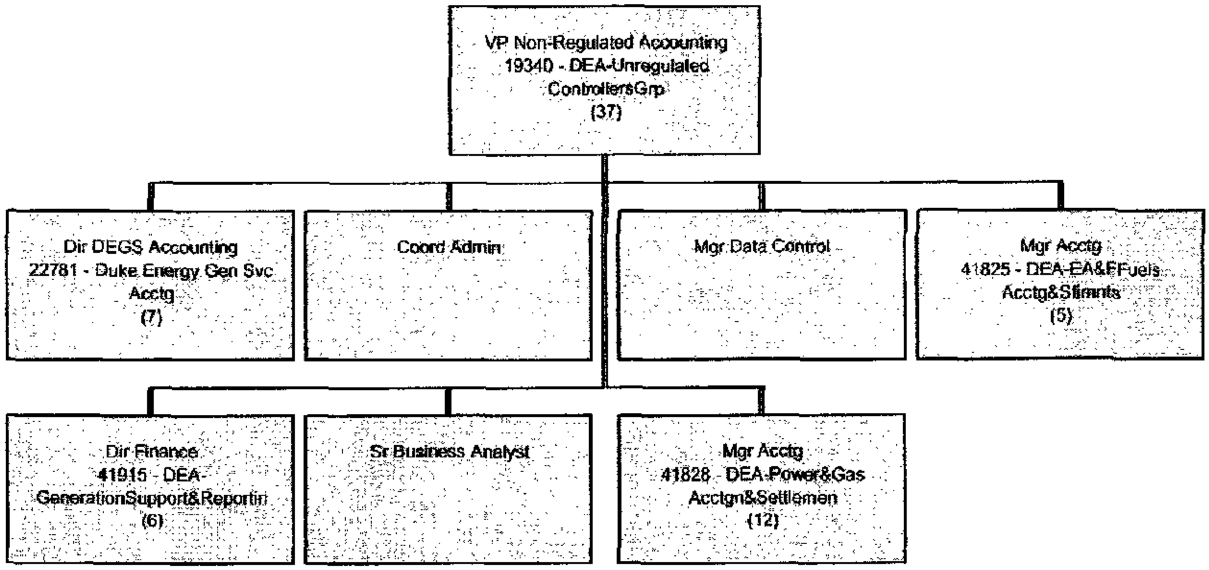
- VP FE&G Accounting
  18440 - US FEGC Planning & Finance
  (119)
  - Dir of Gen Acctg - Carolinas
    14570 - US FEGC Fin & Regulatory Acct
    (17)
  - DP-Dir Asset Actg
    14940 - US FEGC Asset Accounting
    (32)
  - DE-Accounting Manager
    15635 - US FEGC Consolidated Reporting
    (1)
  - DP-Officer Team Secretary
  - DP-Dir Internal Controls
  - DP-Dir Wholesale Actg
    22143 - Wholesale & Joint Owner Acctg
    (25)
  - Dir of Derivative & Rev Anlys
    41607 - US FEGC Rev Derivaties&Anls
    (13)
  - Dir of Gen Acctg - Midwest
    41112 - US FEGC PSI/CGE/ULHP Acct&Rptg
    (23)

Director Wholesale Accounting

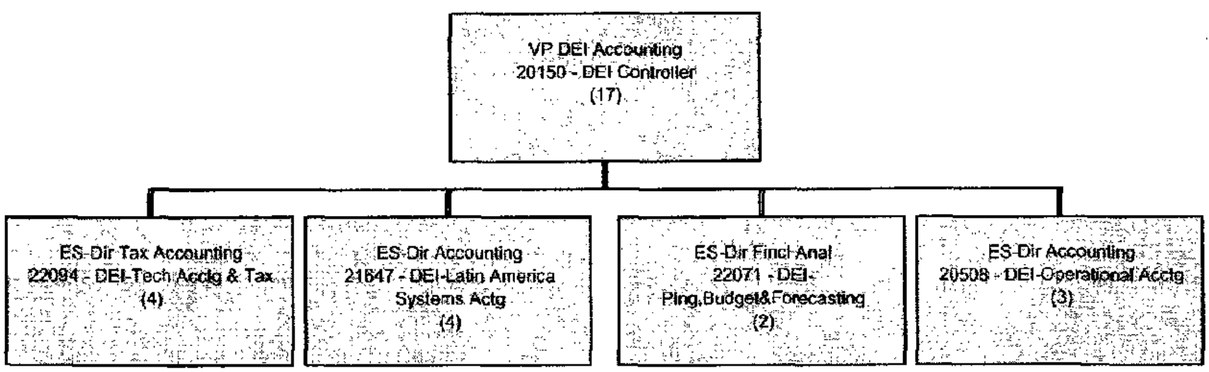
- DP-Dir Wholesale Actg
  22143 - Wholesale & Joint Owner Acctg
  (25)
  - Sr Bus Ana
  - Dir MW BPM Acctg
    41605 - Finance Midwest Back Office
    (10)
  - Hemric,Jana K Mgr Catawba Actg
    12660 - Joint Owner Charlotte
    (8)
  - Business Analyst
  - Actg Mgr
    22245 - Wholesale Accounting Duke
    (4)

DUKE ENERGY CORPORATION MANAGEMENT STRUCTURE

Vice President Non-Regulated Accounting

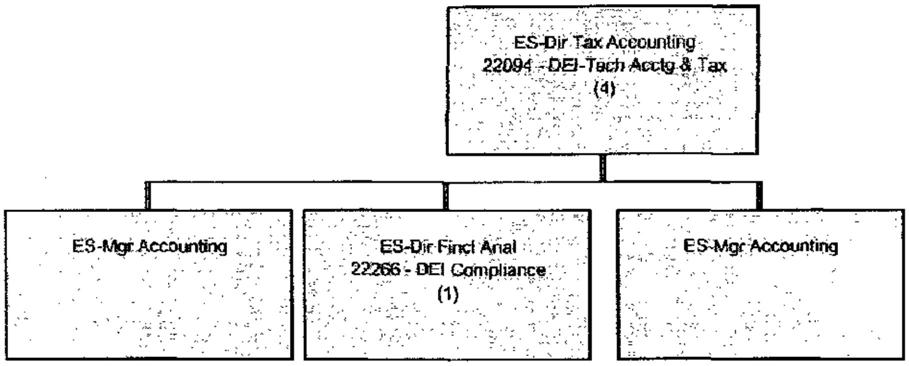


Vice President DEI Accounting

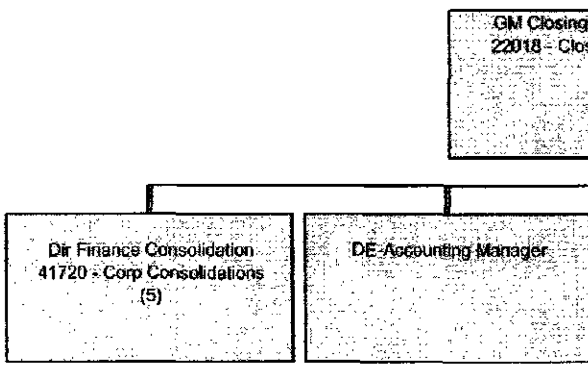


DUKE ENERGY CORPORATION MANAGEMENT STRUCTURE

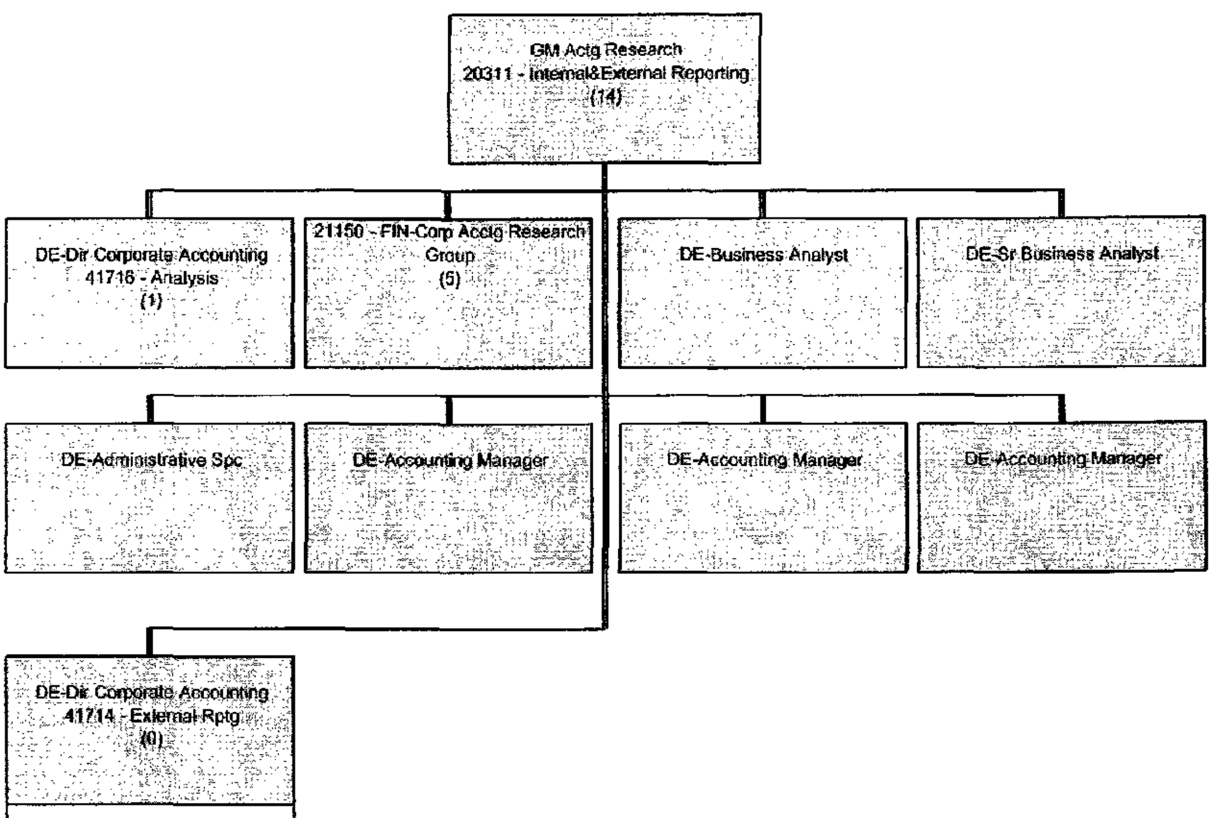
Vice President Tax Accounting



GM Closing & Consolidation



GM Accounting Research



Tracking Sheet - List of Internal Controls and Financial Controls Policies

This list was last updated on 07-01-08	Current Revision Date *	Original Effective Date
Accounting and Financial Reporting		
Account Analysis and Reconciliation	3/31/2008	4/30/2001
Accounting for Asset Impairments, Assets Held for Sale and Discontinued Operations, Including Equity Method Investments (SFAS No. 144 and APB No. 18)	12/17/207	12/1/2004
Accounting for Cash Overdrafts	10/31/2007	3/31/2006
Accounting for Claims between Captive Insurer and Affiliates	3/31/2008	12/16/2004
Accounting for Defined Benefit Pension Plans and Other Post-Retirement Benefit Plans	12/17/2007	12/1/2004
Accounting for Goodwill	12/17/2007	12/1/2004
Accounting for Intercompany Transactions	3/31/2008	7/31/2004
Accounting for Loss Contingencies	12/18/2007	12/18/2007
Accounting for Regulated Entities (SFAS No. 71)	12/17/2007	12/1/2004
Accounting for Risk Management and Hedging Activities	12/17/2007	12/1/2004
Accrual Guidelines	3/31/2008	3/31/2003
Documentation and Consultation for Significant Accounting and Reporting Matters	3/31/2008	9/1/2003
Financial Statement Disclosure of Related Party Transactions	3/31/2008	12/15/2004
Form 8-K Requirements and Filing Procedure	1/1/2008	8/23/2004
Journal Entry Creation and Approval Requirements for Non-System Generated Journals	3/1/2008	9/30/2003
Other Comprehensive Income Accounting Procedures	3/1/2007	12/31/2003
Preparing & Reviewing Financial Schedules, Statements, or Reports	2/1/2008	3/31/2004
Property/Business Interruption Reserve Eliminations in Consolidation	3/31/2008	12/31/2004
Reclassification of Realized Income Statement Activity in Consolidation - Net vs. Gross	4/1/2007	9/30/2003
Revenue and Accounts Receivable		8/31/2000
Revenue Recognition	12/17/2007	12/1/2004
Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues, New Accounting Guidance, and Significant Non-recurring Entries	3/31/2008	7/1/2004
U.S. GAAP Compliance Checklist	3/31/2008	12/1/2004
Expenditures		
Accounts Payable and Imprest Petty Cash	7/11/2006	8/31/2000
Approval of Annual Budget	4/1/2008	8/31/2000
Approval of Business Transactions	4/1/2008	7/1/2000
Check Signing	4/1/2006	8/31/2000
Contract Administration Policy		7/1/2008
Delegation of Authority	1/1/2008	8/31/2000
Delegation of Authority - International Employees	1/30/2008	8/31/2000
Employee Expenses	7/1/2008	8/31/2000
Purchasing Controls Policy	4/1/2008	3/31/2004
Purchasing Authority Policy	1/1/2008	1/1/2008
External Auditor		
Engaging the Independent Auditor for Services	12/12/2007	4/24/2003
Hiring Policy for Employees and Former Employees of the External Auditor	2/1/2008	4/24/2003
Fixed Assets		
Property, Equipment and Inventory Policy		8/31/2000
Other Internal Controls		
Creation, Dissolution or Restructuring of Legal Entities and Subsidiaries	3/15/2008	3/25/2004
Disclosure Controls and Procedures Overview	1/1/2008	1/1/2008
Disclosure Committee Charter	2/1/2008	
Sarbanes-Oxley Change Control	9/15/2007	10/1/2004
Payroll		
Payroll Policy		8/31/2000
Risk Management		
Business Continuity and Crisis Management Policy	6/1/2007	7/1/1998
Commodity Risk Management	4/1/2006	5/24/2004
Credit Policy	5/1/2008	7/15/2003
Credit Delegation of Authority Policy (Formerly Credit Risk Limits)	5/1/2008	4/1/2006
Loan Policy	4/1/2006	1/7/2002
Summary of Internal Controls and Financial Controls Policies		
Summary of Internal Controls and Financial Controls Policies		12/16/2004
Taxes		
Accounting for Income Taxes	3/31/2008	6/30/2004
Property Tax	3/31/2007	8/31/2000
Relations with Tax Authorities	3/31/2008	8/31/2000
Sales/Use and Excise Tax	11/1/2007	8/31/2000
Tax Reserves Policy	3/31/2007	12/31/2004

Account Analysis and Reconciliation Policy

Applicability:	Applies to Enterprise
Originator:	Corporate Controller
Approval:	Corporate Controller
Effective Date:	04/30/2001
Revision Date:	03/31/2008
Reissue Date:	03/31/2008

Statement of Purpose and Philosophy

The purpose of this Policy is to provide guidelines for analyzing and reconciling balance sheet account balances. Routine account analysis and reconciliation is a foundation for strong internal controls and ensuring an accurate general ledger and financial statements. This Policy is applicable to all Business Units/Corporate Areas.

Policy Expectations

- Each Business Unit/Corporate Area should ensure account analysis and reconciliation procedures, at a minimum, comply with the requirements of this Policy.

Accountabilities: Roles and Responsibilities

Corporate Controller's Department

- Maintain a policy for account analysis and reconciliation processes to help ensure that Business Units/Corporate Areas maintain accurate general ledger and financial statement account balances.
- Internal Controls reviews overrides to this Policy for reasonableness and, if appropriate, reports to Corporate Controller.
- Corporate Controller reviews and approves, if appropriate, requests for an exception to this Policy.

Business Units/Corporate Areas

- Ensure the appropriate individuals in the Business Unit/Corporate Area are aware of and comply with the requirements of this Policy
- Implement routine account analysis and reconciliation procedures sufficient to ensure balance sheet accounts and financial statements are accurate, including reconciling to supporting schedules and documentation which substantiate ending balances.
- Ensure account analysis and reconciliations, and necessary corrections, are completed in a timely manner. Reconciliations shall be performed by the last business day of the month following the General Ledger month for which accounts are being reconciled, e.g., March General Ledger account balances shall be reconciled by the last business day in April.
- Maintain adequate documentation to support account balance, account reconciliation, and management review process.
- Reconcile High Risk Accounts on a monthly basis.

- Reconcile Low Risk Accounts at least every three months.
- Define each account as either High Risk or Low Risk and maintain documentation *supporting the rationale for such classification. See the "Standards and Requirements"* section below for the definition of High Risk Accounts and Low Risk Accounts. It is anticipated that High Risk Accounts and Low Risk Accounts would be a subset of the Chart of Accounts.
- Perform account reconciliations at the General Ledger (GL) account chartfield level, or a level that includes more that one GL account chartfield where the activity in the grouping of accounts is similar and can be reconciled together.
- Ensure the account reconciliation documentation is reviewed by management, or management designee, as evidenced by a signature and date. Each Business Unit/Corporate Area is responsible for maintaining this documentation.
- Ensure the "Exceptions Report - Unreconciled Accounts" report is accurate and timely, and management adequately monitors results and implements corrective actions, as necessary.
- Use the "Exceptions Report - Unreconciled Accounts" report to notify the Corporate Controller (submit reports to Internal Controls) of any exception items, Accounts Not Analyzed and/or Accounts Not Current, as described in the *Guidelines section below* that meet the following thresholds for the applicable registrant:

Entities	Threshold (in dollars)
Duke Energy Carolinas, LLC and subsidiaries	$3,000,000
Duke Energy Indiana, Inc. and subsidiaries	$1,000,000
Duke Energy Ohio, Inc. and subsidiaries	$1,000,000
All other Duke Energy Corporation subsidiaries	$6,500,000

Business Unit/Corporate Areas may adopt, at their discretion, lower reporting thresholds. In addition, for administrative ease, Business Units/Corporate Areas may adopt one reporting threshold. However, the threshold adopted for any entity can not be higher than the amounts indicated above. For example, the threshold for Duke Energy Ohio, Inc. and subsidiaries can not be higher than $1 million.

This exception report must be submitted to Internal Controls by the last business day of each month. Report exception items on a GL account chartfield basis.

If there are no exceptions to report, indicate such positive affirmation, to Internal Controls by the last business day of each month.

- Send Policy exception requests to Internal Controls, Corporate Controller's Department. See attached "Request for Ongoing Exception to Policy" for the form to use to request a Policy exception.

<u>Standards and Requirements</u>

- <u>Account Definition</u> - Each balance sheet account should be described adequately to enable a clear determination of proper transactions in the account.

- Comparative and Trend Analysis - Comparative metrics, such as dollar or percent change, or other appropriate measures, should be established to identify significant account fluctuations that need accelerated detail journal analysis. If unusual comparisons or trends cannot be reasonably explained, closely review transactions to identify and correct errors. Metrics should be easily generated and updated.
- Documentation - Documentation should be maintained to support the amounts in accounts, analysis and reconciliation of each account, correcting entries, and the management review process.
- Electronic Reconciliations - The reconciliation process must be documented for an automated reconciliation performed using software applications or computer programs. Management must review and approve the automated process to ensure that the appropriate controls are in place to perform an adequate reconciliation. The electronic reconciliation must be reviewed to ensure that the reconciliation was performed adequately. At a minimum, print summary documentation to provide evidence of the reconciliation. Documentation should be maintained to support that the electronic reconciliation was reviewed for adequate reconciliation and must be signed and dated by management or their designee.
- Frequency - Balance sheet accounts must be routinely analyzed or reconciled at least quarterly to ensure accuracy of financial statements. High Risk Accounts should be analyzed or reconciled monthly.
- High Risk Accounts - Accounts which should be reconciled on a monthly basis even if the balance contained in the accounts is below the applicable registrant materiality threshold level (see Materiality Thresholds), e.g., Cash and Cash Equivalents, Trading and Hedging Accounts, and Clearing Accounts and accounts with subsidiary ledgers. Business Units/Corporate Areas will define which accounts are high risk for their unit/area. In addition to account balance, other factors which Business Unit/Corporate Areas may consider when defining the risk of an account may include the nature of the account, complexity of transactions, volume of transactions, variability of account balance, regulatory and audit impacts, and other factors deemed applicable. Business Units/Corporate Areas must maintain documentation of accounts deemed to be high risk which includes the rationale used to classify accounts as High Risk Accounts.
- Low Risk Accounts - Accounts which contain activity deemed to be of a low risk nature that can be reconciled on a quarterly basis, even if the balances are greater than the applicable registrant materiality threshold (see Materiality Thresholds) level, e.g., accounts which contain balances which amortize on a prorated basis. Business Units/Corporate Areas will define which accounts are low risk for their unit/area. In addition to account balance, other factors which Business Unit/Corporate Areas may consider when defining the risk of an account may include the nature of the account, complexity of transactions, volume of transactions, variability of account balance, regulatory and audit impacts, and other factors deemed applicable. Business Units/Corporate Areas must maintain documentation of accounts deemed to be Low Risk which includes the rationale used to classify accounts as Low Risk Accounts.
- Materiality Thresholds – For purposes of classifying an account as either High Risk or Low Risk, the following materiality thresholds should be considered for each registrant:

Entities	Threshold (in dollars)
Duke Energy Carolinas, LLC and subsidiaries	$10,000,000
Duke Energy Indiana, Inc. and subsidiaries	$3,500,000
Duke Energy Ohio, Inc. and subsidiaries	$4,000,000
All other Duke Energy Corporation subsidiaries	$22,000,000

- General Ledger Reports - Printing details of general ledger balances and activity alone (i.e. Roll-Forward Analysis) does not represent reconciling an account.
- Specific Assignment - Responsibility for analysis of each balance sheet account should be assigned to specific individuals.
- Subsidiary Ledgers - Accounts with subsidiary ledgers must be reconciled to the sub-ledger balance at least monthly. For systems with large transaction volumes, daily reconciliation may be a necessary control. Depending on the number of sub-accounts, sub-ledgers can be very large, or as simple as a one-page spreadsheet.

Guidelines

- Report the following items on the Exceptions Report - Unreconciled Accounts.
    - Accounts Not Analyzed - partially unknown content or unidentified out-of-balance between the balance sheet account and supporting documents or ledger.
    - Accounts Not Current - accounts (a) that contain identified transactions that do not belong in the account, or b) where required control activities have not taken place (i.e., bank reconciliations or 3rd party confirmations), or c) which are clearing accounts that are not expected to clear by year-end.
- Calculated Accounts - Calculated accounts are usually reconciled by reviewing the calculation, such as known basis amount times a predetermined rate.
- Clearing Accounts - Clearing accounts should be analyzed by documenting estimated or calculated future transactions including loading or clearing rates to determine the estimated month of account balance clearance to zero balance. Rates should be adjusted or entries made to clear significant account balances by each quarter-ending month.
- Deferred Debits/Credits - All items comprising the balance should be listed, with each item identified by nature of item, contact name, and anticipated time of resolution. Asset accounts, including Goodwill, must also be routinely analyzed for impairment when warranted by relevant circumstances.
- External Source Accounts - External source accounts must be reconciled to the outside source or statement. For example, cash accounts must be reconciled to checkbooks and bank statements monthly.
- Intercompany Accounts - During the reconciliation process, account owners should coordinate with affiliate account owners to ensure accurate account balances.
- Physical Assets - Physical assets that can be inventoried are considered reconciled if there is a process in place to periodically verify and correct asset quantities to physical counts. In some cases estimates are used (such as aerial surveys for coal inventory). Accounts must also be routinely analyzed for impairment when warranted by relevant circumstances.
- Receivables and Payables - Receivables and payables balances must be reconciled to sub-ledgers that provide a detail list of each account name and amount. Aging schedules should be maintained, and a routine process should be in place to write-off or escheat as appropriate. In some cases, estimates must be used, for example accounts receivables for unread meters.
- Reserve Accounts - Appropriate documentation must be maintained to justify the balance. For example, bad debt reserves may equal a percentage of accounts receivable; injuries and damages reserve may be supported by known claims and estimated claims based on historical experience.
- Roll-Forward Accounts - Roll-forward accounts should be analyzed by reviewing monthly transactions for appropriateness and confirming that the beginning balance plus appropriate monthly transactions equals the ending balance. Roll-forward accounts should be limited to accounts for which the activity in the accounts is determined by entries booked to other accounts (example: Equity). Any accounts which contain balances which can be substantiated by supporting schedules or documentation should not be classified as roll-forward accounts.
- Unamortized Balances - Unamortized balances can be reconciled by comparing the account balance to a monthly amortization rate and the remaining number of months.

Accounting for Asset Impairments, Assets Held for Sale and Discontinued Operations, Including Equity Method Investments (SFAS No. 144 and APB No. 18)

Applicability:	Applies to Enterprise
Originator:	Corporate Controller
Approval:	Corporate Controller
Effective Date:	12/01/2004
Revision Date:	12/17/2007
Reissue Date:	12/17/2007

Statement of Purpose and Philosophy

The purpose of this policy is to provide guidelines related to the accounting and disclosure of asset impairments and assets held for sale as well as the presentation of discontinued operations for long-lived assets under the provisions of Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), and for investments accounted for using the equity method under the provisions of Accounting Principles Board ("APB") Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" ("APB No. 18"). Duke Energy is committed to preparing and providing financial information with the utmost integrity. To facilitate this corporate value, the Corporate Controller's Department will approve policies to ensure the accuracy of books and records (as detailed in the Code of Business Ethics).

Policy Expectations and Scope

The intent of this policy is to communicate the financial accounting and reporting for impairments, assets held for sale and discontinued operations under SFAS No. 144 and APB No. 18. This policy contains a high-level summary of the key requirements of U. S. GAAP as it applies to Duke Energy, including any significant interpretations or policy elections made by Duke Energy, but is not intended to be a substitute for the detail requirements of authoritative GAAP literature for specific issues or matters that may arise.

Except for equity method investments, this policy does not apply to assets that are scoped out of SFAS No. 144 (e.g., goodwill; investments in debt and equity securities accounted for under the cost method, under SFAS No. 114, "Accounting by Creditors for Impairment of a Loan" or SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities;" or instruments accounted for under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended ("SFAS No. 133")). Furthermore, reference is made to the accounting policy entitled "Accounting for Regulated Entities (SFAS No. 71)" which provides additional guidance for monitoring regulatory assets for recoverability.

Examples of assets subject to the accounting and reporting requirements of SFAS No. 144 include:

- Property, plant and equipment
- Assets under capital leases of lessees
- Long-lived assets of lessors subject to operating leases
- Intangibles subject to amortization
- Long-term prepaid assets

This policy is applicable to all business/corporate units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company"), and should help ensure consistent application of the accounting rules for asset impairments, assets held for sale, and discontinued operations classification across the consolidated Duke Energy group.

Materiality

FASB Statements note that "The provisions of this Statement need not be applied to immaterial items." Accordingly, materiality should be considered when applying this policy. However, materiality must be assessed at the business/corporate unit level, as well as at the consolidated level(s), and involves consideration of both quantitative as well as qualitative factors. Any questions regarding materiality should be directed to the Corporate Controller's Department.

Accountability: Roles and Responsibilities

Corporate Controller's Department -

- Maintain an accounting policy for "Accounting for Asset Impairments, Assets Held for Sale and Discontinued Operations, Including Equity Method Investments (SFAS No. 144 and APB No. 18)" available on the Duke Energy portal to help ensure by policy that business/corporate units are aware of the criteria in order to record impairments, classify an asset as held for sale and record discontinued operations under SFAS No. 144 and APB No. 18.
- Establish and communicate the reporting timetable for information needed for SEC filings regarding SFAS No. 144 and APB No. 18 and accumulate the information reported by the business/corporate units for periodic reporting and disclosure purposes (e.g. Form 10-K, Form 10-Q, etc.).
- Determine the presentation of assets held for sale on a consolidated basis at each reporting period.
- Provide guidance/assistance to business/corporate units on the classification and disclosure of assets held for sale and discontinued operations in accordance with SFAS No. 144 and APB No. 18.
- Provide guidance on the consideration of materiality as may be requested by the business/corporate units.
- Coordinate with the business/corporate units to assess the need to file a Form 8-K for any material asset impairments.

Business/Corporate Unit -

- Monitor for impairment indicators.
- Ensure that any required recoverability/impairment analyses for assets to be held and used and any investments accounted for using the equity method are performed in a timely manner and that the appropriate support/documentation is prepared and retained for the analyses.
- Ensure all reporting requirements of assets held for sale are accumulated and reported to the Corporate Controller's Department in accordance with the established reporting timetable.

- *Ensure proper support/documentation exists for the six criteria which must be met in order to classify assets as held for sale.*
- Ensure proper support/documentation exists for the determination of fair value of the assets classified as held for sale, including support for the discount rate used if a discounted cash flow approach is used to determine fair value.
- Ensure that appropriate consideration is given to discontinued operations presentation when assets are disposed of or classified as held for sale.
- Notify the Corporate Controller's Department upon determining that any asset impairment exists and coordinate with the Corporate Controller's Department to assess the need to file a Form 8-K for any material asset impairments.

Standards/Requirements/Background Information

[NOTE: In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value in US GAAP, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements; however SFAS No. 157 amends some of the accounting pronouncements discussed in this policy and therefore, the application of SFAS No. 157 may change Duke Energy's current practice for determining fair values for the areas of accounting covered by this policy. For Duke Energy, SFAS No. 157 is effective as of January 1, 2008 and must be applied prospectively except in certain cases. This version of this accounting policy does not reflect the provisions of SFAS No. 157 since the reissue date of this policy predates the effective date of SFAS No. 157.]

This section primarily contains references to, and excerpts from, the most significant or applicable GAAP authoritative literature. Matters specific or unique to Duke Energy are primarily discussed in the "Accounting Policy" section below.

Background

In August 2001, the FASB issued SFAS No. 144, which superseded the previous asset impairment provisions of SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" ("SFAS No. 121"), and the discontinued operations classification provisions of APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions". SFAS No. 144 requires a long-lived asset to be periodically evaluated for impairment under a held and used model. An asset (asset group) which meets certain criteria to be classified as held for sale is measured at the lower of its carrying amount or fair value less cost to sell and depreciation (amortization) of the asset is ceased. Additionally, subject to meeting certain criteria, a *component of an entity* (as defined - see "Discontinued Operations Presentation" section below), which has been sold or classified as held for sale, is presented as discontinued operations in the Statement of Operations.

The guidance on accounting for equity method investments is included in APB No. 18, which has been in effect since 1971.

Supporting Guidance

This section contains discussions of the following topics:

- Long-Lived Assets to be Held and Used
- Long-Lived Assets to be Disposed Of Other Than by Sale
- Long-Lived Assets to be Disposed Of by Sale
- Equity Method Investments
- Discontinued Operations Presentation
- SEC Form 8-K Reporting Requirements

This section primarily contains references to, and excerpts from, the most significant or applicable GAAP authoritative literature. Matters specific or unique to Duke Energy are primarily discussed in the "Accounting Policy" section below.

Long-Lived Assets to be Held and Used

A long-lived asset held and used (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances which may require an asset (asset group) to be tested for recoverability (note that the following are only examples and is not an "all inclusive" listing of circumstances) (paragraph 8 of SFAS No. 144):

a. A significant decrease in the market price of a long-lived asset (asset group)
b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator
d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)
e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)
f. A current expectation that, *more likely than not,*[1] a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

[1]The term *more likely than not* refers to a level of likelihood that is more than 50 percent.

A long-lived asset (asset group) is not recoverable if its carrying amount (book value) exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). If a long-lived asset (asset group) is not recoverable, it is impaired and an impairment loss shall be recognized only if the carrying amount (book value) of the asset (asset group) exceeds its fair value. Such impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value (paragraph 7 of SFAS No. 144). An impairment loss recognized for a long-lived asset (asset group) to be held and used shall be included in income from continuing operations before income taxes, and also reflected in operating income if such a subtotal is presented in the Statement of Operations.

Grouping of Assets for Recognition and Measurement of Impairment (Asset Group) (paragraphs 10-13 of SFAS No. 144)

For purposes of recognition and measurement of an impairment loss, a long-lived asset or assets shall be grouped with other assets and liabilities (an asset group) at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. However, an impairment loss, if any, that results from applying SFAS No. 144 shall reduce only the carrying amount of a long-lived asset or assets of the group, on a pro-rata basis using the relative carrying amounts of those assets. SFAS No. 144 prohibits entities from reversing impairment losses should facts and circumstances change in the future. In addition, future depreciation would be based on the asset's new cost basis.

In limited circumstances, a long-lived asset (for example, a corporate headquarters facility) may not have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities and of other asset groups. In those circumstances, the asset group for that long-lived asset shall include all assets and liabilities of the entity.

Goodwill shall be included in an asset group to be tested for impairment only if the asset group is or includes a reporting unit (the term "reporting unit" is defined in SFAS No. 142, "Goodwill and Other Intangible Assets ("SFAS No. 142")," as the same level as or one level below an operating segment (as that term is defined in paragraph 10 of SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information"). SFAS No. 142 requires that goodwill be tested for impairment at the reporting unit level). Goodwill shall not be included in a lower-level asset group that includes only part of a reporting unit. Estimates of future cash flows used to test that lower-level asset group for recoverability shall not be adjusted for the effect of excluding goodwill from the group.

Regarding goodwill, paragraph 29 of SFAS No. 142 notes the following regarding the proper sequencing when goodwill and another asset are being assessed for impairment at the same time:

"29. If goodwill and another asset (or asset group) of a reporting unit are tested for impairment at the same time, the other asset (or asset group) shall be tested for impairment before goodwill. For example, if a significant asset group is to be tested for impairment under Statement 144 (thus potentially requiring a goodwill impairment test), the impairment test for the significant asset group would be performed before the goodwill impairment test. If the asset group was impaired, the impairment loss would be recognized prior to goodwill being tested for impairment."

Other than goodwill, the carrying amounts of any assets (such as accounts receivable and inventory) and liabilities (such as accounts payable, long-term debt, and asset retirement obligations) not covered by SFAS No. 144 that are included in an asset group shall be adjusted in accordance with other applicable generally accepted accounting principles prior to testing the asset group for recoverability.

Estimates of Future Cash Flows for Recoverability (paragraphs 16 and 17 of SFAS No. 144)

Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset (asset group).

Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall incorporate the entity's own assumptions about its use of the asset (asset group) and shall consider all available evidence. If alternative courses of action to recover the carrying amount of a long-lived asset (asset group) are under consideration or if a range is estimated for the amount of possible future cash flows associated with the likely course of action, the likelihood of those possible outcomes shall be considered. A probability-weighted approach may be useful in considering the likelihood of those possible outcomes. Such future cash flows used to test the recoverability of a long-lived asset (asset group) to be held and used are <u>undiscounted</u>.

Practicable Considerations in Preparing Estimates of Future Cash Flows for Recoverability

- General Considerations - the assumptions used in estimating future cash inflows should be reasonable in relation to the assumptions used in developing other information used for comparable periods, such as internal budgets and projections and accruals related to incentive compensation plans.
- Cash Flow Estimation Period - The cash flow estimation period should be based upon the long-lived asset's remaining useful life to the entity. Thus, the process of estimating a long-lived asset's remaining useful life is very important because it directly impacts the number of periods over which operating cash flows are to be estimated in performing a recoverability test. When long-lived assets are grouped for purposes of performing the recoverability test, the remaining useful life of the asset group should be based upon the useful life of the "primary asset." The "primary asset" is defined as the principal long-lived tangible asset being depreciated or identifiable intangible asset being amortized that is the most significant component asset from which the group derives its cash-flow-generating capacity. A primary asset of an asset group therefore cannot be land or an intangible asset not being amortized. Factors that an entity should consider in determining whether a long-lived asset is the primary asset are: a) whether other assets of the group would have been acquired by the entity without the asset, b) the level of investment that would be required to replace the asset, and c) the remaining useful life of the asset relative to other assets of the group.
- Asset-Related Expenditures - For a long-lived asset (group) that is "held and used," estimates of future cash flows used to test for recoverability shall be based on the existing service potential (i.e., "as is") of the "primary asset" on the date it is tested. Therefore, estimates of future cash flows used in that test should exclude the cash flows associated with asset-related expenditures that would enhance the existing service potential of the "primary asset" that is in use. The cash flow estimates would include cash flows (including estimated salvage values) associated with future expenditures necessary to maintain the existing service potential, including those that replace the service potential of component parts of a long-lived asset or component assets (other than the primary asset) of an asset group.
- Generally, debt should not be included in an asset group because the lowest level of identifiable cash flows will typically not include cash flows associated with debt (i.e., the principal payments associated with the debt). However, in rare instances, if the lowest level of identifiable cash flows includes cash flows associated with debt principal payments and it is not practical to eliminate those cash flows (which would be more likely to occur when the asset group is a business or reporting unit), then the debt should be included in the asset group (i.e., netted with the carrying amounts of the assets of the group) so as to maintain an appropriate comparison. This basis adjustment provides the same result as if the debt principal payments have been excluded (e.g., debt with a carrying value of $100, would have undiscounted cash flows of $100). SFAS No. 144 prohibits the inclusion of interest expense in assessing the recoverability of long-lived assets.
- End of Estimation Period Cash Flows - because a long-lived asset's value is not depleted over its depreciable life, assuming proceeds on sale in cash flow estimates is appropriate.

SFAS No. 144 does not contain specific guidance on whether the expected undiscounted cash flows should include or exclude income taxes. The following guidance on estimates of future cash flows is contained in SFAS No. 144:

"Estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset (asset group). Those estimates shall exclude interest charges that will be recognized as an expense when incurred."

The following interpretation of this issue is from KPMG:

"QIIB10. Should an entity perform the recoverability test using pre-tax or after-tax cash flows?

In Statement 144, as in Statement 121, the Board did not address the issue of whether estimates of future cash flows used to test recoverability of an asset should include or exclude income taxes. Generally, an entity performs the recoverability testing using pre-tax cash flows because the carrying amounts of the tested long-lived assets are pre-tax. That is, any tax-related consequences of the asset are included in the entity's deferred tax assets and liabilities. Deferred tax amounts related to a long-lived asset generally are not included in the carrying amount of the asset when testing that asset for recoverability under Statement 144.

We believe that an entity should make an accounting policy election to use either pre-tax or after-tax cash flows when testing its long-lived assets for recoverability. In some situations, an exception to a policy to use pre-tax cash flows may be appropriate. For example, we believe that an entity should use after-tax cash flows to test the recoverability of an asset if the asset's tax characteristics strongly influenced the entity's decision to invest in that asset. An example of an asset with that type of tax characteristic is a direct investment in affordable housing (the investor's return depends significantly on income tax credits generated by the investment)."

Additionally, Aspen Publishing's (CCH) Accounting Research Manager has a similar interpretation:

"7-6. Inclusion of Income Taxes in Statement 144 Analyses

(a) Inclusion of Income Taxes in Undiscounted Cash Flows

Question: Statement 144 is silent on the issue of income taxes. Should income taxes be considered in the future cash flows of an asset for purposes of determining whether the carrying amount of an asset is recoverable?

Response: Even though Statement 144 does not require income taxes to be considered in an entity's estimate of expected future cash flows for purposes of the undiscounted recoverability test, the test would normally yield a similar result regardless of whether income taxes are included or excluded as demonstrated below...

The following example demonstrates that the undiscounted cash flow recoverability test for Asset Z results in the same answer on both a pretax and after-tax basis. Three scenarios are used in the example where the pretax undiscounted cash flows are varied to be more than the carrying amount of the asset (Scenario A), equal to the carrying amount of the asset (Scenario B), or less than the carrying amount of the asset (Scenario C).

Assumptions:	Scenario A	Scenario B	Scenario C
Book carrying amount of Asset Z (a)	10,000	10,000	10,000
Tax basis of Asset Z (e)	6,000	6,000	6,000
Temporary difference	4,000	4,000	4,000
Deferred tax liability (assuming 40% tax rate) (b)	1,600	1,600	1,600
Pretax undiscounted cash flows (c)	11,000	10,000	9,700
Pretax Comparison:			
Pretax undiscounted cash flows	11,000	10,000	9,700
Book carrying amount	10,000	10,000	10,000
Impairment?	**No**	**No**	**Yes**
After-tax Comparison:			
Pretax undiscounted cash flows (c)	11,000	10,000	9,700
Future taxes payable (see (d) below)	2,000	1,600	1,480
After-tax cash flows [(c) - (d)]	9,000	8,400	8,220
Book carrying amount less deferred tax liability [(a) - (b)]	8,400	8,400	8,400
Impairment?	**No**	**No**	**Yes**

Calculation of future taxes payable:

Pretax undiscounted cash flows (c)	11,000	10,000	9,700
Depreciation deductions (e)	6,000	6,000	6,000
Future taxable income	5,000	4,000	3,700
Income taxes payable (assuming 40% tax rate) (d)	2,000	1,600	1,480

Note that when performing the after-tax comparison, the book carrying amount must be reduced by the deferred tax liability to arrive at the appropriate amount to compare to the after-tax cash flows."

The above example applies to a taxable entity (e.g., a C corporation). Consideration of the specific facts and circumstances would need to be given for a non-taxable entity (e.g., a limited liability corporation or a partnership). For example, a non-taxable entity that is not a party to any tax sharing agreement and does not provide for income taxes in its financial statements should likely perform the impairment assessment without regard to income tax implications. On the other hand, the implications for a non-taxable entity that is a party to a tax sharing agreement and therefore provides for income taxes in its financial statements would likely be similar to those for a taxable entity.

Determination of Fair Value (paragraphs 22 and 23 of SFAS No. 144)

Note – as discussed on page 3 above, the following excerpts do not reflect amendments by SFAS No. 157 which are effective January 1, 2008.

The fair value of an asset (liability) is the amount at which that asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. The fair value of an asset group or a disposal group refers to the amount at which the group as a whole could be bought or sold in a current single transaction. Therefore, the fair value of the group would not necessarily equate to the sum of the fair values of the individual assets and liabilities of the group.

Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the fair value measurement, if available. However, in many instances, quoted market prices in active markets will not be available for the long-lived assets (asset groups) covered by SFAS No. 144. In those instances, the estimate of fair value shall be based on the best information available, including prices for similar assets (groups) and the results of using other valuation techniques.

A present value technique is often the best available valuation technique with which to estimate the fair value of a long-lived asset (asset group). FASB Concepts Statement No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements," discusses the use of two present value techniques to measure the fair value of an asset (liability). The first is expected present value, in which multiple cash flow scenarios that reflect the range of possible outcomes and a risk-free rate are used to estimate fair value. The second is traditional present value, in which a single set of estimated cash flows and a single interest rate (a rate commensurate with the risk) are used to estimate fair value. Either present value technique can be used for a fair value measurement. However, for long-lived assets (asset groups) that have uncertainties both in timing and amount, an expected present value technique will often be the appropriate technique.

Whether or not cash flows from derivative instruments designated in qualifying cash flow hedges under SFAS No. 133, should be considered in determining whether the carrying value of a long-lived asset is recoverable under SFAS No. 144 has been addressed in the following interpretation included in Aspen Publishing's (CCH) Accounting Research Manager:

"7-13. Interaction Between Statement 133 and Statement 144

Question: May cash flows from derivative instruments designated in qualifying cash flow hedges under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, be considered in determining whether the carrying value of a long-lived asset is recoverable under paragraph 7 of SFAS No. 144?

Response: No. Paragraph 34 of SFAS No. 133 requires that companies apply impairment provisions of generally accepted accounting principles each period after applying hedge accounting for the period. Paragraph 34 of SFAS No. 133 *prohibits a company from considering* the fair value or expected cash flows of a hedging instrument in applying impairment provisions of other GAAP.

Under SFAS No. 144, certain circumstances may require a company to estimate the future cash flows it expects from an asset's use and its eventual disposition. Companies should not consider cash flows from derivative instruments designated in qualifying cash flow hedges under SFAS No. 133 when performing the recoverability test under paragraph 7 of SFAS No. 144. For example, when applying the test to an oil and gas property, the oil and gas producer's estimate of future cash flows should not include cash flows of derivative instruments designated in qualifying cash flow hedges of oil and gas sales related to the property.

However, if a company recognizes an impairment loss in accordance with Statement 144 for an asset to which hedged forecasted transactions relate, paragraph 35 of Statement 133 requires the company to reclassify into earnings any offsetting net gain from accumulated other comprehensive income."

Therefore, cash flows from recognized derivative instruments under SFAS No. 133 should not be included in determining whether the carrying value of a long-lived asset (asset group) is recoverable under SFAS No. 144. However, unrecognized derivative instruments (such as instruments being accounted for under the Normal Purchase and Normal Sale exception in SFAS No. 133) should be *evaluated on a facts and circumstances basis as to whether cash flows from such unrecognized* derivative instruments should be included in the undiscounted cash flows utilized to test the asset (asset group) for recoverability under SFAS No. 144.

Revision of Depreciation or Amortization Estimates (paragraph 9 of SFAS No. 144)

When a long-lived asset *(asset group) is tested for recoverability under* SFAS No. 144, it also may be necessary to review depreciation estimates or amortization periods for the long-lived asset (asset group).Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability. However, any change in the accounting method (e.g., the depreciation method being used) for the asset resulting from that review shall be made only after applying the provisions of SFAS No. 144.

Disclosure Requirements (paragraph 26 of SFAS No. 144)

The following information shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized:

a. A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment;
b. If not separately presented on the face of the statement, the amount of the impairment loss and the caption in the income statement or the statement of activities that includes that loss;
c. The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique); and,
d. If applicable, the segment in which the impaired long-lived asset (asset group) is reported under SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information."

Long-Lived Assets to be Disposed Of Other Than by Sale (paragraphs 27-29 of SFAS No. 144)

A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange for a similar productive long-lived asset, or in a distribution to owners in a spinoff) shall continue to be classified as held and used until it is disposed of. If an asset (asset group) that is to be exchanged for a similar productive long-lived asset (asset group) or distributed to owners in a spinoff is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur.

Long-Lived Assets to be Distributed in to Owners in a Spinoff

Long-lived assets (groups) to be exchanged or distributed to owners in a spinoff are considered disposed of when they are exchanged or distributed. Prior to the exchange or distribution, if the assets are tested for recoverability on a "held and used" basis, the undiscounted cash flows would be based on the use of the asset for its remaining useful life, assuming the disposal transaction will not occur. For example, if an entity has committed to a plan to distribute a long-lived asset (group) to owners in a spinoff but the distribution will not occur for several months and impairment indicators trigger a recoverability test, the cash flow estimates used in that test should assume the long-lived asset will be used over its remaining useful life (even though the distribution of the long-lived asset (group) is expected to occur in the near future).

Long-Lived Assets to be Disposed Of by Sale

A long-lived asset (disposal group) classified as held for sale shall be measured at the lower of its carrying amount or fair value less estimated costs to sell. Costs to sell are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made, including broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Additionally, a long-lived asset shall not be depreciated (amortized) while it is classified as held for sale.

The carrying amounts of any assets that are not covered by SFAS No. 144, including goodwill, that are included in a disposal group classified as held for sale shall be adjusted in accordance with other applicable generally accepted accounting principles prior to measuring the fair value less cost to sell of the disposal group.

Certain assets are specifically scoped out of SFAS No. 144 (including equity method investments, as discussed below). As there is no evidence that presentation of the assets scoped out of SFAS No. 144 to be sold was specifically contemplated, separate presentation of such assets on the face of the balance sheet (as held for sale), while not required, would not be prohibited. Duke Energy's position on this matter is addressed in the "Accounting Policy" section below.

Criteria for Classification as Held for Sale

A long-lived asset is only classified as held for sale in the period in which **all** of the following six criteria (paragraph 30 of SFAS No. 144) are met (commentary on meeting certain of the criteria has been added in *italics* below):

1. Management, having the authority to approve the action, commits to a plan to sell the asset (or group of assets, referred to as "disposal group").
    - *Management must be of the proper level and have the proper authority to be able to commit the entity to a plan to sell.*
    - *If Board approval is required, or management seeks such approval, in order to sell an asset, the entity has not committed to a plan to sell the asset until Board approval is granted (this position is consistent with that previously expressed by the SEC in Staff Accounting Bulletin Topic 5.P.1 (from SAB 100, which was ultimately deleted by SAB 103)). Executive management or Board approval of an overall budget or forecast that includes information on potential asset dispositions does not constitute approval for the purposes of this item if subsequent more detailed approval (e.g. individual asset dispositions) will be required. However, explicit Board approval to proceed with the sales of assets may constitute the requisite level of approval, depending upon the specific facts and circumstances, even if subsequent Board approval will be required under the Company's delegation of authority policy to execute a specific transaction.*
    - *Public announcements concerning an entity's consideration of selling do not meet the definition of "committing to a plan to sell the asset" if subsequent approval is required (such as from an executive committee or board of directors).*
2. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).
    - *Any requirement the Company may have to hold or operate the asset for a certain future period of time would not allow the asset to be available for immediate sale. As an example, if an entity did not intend to sell a property until certain renovations or improvements are completed (in order to increase the value), the asset would not be available for immediate sale until the renovations or improvements are completed. Additionally, any requirement of an entity to continue to operate an asset in order to complete pending customer orders would not allow the asset to be available for immediate sale.*
    - *Any third party requirements to hold or operate the facility for a certain period of time which are outside of the entity's control (such as pending regulatory approvals) would not preclude the asset from being available for immediate sale as long as it is expected the requirement or pending approval will not permanently delay the sale of the asset.*
3. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated.
    - *This would include engagement of investment bankers, deploying of internal staff to market the long-lived asset for sale, etc.*
4. The sale of the asset (disposal group) is probable (i.e. "likely to occur") and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as explained below:
    - *The term "recognition as a completed sale" is interpreted to mean the transaction meets the requirements to be recognized as a sale under the accounting literature, such as SFAS No. 66, "Accounting for Sales of Real Estate", within a one year timeframe.*

- *If delay beyond one-year is outside of the control of the company, held for sale classification may still be appropriate if any of the following conditions are met (the following are the specific items from paragraph 31 of SFAS No. 144):*
  - *If at the date an entity commits to a plan to sell a long-lived asset (disposal group) the entity reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (group) that will extend the period required to complete the sale <u>and</u> (1) actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained from the buyer and (2) a firm purchase commitment is probable within one year of the date an entity commits to a plan to sell the asset;*
  - *If an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a long-lived asset (disposal group) previously classified as held for sale that will extend the period required to complete the sale and (1) actions necessary to respond to the conditions have been or will be timely initiated and (2) a favorable resolution of the delaying factors is expected; or,*
  - *If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a long-lived asset (disposal group) previously classified as held for sale is not sold by the end of that period and (1) during the initial one-year period the entity initiated actions necessary to respond to the change in circumstances, (2) the asset (group) is being actively marketed at a price that is reasonable given the change in circumstances, and (3) the six criteria for classification as held for sale are met.*

5. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value.
   - *"Reasonable sales price" is interpreted as no greater than an asset's fair value*
   - *"Actively marketed" means that the asset (disposal group) is being marketed for sale by the Company. This can be directly by the Company through an offering memorandum, through investment bankers or brokers, etc.*
6. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If the above criteria in paragraph 30 of SFAS No. 144 are met after the balance sheet date but before issuance of the financial statements, a long-lived asset shall continue to be classified as held and used in those financial statements when issued (only classified as held for sale at the date the criteria above are met).

Subsequent Measurement (paragraph 37 of SFAS No. 144)

A loss shall be recognized for any initial or subsequent write-down to fair value less cost to sell. A gain shall be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized (for a write-down to fair value less cost to sell). The loss or gain shall adjust only the carrying amount of a long-lived asset, whether classified as held for sale individually or as part of a disposal group. A gain or loss not previously recognized that results from the sale of a long-lived asset (disposal group) shall be recognized at the date of sale.

Changes to a Plan to Sale (paragraphs 38 and 39 of SFAS No. 144)

If circumstances arise that previously were considered unlikely and, as a result, an entity decides not to sell a long-lived asset (disposal group) previously classified as held for sale, the asset (disposal group) shall be reclassified as held and used. A long-lived asset that is reclassified shall be measured individually at the lower of its (a) carrying amount before the asset (disposal group) was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset (disposal group) been continuously classified as held and used, or (b) fair value at the date of the subsequent decision not to sell.

Any required adjustment to the carrying amount of a long-lived asset that is reclassified as held and used shall be included in income from continuing operations in the period of the subsequent decision not to sell. That adjustment shall be reported in the same income statement caption used to report a loss.

Long-Lived Assets Acquired in a Purchase Business Combination (paragraph B87 of SFAS No. 144)

When long-lived assets newly acquired in a purchase business combination are classified as assets to be sold (disposal group), the purchase price allocation is to reflect this determination. SFAS No. 144 has the following discussion:

"A long-lived asset (disposal group) classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell, whether previously held and used or newly acquired. This Statement also requires that the results of operations of a disposal group classified as held for sale be recognized in the period in which those operations occur, whether reported in continuing operations or in discontinued operations."

Thus, the purchase price allocation would report the disposal group at the lower of its carrying amount or fair value less cost to sell. In the period the disposal group is sold (assuming it is a component of an entity), the respective results from operations would be reported in discontinued operations in the Statement of Operations.

Disclosure Requirements (paragraphs 46-48 of SFAS No. 144)

The disclosure requirements of an asset classified as held for sale are as follows:

- A long-lived asset classified as held for sale shall be presented separately in the balance sheet, if material. The assets and liabilities of a disposal group classified as held for sale shall be presented separately in the asset and liability sections, respectively, of the balance sheet, if material. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale shall be separately disclosed either on the face of the balance sheet or in the notes to financial statements. Additionally, classification of the assets and liabilities included in the disposal group should be considered between current and non-current.

- The following information shall be disclosed in the notes to the financial statements that cover the period in which a long-lived asset (disposal group) either has been sold or is classified as held for sale:
    a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group.
    b. The gain or loss recognized and if not separately presented on the face of the income statement, the caption in the income statement that includes that gain or loss.

c. *If applicable, amounts of revenue and pretax profit or loss reported in discontinued* operations.
d. *If applicable, the segment in which the long-lived asset (disposal group) is reported* under Statement 131.

If an entity subsequently decides to change the plan to sell the long-lived asset (disposal group), a description of the facts and circumstances leading to the decision to change the plan and its effect on the results of operations for the period and any prior periods presented shall be disclosed in the notes to financial statements that include the period of that decision.

<u>Equity Method Investments</u>

Impairment Assessment

The guidance for assessing investments accounted for under the equity method for impairment is included in paragraph 19(h) of APB No. 18:

"A loss in value of an investment which is other than a temporary decline should be recognized. Evidence of a loss in value might include, but would not necessarily be limited to, absence of an ability to recover the carrying amount of the investment or inability of the investee to sustain an earnings capacity which would justify the carrying amount of the investment. A current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors to be evaluated."

APB 18 does not provide any further guidance regarding how to assess a "loss in value." However, the SEC has commented on this matter more than once. For example, at the December 2002 AICPA Conference on Current SEC Developments, the SEC presentation included the following slide:

"Other Hot Topics

Impairment of Equity Method Investments

- Guidance – See paragraph 19(h) of APB 18
- Undiscounted cash flow methodology is not an appropriate means of assessing whether an equity method investment is impaired
- Trigger is "other than temporary" loss in value"

The SEC also commented on this matter at the March 2004 EITF meeting – the following is an extract from the minutes to that meeting:

"The SEC Observer stated that registrants should continue to rigorously assess equity method investments for impairment and indicated that the SEC staff will continue to object to inappropriate impairment analyses for such investments, for example a Statement 144 undiscounted cash flow approach."

The accounting literature does not expressly define what constitutes an "other than temporary" decline in value. However, the SEC has provided some observations on this topic in SEC Staff Accounting Bulleting Topic 5.M., "Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities" ("SAB Topic 5.M." or "SAB 59"). In SAB Topic 5.M., the SEC staff notes that "other than temporary" is not the same as "permanent" and provides the following guidance in assessing whether an impairment should be considered to be "other than temporary":

"There are numerous factors to be considered in such an evaluation and their relative significance will vary from case to case. The staff believes that the following are only a few examples of the factors which, individually or in combination, indicate that a decline is other than temporary and that a write-down of the carrying value is required:

a. The length of the time and the extent to which the market value has been less than cost;
b. The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or
c. The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

Unless evidence exits to support a realizable value equal to or greater than the carrying value of the investment, a write-down to fair value accounted for as a realized loss should be recorded."

SEC Accounting and Auditing Enforcement Release Nos. 309, 316, 370, and 422 provide factors to be evaluated in determining an other-than-temporary impairment in addition to those listed in SAB Topic 5.M, including:

- The condition and trend of the economic cycle,
- The issuer's financial performance and projections,
- Trends in the general market,
- The issuer's capital strength, and
- The issuer's dividend payment record.

Other specific adverse conditions at the investee level are further indicators of an other-than-temporary diminution in value, including:

- *Known liquidity crisis.*
- Bankruptcy proceedings.
- Going concern commentary in the auditor's report on the investee's most recent financial statements.

Financial Statement Presentation and Classification

As noted above, equity method investments are among the assets that are specifically scoped out of SFAS No. 144. APB No. 18 is silent regarding the presentation of any equity method investments to be disposed of. Paragraph 19(c) of APB No. 18 simply notes that the equity investments (e.g., investments in common stock) should be shown in the balance sheet as a single amount. As there is no evidence that presentation of an equity method investment to be sold was specifically contemplated, separate presentation of such assets on the face of the balance sheet (as held for sale), while not required, would not be prohibited. Duke Energy's position on this matter is addressed in the "Accounting Policy" section below.

See also the discussion of equity method investments in the "Discontinued Operations Presentation" section below.

Discontinued Operations

The results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations if both of the following conditions are met: (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction. For these purposes, a component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

The following is a Q&A from KPMG regarding what constitutes a component of an entity:

"QVI1. Can a disposal group that does not include assets within the scope of the impairment provisions of Statement 144 (because the impairment of those assets is addressed by other generally accepted accounting principles) be a component of an entity under paragraph 41?

A. Yes. Assets or groups otherwise outside the scope of Statement 144 for impairment recognition and measurement may represent a component of the entity and, if the asset or group meets the conditions in paragraph 42, qualify for discontinued operations display."

"Significant" continuing involvement is a lower hurdle or threshold than the concept of "substantial" continuing involvement contained in SFAS No. 66 to recognize a transaction as a sale. Therefore, it is possible that a transaction would meet the criteria to be recognized as a sale under SFAS No. 66 as the continuing involvement was not "substantial", but the criteria for classification as discontinued operations would not be met as the continuing involvement is considered "significant".

Additional operational guidance on the assessment of (1) the elimination of cash flows and (2) the significance of any continuing involvement is addressed in EITF Issue No. 03-13, "Applying the Conditions in Paragraph 42 of FASB Statement No. 144in Determining Whether to Report Discontinued Operations ("EITF Issue 03-13")," for which a final consensus was reached in late 2004. In the consensus, the EITF concluded that classification of a disposed component as a discontinued operation is appropriate only if the ongoing entity (1) has no "continuing direct cash flows" (a term Issue 03-13 introduces to interpret paragraph 42(a) of SFAS No. 144), and (2) does not retain an interest, contract, or other arrangement sufficient to enable it to exert significant influence over the disposed component's operating and financial policies after the disposal transaction (an interpretation of paragraph 42(b) of SFAS No. 144).

Paragraphs 13-15 of EITF Issue 03-13 provide an assessment period in which to evaluate whether a disposed component should be classified as a discontinued operation. The assessment period includes the earlier of (i) the date at which the component meets the criteria to be classified as held for sale or (ii) is disposed of, and continues through one year after the disposal date. Those paragraphs from EITF Issue 03-13 are presented below:

"**Assessment Period**

13. The Task Force reached a consensus that the appropriate assessment period should include the point at which the component initially meets the criteria to be classified as held for sale or is disposed of through one year after the date the component is actually disposed of. The assessment should be based on all facts and circumstances, including management's intent and ability to (a) eliminate the cash flows of the disposed component from its operations and (b) not have significant continuing involvement in the operations of the disposed component. For one year after a component has been disposed of, an entity should reassess whether the criteria in paragraph 42 are expected to be met only when significant events or circumstances occur that may change its current assessment. If the occurrence of a significant event or circumstance at any time during the assessment period results in an expectation that the criteria in paragraph 42 will not be met by the end of the assessment period, the component's operations should not be presented as discontinued operations. If the occurrence of a significant event or circumstance at any time during the assessment period results in an expectation that the criteria in paragraph 42 will be met by the end of the assessment period, the component's operations should be presented as discontinued operations. Reclassification into and out of discontinued operations for all periods presented may be required during the assessment period.

14. The assessment period may extend beyond one year after the component is actually disposed of in situations in which events or circumstances beyond an entity's control extend the period required to eliminate the direct cash flows of the disposed component or eliminate significant continuing involvement in the ongoing operations of the disposed component provided that the entity (a) takes the actions necessary to respond to those situations and (b) expects to eliminate the direct cash flows and the significant continuing involvement.

15. The evaluation of whether the criteria in paragraph 42 are expected to be met for a component that is either disposed of or classified as held for sale at the balance sheet date should include significant events or circumstances that occur after the balance sheet date but before the issuance of the financial statements. This evaluation is solely for the purposes of determining the presentation of discontinued operations pursuant to paragraph 42 of Statement 144 and does not apply to any other guidance in Statement 144."

The forward-looking considerations discussed in paragraph 13 of EITF Issue 03-13 include the need to assess any potential implications of any planned or potential purchases or acquisitions. For example, the Duke Energy North America ("DENA") discontinued operations assessment in the 3rd quarter of 2005 required the consideration of the potential implications of the trading operations intended following the proposed merger with Cinergy Corp. that was expected to close in the first half of 2006.

In a period in which a component of an entity either has been disposed of or is classified as held for sale, the income statement of a business enterprise (or statement of activities of a not-for-profit organization) for current and prior periods shall report the results of operations of the component, including any gain or loss recognized related to classification as held for sale, in discontinued operations. The results of operations of a component classified as held for sale shall be reported in discontinued operations in the period(s) in which they occur. The results of discontinued operations, less applicable income taxes (benefit), shall be reported as a separate component of income before extraordinary items and the cumulative effect of accounting changes (if applicable).

EITF Topic No. D-104, "Clarification of Transition Guidance in Paragraph 51 of FASB Statement No. 144," contains the flowing regarding the timing of discontinued operations presentation for a component of an entity to be liquidated or wound down:

"However, if, after Statement 144 is initially applied, a component of an entity will be abandoned through the liquidation or run-off of operations, that component should not be reported as a discontinued operation in accordance with Statement 144 until all operations, including run-off operations, cease."

Regarding significance, or materiality, assessments for discontinued operations presentation, in the basis for conclusions to SFAS No. 144 the FASB commented that one of the reasons for revising the guidance for accounting for discontinued operations was to broaden the disposal transactions presented as discontinued operations to include the results of operations of a component of an entity, as defined. The FASB concluded that the requirements for reporting discontinued operations should not focus on whether a component of an entity is significant or otherwise incorporate a quantitative criterion. Instead, those requirements should focus on whether a component of an entity has operations and cash flows that can be clearly distinguished from the rest of the entity, consistent with the stated objective of broadening the reporting of discontinued operations. Accordingly, the FASB likely anticipated that the materiality threshold for assessing presentation of discontinued operations would be relatively low.

If the disposal transaction or anticipated transaction meets the requirements for presentation as a discontinued operation before the balance sheet date, financial statements for prior periods must also be restated to reflect the discontinued operation. If a material disposal transaction or anticipated transaction meets the requirements for presentation as a discontinued operation <u>after</u> the balance sheet date, but prior to the issuance of the financial statements, the transaction should not be presented as a discontinued operation. Discontinued operations presentation is only appropriate in historical financial statements covering the period during which the discontinued operations presentation requirements are met.

Once the threshold for reporting discontinued operations for a reporting period has been crossed, and the discontinued operations line item(s) are included in the Statement of Operations, any previous dispositions that occurred during the reporting period that were not shown as discontinued operations due to materiality should be reassessed to determine if discontinued operations presentation is now appropriate. Unless the impact is de minimus, it is likely that discontinued operations presentation for any such items will be appropriate.

If a registration statement is filed after the date that a *transaction qualifies for discontinued* operations presentation, but prior to the time such transaction has been presented as a discontinued operation in the historical financial statements (e.g. included in filed financial statements), pro forma financial statements pursuant to Article 11 of Regulation S-X would be required, for all periods presented in the registration statement, if the transaction exceeds the significance threshold in Article 11. While such Article 11 pro forma financial statements are not required in the historical periodic 1934 Act filings (e.g. Forms 10-K and 10-Q), subsequent event disclosure of the transaction should be considered in those financial statements, if material. If a registration statement is filed after a current year transaction has been presented (included in filed financial statements with the SEC) as a discontinued operation, the historical financial statements for all periods included or incorporated by reference in the registration statement (e.g., three years plus any subsequent interim periods) would be required to be restated and reissued to reflect the transaction as a discontinued operation.

SFAS No. 144 specifically does not apply to investments in equity securities accounted for under the cost or equity method, and APB No. 18 does not address the topic of discontinued operations presentation. Additionally, it is unlikely that an investment accounted for under the cost or equity method would qualify as a 'component of an entity', as prescribed by SFAS No. 144. Operations and cash flows of an equity method investment usually cannot be clearly distinguished, operationally and for financial reporting purposes from the rest of an entity (the investor), and thus would not qualify as a disposal group. As pointed out in Deloitte & Touche's interpretations of SFAS No. 144, in November of 2001 the FASB Board clarified that the disposal of an equity method investment, by itself, should not be reported as a discontinued operation under SFAS No. 144, as paragraph 5 excludes investments in equity securities accounted for by the equity method from the scope of SFAS No. 144. Accordingly, unless it is part of a larger disposal group that represents a component of an entity, sale of an equity method investment usually would not be reported as a discontinued operation in the Statement of Operations.

Cash flows relating to discontinued operations are not required to be set out separately in the statement of cash flows, but they may be if the enterprise desires to do so. Whether or not cash flows from discontinued operations are set out separately, the reconciliation of net income to net cash flows from operations should begin with net income, as required by paragraphs 28 and 29 of SFAS No. 95, "Statement of Cash Flows."

Extraordinary items and the cumulative effect of changes in accounting principles are not allocated between continuing and discontinued operations. Accordingly, to the extent that the Company has either an extraordinary item or a change in accounting principle that relate to an entity or operation accounted for as discontinued operations for any of the periods presented, these items should continue to be presented at their full amounts, net of the related income tax effects, in their appropriate locations in the income statement and not reclassified into discontinued operations. Neither accounting changes nor extraordinary items are part of the normal operations of an entity; *therefore, their effects shall not be allocated between continuing operations and discontinued* operations.

Operations to be presented as discontinued may contain intercompany transactions with other business or corporate units (e.g., purchases from, or sales to, other units that will continue to be owned). SFAS No. 144 does not expressly address the treatment of intercompany accounts, but the matter is addressed in the following Deloitte & Touche interpretation of SFAS No. 144:

"INTERCOMPANY SALES TO A DISCONTINUED OPERATION

FASB 144: 43-5
[Issued February 14, 2003]
[Amended December 9, 2005]

Question

Company N is a paper manufacturing company with plants around the country. N owns a distribution business, Company X, who buys paper from N and then sells the paper to outside customers. N is planning to discontinue the operations of X and sell X to another paper manufacturer. N has appropriately eliminated the intercompany sales between itself and X, and therefore, only recognizes the sales from X to the customers.

X will continue to purchase paper from N to sell to outside customers. Therefore, N will continue to have sales to X that will not be eliminated once it is no longer a related party. N has analyzed the significance of the continuing cash flows pursuant to EITF Issue No. 03-13, "Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations," and has concluded that the continuing cash flows are not significant. Therefore, X will be classified as discontinued operation in the second quarterfinancial statements.

May the intercompany sales between N and X that have not been passed on to outside customers remain in continuing operations?

Answer

Yes, the sales from N to X that have not been passed on to outside customers should be shown in the continuing operations of N.

For example: N sells paper to X for $6 with a cost of $4. N's profit is $2. X sells paper to outside customers for $7 with a cost (X's purchase price from N) of $6. X's profit is $1. In the consolidated financial statements of N, the intercompany sales of $6 will be eliminated along with the $6 cost of sales, leaving a profit of $3. The $3 margin will come through as $2 in continuing operations (representing the sales from N to X) and $1 in discontinued operations (representing the sales from X to the outside customers). Next year (assuming the same facts) when N sells paper to X, it will have the same $6 sale, $4 cost of sale and $2 profit in its continuing operations (and will not have the additional $1 profit from sales to the outside customers).

The company should record sales from continuing operations of $6, cost of sales of $4, a profit of $2, and $1 of profit in discontinued operations."

The appropriate presentation of amounts resulting from intercompany transaction will depend on the particular facts and circumstances of each transaction.

SEC Form 8-K Reporting Requirements

In August 2004, the SEC expanded the number of events that are reportable on Form 8-K to include "material impairments." See the separate Duke Energy policy statement entitled "Form 8-K Requirements and Filing Procedure" for further discussion of this matter.

Accounting Policy

A long-lived asset (asset group) classified as "Held and Used" is evaluated periodically for impairment when certain events or changes in circumstances indicate the long-lived asset may not be recoverable. If the long-lived asset is considered impaired, the impairment loss recognized is measured as the difference between the long-lived asset's carrying value and its fair value. Impairment losses are recorded as a component of income from continuing operations before income taxes.

As discussed under "Estimates of Future Cash Flows for Recoverability" above, SFAS No. 144 is silent regarding the consideration of income taxes when assessing *undiscounted* cash flows to determine the recoverability of an asset (asset group). Since the undiscounted recoverability test is expected to normally yield a similar result regardless of whether income taxes are included or excluded, for simplicity purposes, Duke Energy's preferred method, no matter the form of legal entity (C-Corp, LLC, etc.) is not to consider the impact of income taxes. However, in the event that factors indicate that the outcome of the test would differ if income taxes were considered (e.g., a non-conventional fuel source property in which the decision to invest was based in part on receiving special income tax credits), the test should be performed after giving consideration to income taxes.

An asset (asset group) is classified as held for sale and measured at the lower of carrying value or fair value less costs to sell in the period when all of the six criteria in paragraph 30 of SFAS No. 144 are met. Once classified as held for sale, depreciation (or amortization) of the long-lived asset is ceased. If at any time the criteria for classification as held for sale are no longer met, a long-lived asset (disposal group) classified as held for sale shall be reclassified as held and used and measured individually at the lower of its (a) carrying amount before the asset (disposal group) was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset (disposal group) been continuously classified as held and used, or (b) fair value at the date of the subsequent decision not to sell (in accordance with paragraph 38 of SFAS No. 144).

The guidance in SFAS No. 144 does not specify whether assets and liabilities held-for-sale should be classified as current or noncurrent in the statement of financial position. Paragraph B120 of SFAS No. 144 indicates, "The Board concluded that because requirements for classifying assets and liabilities as current or noncurrent are provided by other accounting pronouncements, including ARB No. 43, Chapter 3, "Working Capital," further guidance in this Statement is not needed." ARB No. 43 indicates that current classification applies to those assets that an entity will realize in cash, sell, or consume within one year and those liabilities an entity will discharge by use of current assets or the creation of other current liabilities within one year. Therefore, all assets and liabilities classified as held-for-sale will need to be evaluated for classification as current or non-current. Normally, those assets and liabilities will retain their previous current or noncurrent classification (as held and used) and will be disclosed under the provisions of paragraph 46 of SFAS No. 144.

As noted above there is no authoritative literature that addresses the balance sheet presentation for assets that are intended to be sold but are outside the scope of SFAS No. 144. Accordingly, Duke Energy's policy for presentation is that these assets, including any equity method investments being held for sale, should usually continue to retain their previous presentation and therefore not be presented as "assets held for sale." An exception to this presentation might be made if, for example, a significant operation was being disposed of that included some assets that were within the scope of SFAS No. 144 and some that were outside its scope (e.g., for the substantial exit of DENA announced in September 2005, substantially all of the assets to be disposed of were within the scope of SFAS No. 144, so all, including some contracts not under SFAS No. 144, were presented as assets held for sale, as this was determined to be the most useful presentation to a user of Duke Energy's financial statements).

Regarding any intercompany accounts that may accompany assets being sold (e.g., an intercompany liability to be assumed by a buyer), such intercompany accounts must continue to be eliminated in consolidation until the transaction closes and the accounts cease to represent intercompany transactions. Accordingly, in assessing balance sheet presentation of any such intercompany balances related to assets to be sold, appropriate coordination with the business or corporate unit on the other end of the transaction should occur to ensure that the balances continue to be eliminated in consolidation. Consistent with the treatment of other items that are outside the scope of SFAS No. 144, the normal practice should be to not reclassify intercompany amounts to "assets held for sale" or "liabilities associated with assets held for sale." As discussed under the "Discontinued Operations Presentation" section above, the determination of the appropriate presentation of amounts for intercompany transactions will be dependent on the facts and circumstances surrounding each transaction.

Additionally, the business/corporate unit will be responsible for reporting to the Corporate Controller's Department all the disclosure requirements in accordance with SFAS No. 144 and APB No. 18 (see "Reporting Requirements" below). All asset impairments and assets classified as held for sale shall be reported by each business/corporate unit to the Corporate Controller's Department regardless of any materiality thresholds, as discussed below.

If assets classified as held for sale exceed five percent of total assets on a consolidated basis at the reporting date, they must be separately disclosed on the face of the balance sheet in accordance with SEC Regulation S-X, Rule 5-02. For all other instances, classification as held for sale on a consolidated basis will be determined by the Corporate Controller's Department.

If some, but not all, of the six criteria in SFAS No. 144 are met and the asset is classified as held and used, the potential impact of the following other accounting requirements should be considered:

- The potential need to adjust the remaining depreciable life of the asset. If a loss is anticipated on the ultimate sale of the asset, depreciation expense should be adjusted based upon the remaining period of time the entity expects to use the asset and the expected proceeds from the asset's sale (if less than the historical depreciation expense amount); and
- The potential need to assess the asset for impairment under an "asset to be held and used" scenario, with appropriate probability weighting of the various potential uses of the asset, as discussed in paragraph 17 of SFAS No. 144.

Equity method investments should be assessed for impairment when conditions exist that indicate that the fair value of the investment is less than book value. If the decline in value is considered to be other than temporary, the investment should be written down to its estimated fair value, which establishes a new cost basis in the investment. This new cost basis cannot subsequently be written up to a higher value as a result of increases in fair value, nor can the write-down be reversed over time by amortization of the basis difference (the difference between the carrying value of the investment and the investor's underlying equity in the net assets of the investee) caused by the write-down. Any subsequent increases in the value of the investment should not be recognized until realized.

Reporting and Disclosure Requirements

In financial statements containing a period in which an impairment loss is recognized, the following are required to be disclosed:

- A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment;
- If not separately presented on the face of the statement, the amount of the impairment loss and the caption in the income statement or the statement of activities that includes that loss;
- The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique); and,
- If applicable, the segment in which the impaired long-lived asset (asset group) is reported under SFAS No. 131.

For each asset (disposal group) a business/corporate unit has classified as held for sale, the following items are required to be reported at each quarterly or annual reporting period until the asset is sold or is no longer classified as held for sale:

- Carrying amount of the asset (disposal group) at the reporting balance sheet date
- The account balance the carrying amount of the asset is included within
- The amount of any loss recorded and the classification of the loss in the income statement
- The expected manner and timing of the sale transaction
- The methodology utilized to determined fair value (e.g. appraisals, quoted market prices, comp sales, etc.)

Presentation of Discontinued Operations

Assets sold or classified as "held for sale" must be assessed for presentation as a discontinued operations in accordance with the provisions of SFAS No. 144.

- As a general rule, revenues are required in order to qualify for discontinued operations presentation. For example, the sale of equipment that was never placed into use or partially-completed power plants would likely not qualify for discontinued operations presentation because there were never any revenues generated by these assets.
- A component of an entity may qualify for discontinued operations presentation even if it does not include conventional long-lived assets, such as power plants. For example, a component that represents a trading and marketing operation may qualify for discontinued operations presentation.
- Equity method investments do not qualify for discontinued operations presentation unless they are part of a larger disposal group that represents a component of an entity. This also applies for any investments for which the accounting has changed (e.g., from equity method to consolidation) during the period covered by the financial statements. For example, if an investment is being sold that was consolidated in the most recent year, but accounted for under the equity method in prior years, only the period that the investment was consolidated would be eligible for discontinued operations presentation. The results for the investment for the prior years when it was accounted for using the equity method should remain in continuing operations.
- Discontinued operations are presented at the bottom of the income statement following income from continuing operations
- Discontinued operations presentation is appropriate, subject to materiality considerations, if both of the following conditions are met:
  - The operations and cash flows related to the asset will be eliminated from ongoing operations following the sale; and
  - The Company will not have any significant continuing involvement with the operations of the asset following the sale.

Note that the assessment period in which to evaluate whether a disposed component should be classified as a discontinued operation includes the date at which the component meets the criteria to be classified as held for sale or is disposed of, and continues through one year after the disposal date. Once the threshold for reporting discontinued operations for a reporting period has been crossed, and the discontinued operations line item(s) are included in the Statement of Operations, any previous dispositions that occurred during the reporting period that were not shown as discontinued operations due to materiality should be reassessed to determine if discontinued operations presentation is now appropriate. Unless the impact is de minimus, it is likely that discontinued operations presentation for any such items will be appropriate (management judgment should be applied, and in the event of uncertainty contact the Corporate Controller's Department).

Related Policies, Standards or Procedures

- Accounting for Regulated Entities (SFAS No. 71)
- Accounting for Risk Management and Hedging Activities
- Accounting for Goodwill
- Form 8-K Requirements and Filing Procedure
- Documentation and Consultation for Significant Accounting or Reporting Matters
- Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues, and Significant Non-recurring Entries

Accounting for Claims Between Captive Insurer and Affiliates

Applicability: Applies to Enterprise
Originator: Corporate Controller's Department - Corporate Accounting
Approval: Corporate Controller

Effective Date: 12/30/2004
Revision Date: 03/31/2008
Reissue Date: 03/31/2008

Statement of Purpose and Philosophy

The purpose of this Policy is to provide guidelines for recording insurance claims between Duke Energy Corporation's wholly-owned Captive insurance entities (Bison Insurance Company Limited and NorthSouth Insurance Company Limited, and other affiliates of Duke Energy which are covered by policies issued by these captives (see related Policy titled, "Property/Business Interruption Reserve Eliminations in Consolidation"), as well as other "self-insured" events. Additionally, a systematic process has been implemented to calculate adjusting or elimination entries needed in consolidation for the Duke Energy Corporation consolidated financial statements (see related Policy titled, "Property/Business Interruption Reserve Eliminations in Consolidation").

Policy Expectations and Scope

This Policy is applicable to all Business/Corporate units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company") which are covered by insurance policies by Duke Energy's captive insurance entities. This Policy should help ensure consistent application of the accounting for insurance activities across the consolidated Duke Energy group and assist with the consolidation/elimination process.

The scope of this Policy is related to insurance accounting for policies written between Duke Energy affiliated entities. This Policy does not cover other insurance activities, such as the purchase of policies from third party insurance providers. Additional details or procedural information may exist at the individual Business or Corporate unit level.

Materiality

Financial Accounting Standards Board ("FASB") Statements note that "The provisions of this Statement need not be applied to immaterial items." However, since this Policy will be utilized to ensure the proper elimination or consolidation of affiliated transactions, materiality thresholds should not be applied to this Policy.

Accountability: Roles and Responsibilities

Business/Corporate Unit Management

The Business/Corporate Unit is responsible for timely communication to Captive Insurer of a covered claim. In the initial discussion regarding a claim, the Business/Corporate Unit must provide the PeopleSoft Business Unit (BU) number of the entity making the claim. If the PeopleSoft BU number is not provided in the initial discussion, the Captive claims representative should remind the contact person that the Business/Corporate Unit maintains responsibility for communicating the PeopleSoft BU number to the Captive Insurer before the end of the month in which the claim is initially reported. The Business/Corporate Unit is responsible for recording claims receivable as detailed in the examples below under the "Procedural Details" section. The recording of Business Unit intercompany entries must be completed by the end of the calendar month (i.e. - June '05 intercompany with captive entities must be recorded by June 30th). Please note this is in advance of deadlines established in the Policy on "Accounting for Intercompany Transactions."

Insurance and Risk Management

The Duke Energy Director of Claims is responsible for timely assessment of whether a reported event is covered by insurance. If the event is covered, the Director of Claims is also responsible for communicating to the Business/Corporate Unit the PeopleSoft BU number of the Captive Insurer and whether the claim is covered by Property/Business Interruption insurance or another insurance coverage, such as general liability, in addition to providing a claim number. On a quarterly basis, the Director of Captive Insurance will be responsible for providing a current month-end Outstanding Loss Reserve (OSLR) report to Corporate Accounting. The OSLR report must contain the details requested in the periodic data request from the Corporate Controller's Department.

Corporate Controller's Department

Corporate Accounting is responsible for recording Captive outstanding losses by affiliate each month. Since the information from Insurance and Risk Management is only provided quarterly, approval of this Policy constitutes approval for an exception to the Policy on "Accounting for Intercompany Transactions." In addition, Corporate Accounting will collect data from the general ledger to determine the claims receivable recorded by each BU. By detailed analysis of Captive and BU figures, Corporate Accounting will then prepare and record the necessary elimination/consolidation entries (see related Policy titled, "Property/Business Interruption Reserve Eliminations in Consolidation"). The Captive intercompany entries will be recorded by work-day 2 (i.e. - July 5th for June '05 accounting).

Background

Duke Energy has two wholly-owned Captive insurance entities which primarily provide insurance coverage to Duke Energy affiliated entities. A brief description of each Captive is contained below:

Bison Insurance Company Limited (Bison)

Bison is a Captive insurance company and a wholly-owned subsidiary of Duke Energy domiciled in Bermuda. Captive insurance is by definition a limited purpose insurance company established with the specific objective of insuring risks of its parent company and affiliates. The three categories of insurance covered by Bison that are relevant to this summary are business interruption, property, and general liability. Bison utilizes reinsurance, or insuring with third parties, in order to further limit financial risk over specific dollar levels, by type of coverage. Bison's contractual policy is to indemnify Duke Energy affiliates after an insurable event has occurred and been settled by the affiliate. Each affiliate may choose a range of deductibles with Bison, thus providing them some control over their premium expense.

NorthSouth Insurance Company Limited (NorthSouth)

NorthSouth was formed on December 31, 2002 and insures exposures of Duke Power Company. NorthSouth is wholly-owned by Bison and is domiciled in Bermuda. All insured risks covered by NorthSouth have been fully reinsured by Bison.

Therefore, as a result of the insurance coverage provided by the Captives to the Duke Energy affiliated entities, Duke Energy has self-insured risk (for book purposes) up to the amount of the per incident deductible for the reinsurance policy purchased by the Captive, which in effect minimizes the exposure to the consolidated group for insured events. Self-insured reserves must meet the definition of Statement of Financial Accounting Standards ("SFAS") No. 5, "Accounting for Contingencies" (see related Policy, Accounting for Loss Contingencies) which clarifies the following criteria for recognition of a contingent liability:

An estimated loss from a loss contingency shall be accrued by a charge to income if *both* of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated.

During the policy year, affiliates recognize premium expense and remit payments to the Captive Insurance entity. On the financial records of the Captive entity, premium receipts are recognized as revenue over the policy period. Through intercompany accounting, the premium expense recognized by the Business Unit and the corresponding revenue recorded by Bison is eliminated at the consolidated level. See separate guidance titled "Methodology to Record Intercompany Insurance Activity."

This Policy is meant to derive consistency between amounts recorded as reserves by the Captive (which represent liabilities to the affiliated Duke Energy entities) and amounts recorded as receivables by the Business/Corporate Units (which represent reimbursement amounts due from the Captive for insured events). The policies written by the Duke Energy Captive entities represent indemnity policies which dictate that the Captive is responsible for directly reimbursing the Business/Corporate Unit for covered losses only to the extent the losses have been actually incurred by the Business/Corporate Unit. Therefore, the Captive Insurer is not directly responsible for making payments directly to third parties.

Procedural Details

The following examples provide the appropriate intercompany account(s) and other required fields in order to successfully implement these procedures:

Procedure for Business Units Recording Insured Events

Scenario A- A non-property or non-business interruption claim is incurred by the Business Unit which will not be covered by insurance coverage with the Captive Insurer (amount of claim is below the Business Unit per incident deductible with the Captive Insurer or is not covered by the Captive Insurance policies)

1) At the date any third party claim meets the SFAS No. 5 definition for accrual as a loss contingency (loss is probable and estimable), the Business Unit will record the following journal entry:

A/C #		Dr	Cr
xxx-xx	Operating expenses (per incident deductible)	xxx	
xxx-xx	Accrued expenses		xxx

The above amount recorded as an accrued expense will be required to be readjusted in each subsequent period (if estimates of the probable loss change), until settlement occurs, with offsetting adjustments being recorded to operating expenses. If at any time the probability of loss no longer meets both the criteria in SFAS No. 5, the above accrued expense should be immediately reversed.

2). Business Unit makes payment to the third party for their claim as a result of the incident:

A/C #		Dr	Cr
xxx-xx	Accrued expenses	xxx	
xxx-xx	Cash		xxx

If this payment closes out the claim by the third party, the accrued expense for the claim should be zero.

Scenario B- A non-property or non-business interruption claim is incurred by the Business Unit which will be covered by insurance coverage with the Captive Insurer (amount of claim is above the Business Unit per incident deductible with the Captive Insurer)

1) At the date any third party claim meets the SFAS No. 5 definition for accrual as a loss contingency (loss is probable and estimable), the Business Unit will record the following journal entry (A/R NonProp/ Non BI Interco balance represents the amount which will be claimed for reimbursement from the Captive Insurer):

A/C #	Dr	Cr

0146960	A/R NonProp/Non BI Interco	xxx	
xxx-xx	Operating expenses (per incident deductible)	xxx	
xxx-xx	Accrued expenses		xxx

The intercompany receivable will also need to have the following chartfields populated:

Affiliate: PeopleSoft BU number of the Captive Insurer.

Description: This field should only contain the claim number as provided by the Captive insurance company. The Business/Corporate Unit is responsible for obtaining a claim number and at the same time must be able to provide the PeopleSoft BU number for consolidating entities with claims. Multiple claims should **not** be aggregated in one amount, as the detail amount by claim number must be readily determinable.

The intercompany receivable should be probable of recovery at the Balance Sheet date in order to be recorded.

The above amount recorded as an accrued expense will be required to be readjusted in each subsequent period (if estimates of the probable loss change), until settlement occurs, (with offsetting adjustments being recorded to the A/R NonProp/Non BI Interco account) as changes to the estimate of the loss occur. If at any time the probability of loss no longer meets both the criteria in SFAS No. 5, the above accrued expense should be immediately reversed. Corporate Accounting will collect data from the General Ledger, after the intercompany posting deadline, to determine the claims receivable recorded by each BU. Corporate Accounting will then record a reclassification from third party loss reserves to affiliate payables based on the claims receivable recorded by each BU. Additionally, the Captive insurance company is responsible for communicating claim number changes to the Business/Corporate Unit in the same quarter in which such a change occurs.

2) Business Unit makes payment to the third party for their claim as a result of the incident:

A/C #		Dr	Cr
xxx-xx	Accrued expenses	xxx	
xxx-xx	Cash		xxx

If this payment closes out the claim by the third party, the accrued expense for the claim should be zero.

3) Business Unit receives reimbursement from the Captive Insurer for their claim:

A/C #		Dr	Cr

xxx-xx	Cash	xxx	
0146960	A/R NonProp/Non BI Interco		xxx

The same chartfields are required for the intercompany receivable entry as described in step one above. If this payment closes out the claim, the A/R NonProp/BI Interco related to this claim should be zero. The Business Unit should include a "c" in the description field for any claim for which cash receipts from the Captive Insurer have been received (recorded as a reduction in the receivable).

Scenario C- A property claim to Business Unit owned property (excluding business interruption coverage) is incurred by the Business Unit which will be covered by insurance coverage with the Captive Insurer (amount of claim is above the Business Unit per incident deductible with the Captive Insurer). Additionally, the property has been damaged and is not able to be used and will be replaced

1) At the date of the incident or when the Business Unit determines that specific property has been damaged and will need to be replaced, the carrying value of the damaged equipment is written off:

A/C #		Dr	Cr
0146990	A/R Prop/BI Interco	xxx	
xxx-xx	Operating expenses (per incident deductible)	xxx	
xxx-xx	PP&E - Accumulated Depreciation	xxx	
xxx-xx	PP&E - Cost		xxx

The intercompany receivable will also need to have the following chartfields populated:

Affiliate: PeopleSoft BU number of the Captive Insurer

Description: This field should only contain the claim number as provided by the Captive insurance company. The BU is responsible for obtaining a claim number and at the same time must be able to provide the PeopleSoft BU number for consolidating entities with claims. Multiple claims should **not** be aggregated in one amount, as the detail amount by claim number must be readily determinable.

The intercompany receivable should be probable of recovery at the Balance Sheet date in order to be recorded.

2) The Business Unit expends cash to replace the damaged equipment and capitalizes the replacement cost:

A/C #		Dr	Cr
0146990	A/R Prop/BI Interco	xxx	
xxx-xx	PP&E - Cost	xxx	
xxx-xx	Cash		xxx
0421120	Captiv Invol'tary Cnvsn Clm		xxx

The same chartfields are required for the intercompany receivable entry as described in step one above. The Captiv Invol'tary Cnvsn Clm (intercompany gain) above will eliminate with the expense recorded by the Captive Insurer based on procedures in Corporate Accounting and represents the difference between the carrying value of the damaged equipment and the replacement cost. This entry will also require the affiliate chartfield to be populated.

All contingencies related to the involuntary conversion gain should be resolved prior to recognition of the intercompany receivable. This is a higher threshold than for recognition of an incurred loss as noted in (1) above.

3) Business Unit receives reimbursement from the Captive Insurer for their claim:

A/C #		Dr	Cr
xxx-xx	Cash	xxx	
0146990	A/R Prop/BI Interco		xxx

The same chartfields are required for the intercompany receivable entry as described in step one above. If this payment closes out the claim, the A/R Prop/BI Interco related to this claim should be zero. The Business Unit should include a "c" in the description field for any claim for which cash receipts from the Captive Insurer have been received (recorded as a reduction in the receivable).

<u>Scenario D</u>- *A property claim to Business Unit owned property (excluding business interruption coverage) is incurred by the Business Unit which will be covered by insurance coverage with the Captive Insurer (amount of claim is above the Business Unit per incident deductible with the Captive Insurer). Additionally, the property is still usable and will require repairs (which will be expensed).*

1) At the date of the incident or when the Business Unit determines that specific property has been damaged and will need to be repaired, no entries are recorded.

2) The Business Unit expends cash to repair the damaged equipment and expenses the repair:

A/C #		Dr	Cr
xxx-xx	Operating expenses (repairs)	xxx	

xxx-xx	Cash		xxx

Claim has been filed with the Captive Insurer for reimbursement of the repair costs:

A/C #		Dr	Cr
0146990	A/R Prop/BI Interco	xxx	
xxx-xx	Operating expenses (repairs)		xxx

The intercompany receivable will also need to have the following chartfields populated:

Affiliate: PeopleSoft BU number of the Captive Insurer

Description: This field should only contain the claim number as provided by the Captive insurance company. The BU is responsible for obtaining a claim number and at the same time must be able to provide the PeopleSoft BU number for consolidating entities with claims. Multiple claims should **not** be aggregated in one amount, as the detail amount by claim number must be readily determinable.

The intercompany receivable should be probable of recovery at the Balance Sheet date in order to be recorded.
The amount of the A/R Prop/BI Interco will be for the amount expended by the Business Unit less the per incident deductible with Captive. Therefore, the net Income Statement impact of the above entries (operating expenses) is the per incident deductible.

3) Business Unit receives reimbursement from Captive for their claim:

A/C #		Dr	Cr
xxx-xx	Cash	xxx	
0146990	A/R Prop/BI Interco		xxx

The same chartfields are required for the intercompany receivable entry as described in step one above. If this payment closes out the claim, the A/R Prop/BI Interco related to this claim should be zero. The Business Unit should include a "c" in the description field for any claim for which cash receipts from the Captive Insurer have been received (recorded as a reduction in the receivable).

Scenario E- A property claim to a 3rd party's owned property is incurred by the Business Unit which will be covered by insurance coverage with the Captive (amount of claim is above the Business Unit per incident deductible with the Captive Insurer).

A/C #		Dr	Cr

0146990	A/R Prop/BI Interco	xxx	
xxx-xx	Operating expenses (per incident deductible)	xxx	
xxx-xx	Accrued expenses		xxx

The intercompany receivable will also need to have the following chartfields populated:

Affiliate: PeopleSoft BU number of the Captive Insurer

Description: This field should only contain the claim number as provided by the Captive insurance company. The Business Unit is responsible for obtaining a claim number and at the same time must be able to provide the PeopleSoft BU number for consolidating entities with claims. Multiple claims should **not** be aggregated in one amount, as the detail amount by claim number must be readily determinable.

The intercompany receivable should be probable of recovery at the Balance Sheet date in order to be recorded.

Scenario F - Same as Scenario E above except amount of claim is below the Business Unit per incident deductible with the Captive Insurer.
Accounting for this transaction will follow Scenario A above.

Scenario G - Business Unit incurs property damage and will be unable to provide some or all of its services to customers over a period of time until the property damage has been corrected. This economic loss as a result of services to customers will be covered by business interruption insurance written by the Captive Insurer.

1) Once the per incident policy deductible has been met, each month as the Business Unit incurs additional economic losses which will be covered by a Captive Insurer business interruption policy, the Business Unit will record a journal entry.

A/C #		Dr	Cr
0146990	A/R Prop/BI Interco	xxx	
0495030	Captive Revenue BI Interco		xxx

The intercompany receivable will also need to have the following chartfields populated:

Affiliate: PeopleSoft BU number of the Captive Insurer

Description: This field should only contain the claim number as provided by the Captive insurance company. The Business Uunit is responsible for obtaining a claim number and at the same time must be able to provide the PeopleSoft BU number for consolidating entities with claims.

Multiple claims should **not** be aggregated in one amount, as the detail amount by claim number must be readily determinable.

The Captive Revenue BI Interco (Other Revenue) above will eliminate with the expense recorded by the Captive Insurer based on procedures in Corporate Accounting. This entry will also require the affiliate chartfield to be populated.

The intercompany receivable should be probable of recovery at the Balance Sheet date in order to be recorded.

2) Business Unit receives reimbursement from the Captive Insurer for their claim:

A/C #			Dr	Cr
xxx-xx	Cash		xxx	
0146990		A/R Prop/BI Interco		xxx

The same chartfields are required for the intercompany receivable entry as described in step one above. If this payment closes out the claim, the A/R Prop/BI Interco related to this claim should be zero. The Business Unit should include a "c" in the description field for any claim for which cash receipts from the Captive Insurer have been received (recorded as a reduction in the receivable).

Cash Flow Reporting

For property claims related to the replacement of a Business Unit's owned property which has been damaged in an insured event, any amounts received as reimbursement from the wholly-owned Captive Insurer to the Business/Corporate Unit should not be netted against the capital expenditure. Rather, these reimbursements should be classified in the same way the expenditure is classified by the Captive entity to ensure elimination in the *Consolidated* Statement of Cash Flow.

Regulatory Accounting Treatment Under SFAS No. 71

Any entity subject to the regulatory accounting treatment of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation" should evaluate whether any of the per incident deductible for insured events should be deferred as a regulatory asset. The above journal entries should be revised for such treatment, as applicable.

Standards/Requirements

The intercompany accounts identified in this Policy are exclusively for use in recording Captive insurance affiliate activity, with the following distinction:

Account Purpose

0146960 All Captive receivables (i.e. - general liability), except receivables for property and business interruption claims

0146990 Receivables for property and business interruption claims only

0421120 This account captures the BU gain, if any, from replacement of property

0495030 This account captures the revenues recognized from captive coverage of business interruption claims

0421040 This account captures the revenues recognized from captive coverage of business interruption claims (Franchised Electric only)

The PeopleSoft BU numbers for the Captive companies are as follows:

10006 Bison Insurance Company Limited

10221 NorthSouth Insurance Company Limited

Accounting for Defined Benefit Pension and Other Post-Retirement Benefit Plans

Applicability:	Applies to Enterprise
Originator:	Corporate Controller
Approval:	Corporate Controller
Effective Date:	12/01/2004
Revision Date:	12/17/2007
Reissue Date:	12/17/2007

Statement of Purpose and Philosophy

The purpose of this policy is to provide guidelines for the accounting and disclosure of the defined benefit pension and other post-retirement benefit ("OPEB") plans by Duke Energy Corporation and its subsidiaries. Duke Energy is committed to preparing and providing financial information with the utmost integrity. To facilitate this corporate value, the Corporate Controller's Department will approve policies to ensure the accuracy of books and records (as detailed in the Code of Business Ethics).

Policy Expectations and Scope

All Duke Energy employees involved in the accounting or disclosures for defined benefit pension and other post-retirement benefit plans are expected to be familiar with the accounting and disclosure guidance provided in this policy. This policy should help ensure consistent application of the accounting for defined benefit pension and other post-retirement benefit plans across the consolidated Duke Energy group. This policy contains a high-level summary of the key requirements of U. S. generally accepted accounting principles ("GAAP") as it applies to Duke Energy, including any significant interpretations or policy elections made by Duke Energy, but is not intended to be a substitute for the detail requirements of authoritative GAAP literature for specific issues or matters that may arise. This policy is applicable to all business/corporate units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company").

This policy does not address accounting and disclosures for defined contribution pension plans. The scope of this policy excludes stock-based compensation and post-employment benefits not provided through a pension or other postretirement benefit plan.

Materiality

FASB Statements note that "The provisions of this Statement need not be applied to immaterial items." Accordingly, materiality should be considered when applying this policy. However, materiality must be assessed at the business/corporate unit level (as well as being assessed at the

SEC sub-registrant level), and at the consolidated level(s), and involves consideration of both quantitative as well as qualitative factors. Any questions regarding materiality should be directed to the Corporate Controller's Department.

Accountability: Roles and Responsibilities

Corporate Controller's Department –

- Maintain an accounting policy for defined benefit pension and post-retirement benefit plans available on the portal to help ensure that business/corporate units are aware of the accounting and disclosure requirements related to the plans.
- Establish and communicate the reporting timetable for defined benefit pension and other post-retirement benefit plan information needed for SEC filings, accumulate the information reported by the business/corporate units for periodic reporting and disclosure purposes, prepare the required footnote disclosures and maintain supporting documentation for the disclosures made in the interim and annual SEC filings (e.g. Form 10-K, Form 10-Q, etc).
- Provide guidance/assistance to business/corporate units on accounting and disclosures for the defined benefit pension and other post-retirement benefit plans.
- Determine the appropriate assumptions to be used by the actuary for the annual calculations for the defined benefit pension and other post-retirement benefit plans.
- Coordinate with the third party actuaries and trustees to obtain the results of the annual valuations and measurements.
- Provide the business/corporate units with the appropriate amounts to be recorded for the U.S. defined benefit pension and other post-retirement benefit plans.

Business/Corporate Unit –

- Ensure all reporting requirements for the defined benefit pension and other post-retirement benefit plans are accumulated and reported to the Corporate Controller's Department in accordance with the established reporting timetable.
- Ensure proper support/documentation exists for amounts recorded related to the defined benefit pension and other post-retirement plans (Corporate Accounting records the amounts for all business units for all plans)
- Ensure that the accounting for the defined benefit pension and other post-retirement plans is applied consistently between periods.

Standards/Requirements/Background Information

Background Information

During the three years ended December 31, 2007, Duke Energy and its subsidiaries have maintained a variety of employee benefit plans, including qualified pension plans, nonqualified pension plans, and savings plans (collectively referred to as "Retirement Plans") and other postretirement benefits/welfare plans. In general,

1. Duke Energy has maintained substantially all plans sponsored by Duke Energy, Duke Energy Carolinas and Crescent Resources (up through the date of the sale of the effective 50% interest in Crescent Resources in 2006) throughout the three year period.

2. Duke Energy has been the ultimate parent company with respect to the plans sponsored by Cinergy Corp. and its subsidiaries (referred to as the "legacy Cinergy plans") since April 1, 2006, the effective date of the merger with Cinergy.

3. Duke Energy has been the ultimate parent company with respect to the pension and other post-retirement plans sponsored by Westcoast, Union Gas, Engage Energy and Duke Energy Gas Transmission - Canada since the effective date of the merger with Westcoast Energy (March 1, 2002) These plans were transferred to Spectra Energy as a result of the spin-off of Duke Energy's natural gas businesses to Duke Energy shareholders, which was effective January 2, 2007. Accordingly, a discussion of these plans is not included within this accounting policy for 2007.

4. Certain subsidiaries in Duke Energy's international segment have obligations to provide employee benefits which may be funded in part through retirement plans and other postretirement benefit/welfare plans.

The remainder of this background is focused on the benefit plans described in items 1 and 2 above (the Duke Energy U.S. Plans".)

Retirement Plans

Duke Energy U.S. Plans

Duke Energy and its subsidiaries (including legacy Cinergy operations) maintain non-contributory defined benefit retirement plans ("U.S. Plans"). U.S. Plans covering most employees in the Carolinas use a cash balance formula. Under a cash balance formula, a plan participant accumulates a retirement benefit consisting of pay credits that are based upon a percentage (which may vary with age and years of service) of current eligible earnings and current interest credits. Certain legacy Cinergy U.S. employees are covered under plans that use a final average earnings formula. Under a final average earnings formula, a plan participant accumulates a retirement benefit equal to a percentage of their highest 3-year average earnings, plus a percentage of the their highest 3-year average earnings in excess of covered compensation per year of participation (maximum of 35 years), plus a percentage of their highest 3-year average earnings times years of participation in excess of 35 years.

Duke Energy also maintains non-qualified, non-contributory defined benefit retirement plans which cover certain U.S. executives.

Duke Energy also sponsors employee savings plans that cover substantially all U.S. employees. Most employees participate in a matching contribution formula where Duke Energy provides a matching contribution generally equal to 100% of before-tax employee contributions, of up to 6% of eligible pay per pay period. This accounting policy does not specifically address the accounting for employee savings plans since it is relatively straight-forward in nature.

Welfare Plans (Other Postretirement Benefit Plans)

Duke Energy U.S. Plans

Duke Energy and most of its subsidiaries provide some health care and life insurance benefits for retired employees on a contributory and non-contributory basis. Employees are eligible for these benefits if they have met age and service requirements at retirement, as defined in the plans.

Employee Benefit Plan Asset Management and Administration

The following discussion relates to the Duke Energy U.S. Plans only. Responsibilities for asset management and benefit plan administration of the Westcoast plans were transferred to Spectra Energy effective January 2, 2007.

The assets for Duke Energy U.S. Plans pension and other post retirement benefit plans are maintained by a master trust. The investment objective of the master trust is to achieve reasonable returns on trust assets, subject to a prudent level of portfolio risk, for the purpose of enhancing the security of benefits for plan participants. The asset allocation target was set after considering the investment objective and the risk profile with respect to the trust. U.S. equities are held for their high expected return. Non-U.S. equities, debt securities, and real estate are held for diversification. Investments within asset classes are to be diversified to achieve broad market participation and reduce the impact of individual managers or investments. Duke Energy regularly reviews its actual asset allocation and periodically rebalances its investments to the targeted allocation when considered appropriate.

Duke Energy also invests other post-retirement assets in various VEBA trusts, grantor trusts, and rabbi trusts for employee benefits, post-retirement medical benefits, deferred compensation, and other benefits. The investment objective of these trusts is to achieve sufficient returns on trust assets, subject to a prudent level of portfolio risk, for the purpose of promoting the security of plan benefits for participants. The trusts are passively managed.

Benefit Plan Administration

Designated members of the Duke Energy Treasury Group regularly review the actual asset allocations and advise the investment committees about the performance of the trusts for the Duke Energy U.S. Plans. The investment committees consist primarily of members familiar with financial or investment matters and meets on at least a quarterly basis to monitor the activities of the trusts. For the Duke Energy U.S. plans, the investment committees make the decisions to periodically rebalance the investments to the targeted allocations when considered appropriate. The fair value of the plan assets is the current market value of the assets, as determined by the trustee. The trustee provides this information to Duke Energy after the monthly close.

Annually, a third party actuary is to be engaged by Duke Energy to assess the plans and is to present a range of assumptions, based upon factors including, the terms of the plan, the demographics of the plan participants, current economic environment, investment mix, discount rate, return on assets and salary increases, to a committee of Duke Energy personnel including representatives from the Corporate Controller and the Human Resource groups. The Corporate Controller determines the assumptions to be used by the actuary to calculate the pension and other post-retirement benefit obligation based upon the range of assumptions presented by the third party actuary.

Using the assumptions selected by management, the actuary calculates the following valuations:

- Obligation Valuation - determines appropriate liabilities and funding requirements based on rules and regulations of applicable pension regulatory groups. These two items may also be used to calculate any cash contribution required for the ongoing plan. The Obligation Valuation is performed as of December 31 and the funded status of the benefit plans is booked as of December 31st in compliance with SFAS No. 158 (the valuation date changed from September 30 to December 31 effective in 2007 with the adoption of SFAS No. 158).
- Expense Valuation - determines the expense of the ongoing plan for accounting purposes for the following year.
- Accrued Benefits Valuation - determines liabilities for benefits accrued as of the valuation date.

Funding

Duke Energy's policy is to fund amounts on an actuarial basis to provide assets sufficient to meet benefits to be paid to plan participants.

Supporting Accounting Guidance

[NOTE: In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value in US GAAP, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements; however SFAS No. 157 amends some of the accounting pronouncements discussed in this policy and therefore, the application of SFAS No. 157 may change Duke Energy's current practice for determining fair values for the areas of accounting covered by this policy. For Duke Energy, SFAS No. 157 is effective as of January 1, 2008 and must be applied prospectively except in certain cases. This version of this accounting policy does not reflect the provisions of SFAS No. 157 since the reissue date of this policy predates the effective date of SFAS No. 157.]

Duke Energy's plans for retirement benefits are generally treated for accounting purposes as defined benefit or defined contribution pension plans. The welfare benefits provided by Duke Energy's plans are generally treated for accounting purposes as postretirement benefits other than pensions ("OPEB").

The remainder of this policy relates to defined benefit pension (hereafter referred to as "pension") plans and OPEB.

The primary authoritative accounting standards for pensions and OPEB plans are the following pronouncements of the Financial Accounting Standards Board:

- Statement of Financial Accounting Standards (SFAS) No. 87, "***Employers' Accounting for Pensions,***" (SFAS No. 87)
- SFAS No. 88, "***Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits***"

- SFAS No. 106, "***Employers' Accounting for Postretirement Benefits Other Than Pensions,***" (SFAS No. 106).
- SFAS No. 132(R), "***Employers' Disclosures about Pensions and Other Postretirement Benefits.***"
- SFAS No. 158, "***Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106 and 132(R).***"

The Emerging Issues Task Force has also published issues that provide supplemental guidance. These EITF issues and topics are listed in Appendix A.

These standards include requirements and guidance related to (1) measurement of employee benefit plan assets and obligations, (2) settlements and curtailments of obligations, (3) recognition of assets and obligations on the balance sheet ("balance sheet recognition"), (4) determination of net period pension cost ("income statement recognition"), (5) measurement dates, and (6) disclosures. In some cases, different standards apply to pension plans from standards for other postretirement benefit plans.

The following paragraphs contain excerpts from the most significant applicable accounting literature. Matters specific or unique to Duke Energy are primarily discussed in the "Accounting Policy" section below.

Periodic Cost Recognition

The following discussion uses the term "periodic cost" to refer to the amount of defined benefit pension and OPEB benefits attributable to an accounting period. The periodic costs includes the amount of "expense" reflected in the income statements as wells as amounts that may be capitalized as part of the cost of an asset.

Net periodic benefit cost is made up of several components that reflect different aspects of the employer's financial arrangements as well as the cost of benefits earned by employees. The cost of a benefit can be determined without regard to how the employer decides to finance the plan.

The net periodic benefit cost recognized for a period consists of the following components.

Components of Net Periodic Benefit Cost

Component	Pensions	OPEB
	(Reference to SFAS No. 87)	*(Reference to SFAS No. 106)*
Service cost	*(¶21)*	*(¶47)*
Interest cost	*(¶22)*	*(¶48)*
Actual return on plan assets	*(¶23)*	*(¶49)*
Amortization of unrecognized prior service cost	*(¶24-28)*	*(¶50-55)*

Gain or loss	*(¶30-34)*	*(¶56-63)*
Amortization of the unrecognized net transition asset or liability	*(¶77)*	*(¶110-112)*

Recognition of Assets and Obligations on the Balance Sheet

Under SFAS No. 158, effective for fiscal years ending after December 15, 2006, an employer that is a business entity with publicly traded equity securities and sponsors one or more single-employer defined benefit plans is required to:

a. Recognize the funded status of a benefit plan -- measured as the difference between the fair value of plan assets and the benefit obligation – in its statement of financial position. For a pension plan, the benefit obligation is the projected benefit obligation; for any other postretirement benefit plan, the benefit obligation is the accumulated postretirement benefit obligation. (¶4a)

b. Aggregate the statuses of all overfunded plans and recognize that amount as a noncurrent asset in its statement of financial position. (¶4b)

Aggregate the statuses of all underfunded plans and recognize that amount as a liability in its statement of financial position. The current portion of such liability (determined on plan-by-plan basis) is the amount by which (1) the actuarial present value of benefits included in the benefit obligation payable in the next 12 months exceeds (2) the fair value of plan assets. (¶4b)

c. Recognize as a component of other comprehensive income the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost of the period. *(¶4c) :(Note: For Duke Energy, the unrecognized components of net periodic benefit cost related to the company's regulated operations (e.g., the majority of Duke Energy's electric operations are regulated and thus subject to the accounting requirements of SFAS No. 71), should be reflected in regulatory assets (or regulatory liabilities), subject to the regulatory treatment of such costs for each regulated jurisdiction. See Duke Energy s separate policy entitled "Accounting for Regulated Entities (SFAS No. 71)".*

d. Recognize corresponding adjustments in AOCI when (1) gains or losses, (2) prior service costs or credits, and (3) transition assets or obligations remaining from the initial application of SFAS No. 87 and SFAS No. 106 are subsequently recognized as components of net period benefit costs. (¶4d)

e. Apply the provisions of FASB Statement No. 109, Accounting for Income Taxes, to determine the applicable income tax effects of items (a)-(d) above. (¶4e)

.

Measurement of Benefit Plan Costs, Obligations and Assets,

Pension Benefit Obligations

(References to SFAS No. 87 are in italics)

For a pension plan, the benefit obligation is the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date. *(¶264)*

- The attribution of pension benefits to periods of employee services is based on the use of actuarial assumptions to calculate the actuarial present value of those benefits. Actuarial assumptions reflect the time value of money (discount rate) and the probability of payment (assumptions as to mortality, turnover, early retirement, and so forth). *(¶39)*
- The projected benefit obligation reflects future compensation levels to the extent that the pension benefit formula defined pension benefits wholly or partially as a function of future compensation levels (that is, for a final-pay plan or a career-average-pay plan) *(¶46)*

OPEB Obligations

An OPEB obligation is measured as the actuarial present value of the benefits expected to be provided under the plan, reduced by the actuarial present value of contributions expected to be received from the plan participants during their remaining active service and postretirement periods.

- In determining the amount of the contributions expected to be received from those participants toward the cost of their postretirement benefits, consideration is given to any related substantive plan provisions, such as an employer's past practice of consistently increasing or reducing the contribution rates.
- An obligation to return contributions received from employees who do not attain eligibility for postretirement benefits and, if applicable, any interest accrued on those contributions shall be recognized as a component of an employer's postretirement benefit obligation.

For further information, see SFAS No. 106, ¶27.

Pension Plan Assets

For purposes of measuring plan assets, plan investments, whether equity or debt securities, real estate, or other, are measured at their fair value (see "Fair Value" below) as of the measurement date. See SFAS No. 87, ¶49.

In accordance with SFAS No. 158, the fair value of the plan assets is combined with the projected benefit obligation to arrive at the appropriate asset/liability presentation in the balance sheet.

OPEB Plan Assets

Plan assets are assets—usually stocks, bonds, and other investments (except certain insurance contracts)—that have been segregated and restricted (sometimes in a trust) to be used for postretirement benefits. The amount of plan assets includes amounts contributed by the employer, and by plan participants for a contributory plan, and amounts earned from investing the contributions, less benefits, income taxes, and other expenses incurred. Plan assets ordinarily cannot be withdrawn by the employer except under certain circumstances when a plan has assets in excess of obligations and the employer has taken certain steps to satisfy existing obligations.

Securities of the employer held by the plan are includable in plan assets provided they are transferable. *(See SFAS No. 106, ¶63)*

Assets not segregated in a trust, or otherwise effectively restricted, so that they cannot be used by the employer for other purposes are not plan assets for purposes of accounting for OPEB, even though the employer may intend that those assets be used to provide postretirement benefits. Those assets shall be accounted for in the same manner as other employer assets of a similar nature and with similar restrictions. Amounts accrued by the employer but not yet paid to the plan are not plan assets for purposes of accounting for OPEB. *(See SFAS No. 106, ¶64.)*

For purposes of measuring plan assets, plan investments, whether equity or debt securities, real estate, or other, are measured at their fair value (see "Fair Value" below) as of the measurement date. See SFAS No. 106, ¶65.

In accordance with SFAS No. 158, the fair value of the plan assets is combined with the accumulated benefit obligation to arrive at the appropriate asset/liability presentation in the balance sheet.

Fair Value

Note: *Note – as discussed on page 4 above, the following excerpts do not reflect amendments by SFAS No. 157 which are effective January 1, 2008.*

The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value is measured by the market price if an active market exists for the investment. If no active market exists for an investment but such a market exists for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a current rate commensurate with the risk involved. *(See SFAS No.87, ¶49 and SFAS No. 106, ¶65)*

Settlements and Curtailments

A transaction may result in the settlement or curtailment of a benefit obligation. SFAS No. 88's provisions related to settlements and curtailments are to be applied on a plan-by-plan basis. Therefore, the significance of a reduction or elimination should be evaluated in relation to the participants of the affected pension plan, not to the total work force employed at the affected division or by the company as a whole.

- A settlement is defined as a transaction that:
    - Is an irrevocable action, and
    - Relieves the employer (or the plan) of primary responsibility for a benefit obligation, and
    - Eliminates significant risk related to the obligation and the asset used to effect the settlement.

A transaction that does not meet these three criteria does not constitute a settlement. (SFAS No. 88 ¶3 and 4 and SFAS No. 106 ¶90 and 91). SFAS No. 88 provides two examples of transactions that meet all three criteria: 1) Making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits; and 2) Purchasing nonparticipating annuity contracts to cover vested benefits. In addition to the examples in SFAS No. 88, a settlement could be accomplished by payments to participants in noncash assets, by transfer of employee interests into a defined contribution plan, or by selling a plant, division, subsidiary or business segment where the buyer assumes all or part of the seller's pension obligation provided all the criteria are met. Determining whether other types of transactions constitute settlements requires a careful analysis of the substance of the transactions.

- For a pension plan, a curtailment is an event that significantly reduces the expected years of future service of present employees or eliminates for a significant number of employees the accrual of benefits for some or all of their future services. *(SFAS No. 88 ¶6)* For other post-retirement benefits, a curtailment is an event that reduces significantly the expected years of future service of active plan participants or eliminates the accrual of defined benefits for some or all of the future services of a significant number of active plan participants. *(SFAS No. 106 ¶96)* Curtailments include termination of employees' services earlier than expected or by termination or suspension of a plan so that employees do not earn additional benefits for future services. Consistent with interpretative guidance from Deloitte & Touche, the threshold for significance as used in the definition of curtailment is a matter of judgment; however, in general, 10 percent or more is considered significant. Thus, a significant reduction would be deemed to occur when the decrease in the expected years of future service is 10 percent or more. Likewise, a curtailment would be deemed to occur when benefits are eliminated for 10 percent or more of the employees.

- If a transaction does not meet the definition of a settlement or a curtailment, it is treated as a plan amendment. In other words, if "curtailment" or "settlement" is deemed not to have occurred, any changes in the benefit obligations that result from the event that led to the settlement or curtailment analysis is "rolled" into the existing actuarial gains and losses and recognized in future periods. This recognition model is consistent with the guidance in paragraphs 29, 32, and 33 of SFAS 87.

A plan termination occurs when the obligation is settled and the plan ceases to exist. If a plan termination occurs and the plan is not replaced by a successor defined benefit plan, both a settlement and a curtailment have occurred (whether or not the employees continue to work for the employer). (SFAS 106 ¶100)

<u>Accounting for a Settlement</u>

A settlement may result in recognizing a gain or loss.

<u>Pension Plans Settlements</u>

(¶ references in italics refer to paragraphs in SFAS No. 88.)

For pension plans, the maximum amount of gain or loss subject to recognition in earnings is the sum of (a) the unrecognized net gain or loss, including any gain or loss first measured at the time of settlement, and (b) any remaining unrecognized net asset existing at the time of initial application of SFAS 87 that remains unamortized at the date of settlement *(¶9 and ¶21)*

The gain or loss is accounted for as follows:

- *If the entire benefit obligation is settled, the maximum amount of gain or loss is recognized in earnings.*
- If only a part of the projected benefit obligation is settled, a pro rata portion of the maximum amount equal to the percentage reduction in the project benefit obligation is recognized in earnings. *(SFAS No. 88, ¶ 9 and 21)*

<u>*OPEB Settlements*</u>

(¶ references in italics refer to paragraphs in SFAS No. 106.)

For settlements of other post-retirement benefits plans, the gain or loss subject to recognition in income (the "maximum gain or loss") is the sum of (a) the unrecognized net gain or loss, including the gain or loss resulting form remeasurements of plan assets and the accumulated OPEB obligation at the time of settlement, and (b) any remaining unrecognized transition asset. *(¶92)*

The *gain or loss is accounted for as follows (¶93):*

Determination of Gain or Loss on OPEB Settlement

If...	...and the amount subject to recognition is a	
	Gain	Loss
The entire accumulated benefit obligation is settled	Recognize the maximum settlement gain as (1) a reduction in any remaining unrecognized transition obligation and (2) any excess gain in income	The maximum settlement loss is recognized in income
Only part of the accumulated benefit obligation is settled	Recognize a pro rata portion of the maximum settlement gain as (1) a reduction in any remaining unrecognized transition obligation and (2) the excess, if any, in income	Recognize in income a pro rata portion of the maximum settlement loss

<u>Accounting for a Curtailment</u>

A curtailment may result in a gain or loss.

For a curtailment, the gain or loss subject to recognition in earnings consists of the following effects:

(a) The unrecognized prior service cost associated with years of service no longer expected to be rendered as the result of a curtailment is a loss *(the description of this item differs slightly between*

SFAS No. 88 ¶12 and SFAS No. 106 ¶97)

(b) For pensions, any remaining net obligation existing at the time of initial application of SFAS 87 that remains unamortized at the date of the curtailment *(SFAS No. 88 ¶21)* and any unrecognized costs of retroactive plan amendments.

For OPEB, the portion of any remaining unrecognized transition obligation attributable to the previously expected remaining future years of service. *(SFAS No. 106 ¶97)*

(c) The curtailment gain – i.e., the decrease in the projected benefit obligation to the extent that it exceeds any unrecognized net loss *(SFAS No. 88 ¶13 and SFAS No. 106 ¶98)*

(d) The curtailment loss – i.e., the increase in the projected benefit obligation to the extent that it exceeds any unrecognized net gain *(SFAS No. 88 ¶13 and SFAS No. 106 ¶98)*

If the sum of effects (a) through (d) is a net loss, it is recognized in earnings when it is probable that a curtailment will occur and the effects are reasonably estimable. If the sum of effects (a) through (d) is a net gain, it is recognized in earnings when the related employees terminate or the plan suspension or amendment is adopted. *(SFAS No. 88 ¶14 and SFAS No. 106 ¶99)*

Measurement Dates

Under the measurement date requirements of SFAS No. 158, an employer is required to measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions). Duke Energy has adopted the measurement date provisions of SFAS No. 158; therefore, all plan assets and obligations are required to be measured as of December 31 of each year (any exceptions desired should be reported to and discussed with the Corporate Controller's Department).

For interim and annual financial statements, the measurements of plan assets and benefit obligations used in determining net periodic pension cost are required to be based on the assumptions used for the previous year-end measurements unless either:

- More recent measurements of both plan assets and benefit obligations are available; or
- A "significant event" occurs, such as a plan amendment that would ordinarily call for such measurements.

The availability of more recent measurements largely depends on whether a company needs them during a year. For example, the company might obtain measurements of its benefit obligations and plan assets at midyear in connection with negotiations relating to labor relations, merger or acquisition plans, or other business reasons. If so—and provided the measurements comply with Statement 87's "best estimate" and other requirements—the more recent measurements **are required to be used** for determining net periodic pension cost for the remainder of the year (or until more recent measurements are available, whichever occurs first).

The following are the primary events that would ordinarily be considered significant events:

- Plan amendments
- Business combinations
- Events covered by Statement 88 —settlements, curtailments, or in some cases, termination benefits
- Plan mergers, split-ups, or transfers of plan assets (without obligation transfers) from one plan to another

A plan amendment or significant event affecting one plan does not require more recent measurements for the unaffected plans.

Disclosures

SFAS No. 132(R) ¶6-7 provide guidance for aggregating disclosure information for employers with two or more benefit plans.

SFAS No. 132(R) ¶5 and SFAS No. 158 ¶7describe disclosures required in annual financial statements.

SFAS No. 132(R) ¶9 describes disclosure required in interim financial reports.

SFAS No. 132(R) also describes additional disclosures required for defined contribution plans (¶11) and multiemployer plans (¶12)

SFAS No. 158 describes additional disclosures required in the year of application.

Accounting Policy

The following is a discussion of matters specific or unique to Duke Energy with respect to the accounting for employee benefit plans.

Application to Duke Energy subsidiaries

Subsidiaries of Duke Energy which participate in a plan sponsored by its parent should generally follow the accounting required in SFAS Nos. 87 and 106 for multiemployer plans. In general, a participant in a multiemployer plan recognizes as net pension cost the require contribution for the period and recognizing as a liability any contributions due and unpaid. However, the net periodic pension cost recognized by a subsidiary is not necessarily equivalent to the required contribution for the period. Rather, the net periodic pension cost recognized by the subsidiary should be the amounts allocated to the subsidiary from the parent company for pension cost and any related credits from the amortization of a net asset at transition, which may not equate to the subsidiary's required contribution for the period. Regardless of the amounts recorded, adequate disclosures should be provided to indicate the amounts recorded.

Measurement Assumptions

The calculation of pension expense, other post-retirement expense and related pension and other post-retirement liabilities require the use of assumptions. Changes in these assumptions can result in different expense and reported liability amounts, and future actual experience can differ from the assumptions. The most critical assumptions for pension and other post-retirement benefits are the expected long-term rate of return on plan assets and the assumed discount rate. Additionally, the health care trend rate assumption is critical for other post-retirement benefits.

Rate of Return

The expected long-term rate of return is developed using a weighted average calculation of expected returns based primarily on future expected returns across asset classes considering the use of active asset managers.

Discount rate

The discount rate used to determine the pension and other post-retirement benefit obligations is based on an AA bond yield curve. The yield is selected based on bonds with cash flows that match the timing and amount of the expected benefit payments under the plan.

Health Care Trends

Duke Energy's U.S. post-retirement plan uses a medical care trend rate which reflects the near and long-term expectation of increases in medical health care costs. Duke Energy's U.S. post-retirement plan uses a prescription drug tend rate which reflects the near and long-term expectation of increases in prescription drug health care costs.

Net Periodic Benefit Cost

Service Costs

Pension and other post-retirement benefits costs are accrued over an employee's active service period to the date of full benefits eligibility. Service cost is the actuarial present value of benefits attributed by the plan's benefit formula to employee service rendered during a reporting period.

Actuarial Gains and Losses

Generally speaking, actuarial gains and losses are amortized over the average remaining service period of the active employees.

Actual Return on Plan Assets

Duke Energy determines the market-related value of plan assets using a calculated value that recognizes changes in fair value of the plan assets in a particular year on a straight-line basis over the next five years.

Dividends on Duke Energy shares held by the savings plan are charged to retained earnings when declared and shares held in the plan are considered outstanding in the calculation of basic and diluted earnings per share.

Amortization of Prior Service Costs

Prior service costs are amortized over the average remaining service period of the active employees.

Settlements and Curtailments

If (i) the cost of all settlements in a year is less than or equal to (ii) the sum of the service component and interest cost component of net period benefit cost for the plan for the year, then Duke Energy does not recognize any of the gain or loss in earnings.

For a pension plan, Duke Energy recognizes a curtailment when an event (1) reduces by 10% or more the expected years of future service of present employees or (2) eliminates for 10% or more of employees the accrual of benefits for some or all of their future services.

For other post-retirement benefits, Duke Energy recognizes a curtailment when an event (1) reduces by 10% or more the expected years of future service of active plan participants or (2) eliminates the accrual of defined benefits for some or all of the future services for of 10% or more of active plan participants.

Measurement Date

Duke Energy adopted the change in measurement date from September 30 to December 31 effective January 1, 2007 by remeasuring plan assets and benefit obligations as of that date, pursuant to the transition requirements of SFAS No. 158. Net periodic benefit cost for the three-month period between September 30, 2006 and December 31, 2006 were recognized, net of tax, as a separate adjustment of retained earnings as of January 1, 2007. Additionally, changes in plan assets and plan obligations between September 30, 2006 and December 31, 2006 not related to net periodic benefit cost were recognized, net of tax, as an adjustment to OCI.

Accounting by Regulated Entities

The implications of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," for operations of Duke Energy that are subject to this accounting are addressed in Duke Energy s separate policy entitled "Accounting for Regulated Entities (SFAS No. 71)".

Key Terms

Key terms used in the discussion of accounting for defined benefit pension plans and OPEB are FASB standards cited above and the FASB Current Text.

Related Policies, Standards, or Procedures

Duke Energy's *Life Tracks* Benefit Program Booklets
Administrative Information
Duke Energy Retirement Savings Plan: Summary Plan Description and Prospectus
Duke Energy Retirement Cash Savings Plan

Appendix A
Supplemental Accounting Guidance from the Emerging Issues Task Force (EITF)

EITF Issue No. 86-27, "*Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan*"

EITF Issue No. 88-1, "*Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan*"

EITF Issue No. 88-23, "*Lump-Sum Payments under Union Contracts*"

EITF Issue No. 90-3, "*Accounting for Employers' Obligations for Future Contributions to a Multiemployer Pension Plan*"

EITF Issue No. 91-7, "*Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits*"

EITF Issue No. 92-12, "*Accounting for OPEB Costs by Rate-Regulated Enterprises*"

EITF Issue No. 92-13, "*Accounting for Estimated Payments in Connection with the Coal Industry Retiree Health Benefit Act of 1992*"

EITF Issue No. 93-3, "*Plan Assets under FASB Statement No. 106*"

EITF Issue No. 03-2, "*Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities*"

EITF Issue No. 03-4, "*Determining the Classification and Benefit Attribution Method for a 'Cash Balance' Pension Plan*"

EITF Topic No. D-27, "*Accounting for the Transfer of Excess Pension Assets to a Retiree Health Care Benefits Account*"

EITF Topic No. D-36, "*Selection of Discount Rates Used for Measuring Defined Benefit Pension Obligations and Obligations of Postretirement Benefit Plans Other Than Pensions*"

Accounting for Goodwill

Applicability:	Applies to Enterprise
Originator:	Corporate Controller
Approval:	Corporate Controller
Effective Date:	12/01/2004
Revision Date:	12/17/2007
Reissue Date:	12/17/2007

Statement of Purpose and Philosophy

The purpose of this policy is to provide guidelines related to the financial accounting and reporting for goodwill under the provisions of FASB Statement No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"). Duke Energy is committed to preparing and providing financial information with the utmost integrity. To facilitate this corporate value, the Corporate Controller's Department will approve policies to ensure the accuracy of books and records (as detailed in the Code of Business Ethics).

Policy Expectations and Scope

The intent of this policy is to communicate the financial accounting and reporting for goodwill under the provisions of SFAS No. 142. SFAS No. 142 addresses how goodwill should be accounted for after it has been initially recognized in the financial statements, including requiring goodwill to be tested for impairment annually, and not allowing goodwill to be amortized. This policy contains a high-level summary of the key requirements of U. S. GAAP as it applies to Duke Energy, including any significant interpretations or policy elections made by Duke Energy, but is not intended to be a substitute for the detail requirements of authoritative GAAP literature for specific issues or matters that may arise. This policy does not address the application of purchase accounting under FASB Statement No. 141, "Business Combinations," or the initial recognition of goodwill.

This policy is applicable to all business/corporate units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company"), and should help ensure consistent application of the accounting for goodwill across the consolidated Duke Energy group.

Materiality

FASB Statements note that "The provisions of this Statement need not be applied to immaterial items." Accordingly, materiality should be considered when applying this policy. However, materiality must be assessed at the Business/Corporate Unit as well as at the consolidated levels, and involves consideration of both quantitative as well as qualitative factors. Any questions regarding materiality should be directed to the Corporate Controller's Department.

Accountability: Roles and Responsibilities

Corporate Controller's Department -

- Maintain an accounting policy for goodwill available on the Duke Energy portal to help ensure that business/corporate units are aware of how to account for goodwill, and when goodwill is to be tested for impairment.
- Establish and communicate the reporting timetable for goodwill information needed for SEC filings, and accumulate the information reported by the business/corporate units for periodic reporting and disclosure purposes (e.g. Form 10-K, Form 10-Q, etc.).
- Determine the financial statement presentation of goodwill and any goodwill impairment loss on a consolidated basis at each reporting period.
- Coordinate with the business/corporate units to ensure that proper documentation exists to support the level of operations identified as constituting a reporting unit.
- Provide guidance/assistance to business/corporate units on when goodwill should be tested for impairment under certain circumstances, and how goodwill should be tested for impairment.
- Provide guidance to business/corporate units on the allocation of any corporate goodwill to a reporting unit and, as appropriate, assist in the impairment tests of any goodwill that resides at the corporate level.
- Provide guidance on the consideration of materiality as may be requested by the business/corporate units.
- Coordinate with the business/corporate units to assess the need to file a Form 8-K for any material goodwill impairments.

Business/Corporate Unit -

- Ensure all reporting requirements of goodwill and any goodwill impairment loss are accumulated and reported to the Corporate Controller's Department in accordance with the established reporting timetable.
- Coordinate with the Corporate Controller's Department to ensure that proper documentation exists to support the level of operations identified as constituting a reporting unit.
- Ensure proper support/documentation exists for the determination of estimated fair value of the reporting unit (or portion of a reporting unit, if the business/corporate unit is a portion of a reporting unit) that was evaluated for goodwill impairment, including determination of the appropriate discount rate to be used if a discounted cash flow approach is used to estimate fair value.
- Ensure proper support/documentation exists for the recording of any goodwill impairment loss.
- Ensure proper support/documentation exists if no new impairment assessment was performed at the annual testing date for the respective reporting unit (or portion of a reporting unit, if the business/corporate unit is a portion of a reporting unit).
- Monitor for any triggering events that would warrant a goodwill impairment assessment between annual testing dates.
- Notify the Corporate Controller's Department upon determining that any goodwill impairment exists and coordinate with the Corporate Controller's Department to assess the need to file a Form 8-K for any material goodwill impairments.

Standards/Requirements

[NOTE: In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value in US GAAP, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements; however SFAS No. 157 amends some of the accounting pronouncements discussed in this policy and therefore, the application of SFAS No. 157 may change Duke Energy's current

practice for determining fair values for the areas of accounting covered by this policy. For Duke Energy, SFAS No. 157 is effective as of January 1, 2008 and must be applied prospectively except in certain cases. This version of this accounting policy does not reflect the provisions of SFAS No. 157 since the reissue date of this policy predates the effective date of SFAS No. 157.]

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 142, which superseded the previous guidance for intangible assets prescribed in APB Opinion No. 17, "Intangible Assets". Duke Energy adopted SFAS No. 142 effective January 1, 2002. SFAS No. 142 requires goodwill to be tested for impairment annually, and does not allow goodwill to be amortized.

Supporting Guidance

This section primarily contains references to, and excerpts from, the most significant or applicable GAAP authoritative literature. Matters specific or unique to Duke Energy are primarily discussed in the "Accounting Policy" section below.

Goodwill Definition and Recognition:

Goodwill is defined in SFAS No. 142 as follows:

"The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. The amount recognized as goodwill includes acquired intangible assets that do not meet the criteria in FASB Statement No. 141, "Business Combinations," for recognition as an asset apart from goodwill."

As noted in the definition, goodwill for accounting purposes represents the residual value paid in a business combination over the amounts assigned to individual assets acquired and liabilities assumed. Accordingly, no amount should be recorded for any goodwill that is generated internally from ongoing business operations.

When to Test Goodwill for Impairment:

Goodwill shall be tested for impairment at the reporting unit (see Appendix A for guidance on determination of a reporting unit) level on an annual basis. The impairment test is a two-step process. The first step involves comparing the fair value (see Appendix B for definition of fair value and guidance on measuring fair value and the discussion of the valuation considerations in EITF Issue No. 02-13 in the "Deferred Income Taxes" section below) of the reporting unit to its carrying value, including goodwill. If carrying value exceeds fair value, step two of the test is required. Step two involves a hypothetical purchase price allocation, to determine the "implied fair value" of goodwill, (i.e. the amount of goodwill that would result in a purchase business combination as of the date the impairment test is being performed). Step two involves allocating the fair value of the reporting unit to all tangible and intangible assets and liabilities, with any remaining unallocated fair value representing the implied fair value of goodwill. If this implied fair value of goodwill is less than book value, then an impairment loss is recognized for the difference.

Paragraphs 19-22 of SFAS No. 142 discuss the use of the two-step method in the recognition and measurement of a goodwill impairment loss.

The date of the annual goodwill impairment test can differ for reporting units, and the annual impairment test can be performed at any time during the year provided that it is performed at the same time each year. Goodwill shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Examples of such events or circumstances include (paragraph 28, SFAS No. 142):

- A significant adverse change in legal factors or in the business climate.
- An adverse action or assessment by a regulator.
- Unanticipated competition.
- A loss of key personnel.
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of.
- The testing for recoverability under SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," of a significant asset group within a reporting unit.
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

In addition, goodwill must be tested for impairment after a portion of goodwill has been allocated to a portion of a reporting unit to be disposed of.

Per paragraph 27 of SFAS No. 142, a detailed determination of the fair value of a reporting unit may be carried forward from one year to the next if all of the following criteria have been met:

a. "The assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination. (A recent significant acquisition or a reorganization of an entity's segment reporting structure is an example of an event that might significantly change the composition of a reporting unit.)
b. The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin.
c. Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit is remote."

If goodwill and another asset (or asset group) of a reporting unit are tested for impairment at the same time, the other asset (or asset group) shall be tested for impairment before goodwill. For example, if a significant asset group is to be tested for impairment under SFAS No. 144 (thus potentially requiring a goodwill impairment test), the impairment test for the significant asset group would be performed before the goodwill impairment test. If the asset group was impaired, the impairment loss would be recognized prior to goodwill being tested for impairment. (paragraph 29, SFAS No. 142)

Goodwill Impairment Testing by a Subsidiary:

Paragraph 37 of SFAS No. 142 notes that subsidiary goodwill shall be tested for impairment at the subsidiary level using the subsidiary's reporting units. If a goodwill impairment loss is recognized at the subsidiary level, goodwill of the reporting unit or units (at the higher consolidated level) in which the subsidiary's reporting unit with impaired goodwill resides must be tested for impairment if the event that gave rise to the loss at the subsidiary level would more likely than not reduce the fair value of the reporting unit (at the higher consolidated level) below its carrying amount. Only if goodwill of that higher-level reporting unit is impaired would a goodwill impairment loss be recognized at the consolidated level.

Goodwill Impairment Testing When a Noncontrolling Interest Exists:

Paragraph 38 of SFAS No. 142 discusses goodwill impairment testing when a noncontrolling interest exists (a noncontrolling interest is sometimes referred to as a minority interest). Goodwill arising from a business combination with a continuing noncontrolling interest shall be tested for impairment using an approach consistent with the approach used to measure the noncontrolling interest at the acquisition date. For example, if goodwill is initially recognized based only on the controlling interest of the parent, the fair value of the reporting unit used in the impairment test should be based on that controlling interest and should not reflect the portion of fair value attributable to the noncontrolling interest. Similarly, the implied fair value of goodwill that is determined in the second step of the impairment test and used to measure the impairment loss should reflect only the parent company's interest in that goodwill.

Disposal of All or a Portion of a Reporting Unit:

When a reporting unit is to be disposed of in its entirety, goodwill of that reporting unit shall be included in the carrying amount of the reporting unit in determining the gain or loss on disposal. When a portion of a reporting unit that constitutes a business is to be disposed of, goodwill associated with that business shall be included in the carrying amount of the business in determining the gain or loss on disposal (a "business" is defined as "a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors, consisting of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues"(from paragraph 6, EITF Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business")). The amount of goodwill to be included in that carrying amount shall be based on the relative fair values of the business to be disposed of and the portion of the reporting unit that will be retained. For example, if a business is being sold for $100 and the fair value of the reporting unit excluding the business being sold is $300, 25 percent of the goodwill residing in the reporting unit would be included in the carrying amount of the business to be sold.

However, if the business to be disposed of was never integrated into the reporting unit after its acquisition and thus the benefits of the acquired goodwill were never realized by the rest of the reporting unit, the current carrying amount of that acquired goodwill shall be included in the carrying amount of the business to be disposed of. That situation might occur when the acquired business is operated as a stand-alone entity or when the business is to be disposed of shortly after it is acquired. When only a portion of goodwill is allocated to a business to be disposed of, the goodwill remaining in the portion of the reporting unit to be retained shall be tested for impairment in accordance with paragraphs 19-22 (using its adjusted carrying amount). [paragraph 39, SFAS No. 142]

Equity Method Investments:

Per paragraph 40 of SFAS No. 142, goodwill recognized on an equity method investment (i.e. the portion of the difference between the cost of an investment and the amount of underlying equity in net assets of an equity method investee) shall not be amortized. However, equity method goodwill shall not be reviewed for impairment in accordance with SFAS No. 142. Equity method investments shall continue to be reviewed for impairment in accordance with paragraph 19(h) of APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock." (Refer to Duke Energy's accounting policy titled "Accounting for Asset Impairments, Assets Held for Sale and Discontinued Operations (SFAS No. 144 and APB No. 18)")

Assigning Goodwill to Reporting Units:

Paragraphs 34 and 35 of SFAS No. 142 address assigning goodwill to reporting units.

"34. For the purpose of testing goodwill for impairment, all goodwill acquired in a business combination shall be assigned to one or more reporting units as of the acquisition date. Goodwill shall be assigned to reporting units of the acquiring entity that are expected to benefit from the synergies of the combination even though other assets or liabilities of the acquired entity may not be assigned to that reporting unit. The total amount of acquired goodwill may be divided among a number of reporting units. The methodology used to determine the amount of goodwill to assign to a reporting unit shall be reasonable and supportable and shall be applied in a consistent manner. In addition, that methodology shall be consistent with the objectives of the process of assigning goodwill to reporting units described in paragraph 35.

35. In concept, the amount of goodwill assigned to a reporting unit would be determined in a manner similar to how the amount of goodwill recognized in a business combination is determined. An entity would determine the fair value of the acquired business (or portion thereof) to be included in a reporting unit—in essence a "purchase price" for that business. The entity would then allocate that purchase price to the individual assets acquired and liabilities assumed related to that acquired business (or portion thereof). Any excess purchase price is the amount of goodwill assigned to that reporting unit. However, if goodwill is to be assigned to a reporting unit that has not been assigned any of the assets acquired or liabilities assumed in that acquisition, the amount of goodwill to be assigned to that unit might be determined by applying a "with and without" computation. That is, the difference between the fair value of that reporting unit before the acquisition and its fair value after the acquisition represents the amount of goodwill to be assigned to that reporting unit."

Deferred Income Taxes:

Paragraph 30 of SFAS No. 109, "Accounting for Income Taxes", states that deferred income taxes are not recognized for any portion of goodwill for which amortization is not deductible for income tax purposes. Paragraphs 261 and 262 of SFAS No. 109 provide additional guidance for recognition of deferred income taxes related to goodwill when amortization of goodwill is deductible for tax purposes.

EITF Issue No. 02-13, "Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB Statement No. 142," reached a consensus on several issues related to deferred income taxes and goodwill impairment. First, when deciding whether to estimate the fair value of a reporting unit based on a purchase or sale in a taxable or nontaxable transaction, it is a matter of judgment that depends on relevant facts and circumstances and must be evaluated carefully on a case-by-case basis. Consideration should be given to assumptions that marketplace participants would incorporate into their estimates of fair value, the feasibility of the assumed structure (including whether the reporting unit could be sold in a nontaxable transaction and whether there are any laws or regulations that could impact the ability to treat the sale as nontaxable) and whether the assumed structure results in the highest economic value to the seller for the reporting unit, including consideration of related tax implications. Second, the issue decided that deferred income taxes should be included in the carrying value of the reporting unit, regardless of whether the fair value of the reporting unit will be determined assuming it would be bought or sold in a taxable or nontaxable transaction. Finally, when estimating the fair value of the reporting unit in Step 1 of the impairment test, the issue determined that an entity should use its existing income tax bases if the assumed structure used to estimate the fair value of the reporting unit was a nontaxable transaction, and it should use new income tax bases if the assumed structure was a taxable transaction.

Disclosure Requirements:

The disclosure requirements for the carrying amount of goodwill and for any goodwill impairment loss recognized are as follows (paragraphs 45-47 of SFAS No. 142):

- The changes in the carrying amount of goodwill during the period including:
  (1) The aggregate amount of goodwill acquired
  (2) The aggregate amount of impairment losses recognized
  (3) The amount of goodwill included in the gain or loss on disposal of all or a portion of a reporting unit.
- Entities that report segment information in accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," shall provide the above information about goodwill in total and for each reportable segment and shall disclose any significant changes in the allocation of goodwill by reportable segment. If any portion of goodwill has not yet been allocated to a reporting unit at the date the financial statements are issued, that unallocated amount and the reasons for not allocating that amount shall be disclosed.
- For each goodwill impairment loss recognized, the following information shall be disclosed in the notes to the financial statements that include the period in which the impairment loss is recognized:
  - A description of the facts and circumstances leading to the impairment
  - The amount of the impairment loss and the method of determining the fair value of the associated reporting unit (whether based on quoted market prices, prices of comparable businesses, a present value or other valuation technique, or a combination thereof)
  - If a recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons therefore and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.

Unless related to a component of an entity that is being presented as a discontinued operation, a goodwill impairment loss shall be included in income from continuing operations before income taxes, and also reflected in operating income if such a subtotal is presented in the Statement of Operations.

SEC Form 8-K Reporting Requirements:

In August 2004, the SEC expanded the number of events that are reportable on Form 8-K to include "material impairments." See the separate Duke Energy policy statement entitled "Form 8-K Requirements and Filing Procedure" for further discussion of this matter.

Accounting Policy

Duke Energy evaluates goodwill for potential impairment under the guidance of SFAS No. 142, Goodwill and Other Intangible Assets" (SFAS No. 142). Under this provision, Duke Energy has designated August 31 as the date it performs the annual review for impairment for its reporting units. Under the provisions of SFAS No. 142, Duke Energy performs the annual review for impairment at the reporting unit level, which has been determined to be an operating segment or one level below. (See Appendix A for guidance on determining reporting units.) Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. Goodwill of a reporting unit shall be tested for impairment at an interim date if the events or circumstances, described in paragraph 28 of SFAS No. 142 (describe above) exist. If none of these above certain circumstances or events have occurred, and the three requirements in paragraph 27 of SFAS No. 142 are met, no new impairment assessment need be performed. The business unit shall document that there were no triggering events during the current year and that these requirements were met. This documentation shall be provided in accordance with the established annual testing timetable for the respective reporting unit.

Recognition and Measurement of an Impairment Loss:

Impairment testing of goodwill consists of a two-step process. The first step involves a comparison of the implied fair value of a reporting unit with its carrying amount. If the carrying amount of the reporting unit exceeds its fair value, the second step of the process involves a comparison of the fair value and carrying value of the goodwill of that reporting unit. If the carrying value of the goodwill of a reporting unit exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to the excess. Additional impairment tests are performed between the annual reviews if events or changes in circumstances make it more likely than not that the fair value of a reporting unit is below its carrying amount.

See Appendix B for guidance on measuring fair value and the discussion of the valuation considerations in EITF Issue No. 02-13 in the "Deferred Income Taxes" section above. Duke Energy primarily uses a discounted cash flow analysis to determine fair value of a reporting unit. Key assumptions in the determination of fair value include the use of an appropriate discount rate, estimated future cash flows and estimated run rates of operation, maintenance, general and administrative costs, income taxes and other applicable costs and expenses. In estimating cash flows, Duke Energy incorporates expected growth rates, stability and ability to renew as well as other factors into its revenue and expense forecasts.

When a reporting unit is to be disposed of in its entirety, goodwill of that reporting unit shall be included in the carrying amount of the reporting unit in determining the gain or loss on disposal. When a portion of a reporting unit is to be disposed of, a determination shall be made on whether that portion of the reporting unit constitutes a business. If it does constitute a business, the goodwill associated with that business (based on the relative fair values of the business to be disposed of and the portion of the reporting unit that will be retained) shall be included in the carrying amount of the business in determining the gain or loss on disposal. If however the business to be disposed of was never integrated into the reporting unit after its acquisition and thus the benefits of the acquired goodwill were never realized by the rest of the reporting unit, the current carrying amount of that acquired goodwill shall be included in the carrying amount of the business to be disposed of.

Equity method goodwill shall not be reviewed for impairment in accordance with SFAS No. 142. Equity method investments shall be reviewed for impairment in accordance with paragraph 19(h) of APB Opinion 18, which states that a loss in value of an investment which is other than a temporary decline should be recognized. (Refer to Duke Energy's accounting policy titled "Accounting for Asset Impairments, Assets Held for Sale and Discontinued Operations (SFAS No. 144 and APB No. 18)")

Allocation of Corporate Goodwill to Reporting Units:

Goodwill shall be assigned to reporting units of the acquiring entity that are expected to benefit from the synergies of the combination even though other assets or liabilities of the acquired entity may not be assigned to that reporting unit. The total amount of acquired goodwill may be divided among a number of reporting units. The methodology used to determine the amount of goodwill to assign to a reporting unit shall be reasonable and supportable and shall be applied in a consistent manner. In addition, that methodology shall be consistent with the objectives of the process of assigning goodwill to reporting units as determined in a purchase price allocation (purchase business combination).

Reporting Requirements – At each quarterly and annual reporting period:

- The aggregate amount of goodwill shall be presented as a separate line item in the balance sheet.
- The aggregate amount of goodwill impairment losses shall be presented as a separate line item in the income statement as part of income from continuing operations. A goodwill impairment loss associated with a discontinued operation shall be included (on a net-of-tax basis) within the results of discontinued operations.
- See above for disclosure requirements for the carrying amount of goodwill and for any goodwill impairment loss recognized.

Key Terms

Fair value – see discussion in Appendix B for details around fair value.

Reporting unit - see discussion in Appendix A for details around reporting unit.

Accounting for Intercompany Transactions Policy

Applicability:	Applies to Enterprise
Originator:	Corporate Controller
Approval:	*Corporate Controller*
Effective Date:	07/31/2004
Revision Date:	03/31/2008
Reissue Date:	03/31/2008

Outline

I. Policy Intent/Philosophy

The Accounting for Intercompany Transactions Policy ("the Policy") was established to define the accounting standards for ensuring the timely, accurate and consistent reconciliation, recording and elimination of intercompany transactions in accordance with U.S. Generally Accepted Accounting Principles ("USGAAP"), including defining:

- roles and responsibilities
- process for dispute resolution
- process for non-routine transactions

For the purpose of this Policy, intercompany transactions are defined as both intra-business unit transactions (transactions within a consolidated business unit) and inter-business unit transactions (transactions between consolidated business units).

Intercompany transactions for the purposes of this Policy include, but are not limited to, the recording of actuals, estimates, accruals, expense/revenue reimbursements, loans, and allocations.

This Policy is applicable to all business units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company").

This Policy is not applicable for investments in unconsolidated domestic and international affiliates that are not controlled by Duke Energy, which are accounted for using the equity method.

II. Policy Expectations

All Business Unit Accounting personnel of Duke Energy involved with the recording of intercompany transactions shall:

- Ensure compliance with the Policy including all appendices and all related policies, standards or procedures referenced in the Policy;
- Make every effort to minimize the possibility of disputes arising from transactions between affiliates by properly documenting all intercompany transactions per the Code of Business Ethics - Accuracy of Books & Records and Reporting Information and Contract Authorization ("COBE").

III. Policy Definitions

Corporate Controller or his/her designee "Corp Controller" - defined as the person who is in the role of Controller for Duke Energy Corporation or his/her designee.

"BU Controller" or his/her designee - defined as the person(s) who is a Direct Report to the Corporate Controller and is responsible for the accounting of each of the reportable segments of Duke Energy Corporation.

Enterprise Intercompany Process Owner "Enterprise IPO" - defined as the person who is in the role of Intercompany Process Owner for all of Duke Energy Corporation and its consolidated subsidiaries.

Business Unit Intercompany Process Owner "BU IPO" - defined as the person who is in the role of Intercompany Process Owner for each of the reportable segments of Duke Energy Corporation.

Seller/Sender Corporate or Business Unit "Seller/Sender" - defined as the corporate or business unit who is selling the product/service or sending the charge. For intercompany cash sweeps or other cash-related transactions between Duke Energy Corp and any other business unit, the Corporate Accounting Department will be responsible for all journal entries and all Seller/Sender activities no matter whether Duke Energy Corp is sending or receiving cash.

Purchaser/Receiver Corporate or Business Unit "Purchaser/Receiver" - defined as the corporate or business unit who is purchasing the product/service or receiving the charge.

Monthly and Quarterly Close Calendar "the Calendar" - *defined as the monthly and quarterly* schedule of all close related due dates and deadlines distributed by the Corporate Controller's Office of Duke Energy Corporation.

IV. Policy Requirements

A. **Timing**
In accordance with the dates established by the Corporate Controller and distributed in the Calendar,

- All intercompany transactions shall be recorded
- All intercompany account balances shall be reconciled and eliminated
- All intercompany discrepancies shall be resolved

Any intercompany transaction that is not completed in accordance with the dates distributed in the Calendar shall be reported to the Enterprise IPO.

B. **Dispute Resolution**
Every effort shall be made to resolve disputed items directly between the Seller/Sender and the Purchaser/Receiver prior to the deadline for recording intercompany transactions distributed in the Calendar. In the event that "actual" transaction amounts cannot be mutually agreed upon (i.e., disputes over quantity and/or pricing), prior to this deadline, the Seller's/Sender's supporting documentation shall be used to record the transaction by both parties in the financial system in order to meet this deadline.

Disputed transactions between affiliates not resolved during the current accounting period shall not be recorded to a deferred account or any other account on the balance sheet or income statement, nor shall the balance be offset against 3rd party balances. These disputed balances (i.e., the difference between the amount recorded to the general ledger by the Seller/Sender and the amount the Purchaser/Receiver believes to be the correct amount billed/received), shall be properly documented in the Intercompany Schedule of Disputed Items and shall be resolved before workday 1 of the following accounting period. (Refer to attached Appendix A- the Intercompany Dispute Resolution Procedure for more details).

Sound business judgment shall be used when resolving disputes. For example, where a third-party statement is the source and is available, it shall be used as the defining document for resolution. If a third-party statement is not available, the parties shall refer to contractual documentation or tariffs as a means for resolution. In cases where one party did not record one side of the transaction, the other party shall provide the supporting documentation for issue resolution.

Intercompany transactions in dispute shall not preclude cash settlement, where required, in accordance with related contractual documentation or tariffs. To reduce time spent processing and reconciling intercompany transactions, the relative value and materiality of the disputed transaction should be considered.

C. **Methods for Recording Intercompany Transactions**

When recording intercompany transactions to the general ledger, designated intercompany accounts and one of the following methods shall be used. Also any subsequent reclass entries (for analysis and/or regulatory requirements) shall be recorded using contra accounts. (Refer to attached Appendix B for flowcharts of each method and Appendix C regarding general ledger accounts). Any exceptions to use of the designated intercompany or contra accounts must be approved by the Enterprise IPO prior to recording any entries to the general ledger.

- **Auto-generating**
  All intercompany transactions required for recording loans, cash sweeps, or that generate the booking of revenue and generation of a receivable where both affiliates are on the enterprise PeopleSoft ledger shall be recorded using the Auto-generating Method. The Auto-generating Method only handles US Dollar denominated transactions; any non US Dollar denominated transactions shall be exempt from using this method. This method automatically generates the Purchaser/Receiver transaction based on the Seller/Sender transaction and is available to all business units within the enterprise PeopleSoft general ledger.
- **Manual Balancing**
  Although manual balancing is not the preferred method for recording inter-business unit transactions, manual balancing can be used when deemed necessary. Examples include: intercompany transactions that are required for recording investment/equity, intercompany derivatives, non-U.S. dollar denominated transactions or, in the case where the transaction is with an affiliate who is not on the enterprise-wide PeopleSoft sourced general ledger.

  Prior to recording inter-business unit transactions using the manual balancing method, both the Seller/Sender and Purchaser/Receiver must submit a request for approval to the Enterprise IPO. The request shall include the reason for using this method and documentation of the mitigating controls in place to ensure compliance with the Policy. (Refer to attached Appendix D for Manual Balancing Approval Request Form).

- **Automated Crossbill**
  All intercompany transactions that are required for recording allocations or expense/revenue transfers between corporate/business units shall be recorded using the Automated Crossbill Method. Allocations or expense/revenue transactions recorded using this method may be recorded to 3rd party accounts rather than designated intercompany accounts as long as individuals responsible for the transaction ensure the propriety of the effect to the consolidated financial statement line items. The PeopleSoft system automatically generates the related receivable or payable to intercompany accounts.

D. **Settlements**

All intercompany transactions between affiliates that do not cross country borders, except federal and state taxes payable, shall be settled at least once per quarter (in advance of quarter close), unless otherwise provided in accordance with related contractual documentation or tariffs. The settlement shall occur either through cash settlement, reclassification to intercompany advances, intercompany notes receivable or payable or reclassification to equity.

All intercompany transactions between affiliates that do cross country borders, must be in cash and shall occur at least once per month, unless otherwise provided in accordance with related contractual documentation or tariffs.

In order to reduce costs associated with transferring cash, intercompany accounts receivable and accounts payable balances shall be netted prior to settling with cash, unless otherwise restricted in related contractual documentation or tariffs or unless previously agreed by both affiliates to settle in gross to facilitate account reconciliation.

- **Settlement of Wholly Owned Affiliate Transactions**
  Transactions between affiliates that are **wholly owned** by Duke Energy, and do not cross country borders, are generally not settled in cash unless there is a specific business reason, or contractual obligation to do so. All wholly owned intercompany balances not settled in cash shall be reclassified to the intercompany advance account on a one month lag by the Enterprise IPO, or his/her designee (i.e., prior month balances are reclassified during the

current month), except for federal and state taxes payable which shall be reclassified to the intercompany advance account annually. At least once per quarter, the Enterprise IPO will be responsible for reviewing the intercompany advance account of any SEC registrant of Duke Energy to determine whether any of the balances should be converted to a note or equity. The Enterprise IPO shall consult with the BU Controller, Corporate Treasurer's Department, and the Tax Department to evaluate the impacts, if any (i.e., debt/equity ratio, tax, etc.) and will coordinate with the appropriate subject matter experts prior to reclassifying any of the balances. Refer to the Intercompany Funding Policy and Business Unit Capitalization Protocol documentation for additional information.

- **Settlement of Non Wholly Owned Affiliate Transactions**
  Where the intercompany transaction is with an affiliate that is not wholly owned by Duke Energy, unless otherwise provided in related contractual documentation or tariff, the transaction shall be settled in cash on a monthly basis. The Enterprise IPO and the BU IPO's will be responsible for monitoring these transactions to determine that settlement has occurred timely and in accordance with related contractual documentation or tariffs and/or the Calendar as appropriate.

E. **Accounting for Non-Routine Transactions**
From time to time the Company may be involved in accounting for major transactions, new accounting guidelines/pronouncements/issues, and significant, non-recurring transactions (e.g. sale of a business). When these situations arise, the BU Controller will be responsible for ensuring the accounting for intercompany transactions is considered and that any identified affiliate transactions are accurately recorded and eliminated during the consolidations processing. Refer to the Documentation and Consultation for Significant Accounting or Reporting Matters Policy and/or Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues, New Accounting Guidance and Significant Non-recurring Entries Policy for additional information.

F. **Consolidations/Eliminations**
All intercompany transactions shall be eliminated within the consolidated financial statements of Duke Energy in accordance with USGAAP. In order to ensure accurate and timely elimination of all designated intercompany account balances and elimination of intercompany profit, the Intercompany Process Owners will be responsible for reconciling the Intercompany Out of Balance Report and reviewing other reports as deemed necessary to ensure the propriety of intercompany balances and the effect of the eliminations on consolidated financial statement line items, and submitting reports to the Corporate and BU Controllers for final review and sign off. (Refer to attached Appendix E for the Eliminations Procedures for more details).

G. **Account Reconciliations**
Account analysis and reconciliations of intercompany accounts shall be performed in accordance with the Account Analysis and Reconciliation Policy. During the reconciliation process, account owners should coordinate with affiliate account owners to ensure accurate account balances.

V. Roles and Responsibilities

A. Corporate Controller

- Ensure by policy, procedure, review and sign off that all business units are recording intercompany transactions on a timely, accurate and consistent basis;
- Designate an individual who will serve as Enterprise Intercompany Process Owner;
- Establish and enforce a cutoff date for each accounting period for recording, reconciling and eliminating intercompany transactions and resolving any out of balances which will be distributed in the Calendar;
- Address disputed intercompany transactions between business units that remain unresolved after close of workday 1 of the following accounting period and is ultimately responsible for ensuring resolution;
- Perform final review and sign off of monthly Intercompany Schedule of Disputed Balances, Intercompany Out of Balance Report and other reports as deemed necessary to ensure the

propriety of intercompany balances and the effect of the eliminations on consolidated financial statement line items;

- Perform general administration of the Policy, including periodic review and update for changes in accounting standards, business conditions and other factors;
- When accounting for non-routine transactions, ensure the accounting for intercompany transactions is considered and that any identified affiliate transactions are accurately recorded and eliminated during the consolidations processing.

B. **Business Unit Controllers**

- Ensure assigned business units are recording intercompany transactions on a timely, accurate and consistent basis and are in compliance with the Policy and all related policies and procedures;
- Designate an individual who will serve as Intercompany Process Owner for assigned business units;
- Understand the legal entity structure for assigned business units and ensure accounting entries are consistent with the legal hierarchy. Refer to the Creation, Dissolution, or Restructuring of Legal Entities & Subsidiaries Policy;
- Ensure disputed intercompany transactions between business units and/or corporate are resolved. If necessary work with the affiliate BU Controller to reach a resolution and record proper transactions by the deadline distributed in the Calendar;
- Perform final review and sign off of monthly Intercompany Schedule of Disputed Balances, Intercompany Out of Balance Report and other reports as deemed necessary to ensure the propriety of intercompany balances and the effect of the eliminations on consolidated financial statement line items for assigned business units;
- When accounting for non-routine transactions, ensure the accounting for intercompany transactions is considered and that any identified affiliate transactions are accurately recorded and eliminated during the consolidations processing.

C. **Enterprise Intercompany Process Owner**

- Ensure each of the BU IPO's are in compliance with the Policy;
- Ensure all disputed balances between affiliates are resolved by maintaining the Intercompany Schedule of Disputed Items and administering the Dispute Resolution Procedure (Refer to attached Appendix A for the Dispute Resolution Procedure);
- Ensure all intercompany balances are accurately and timely eliminated during the consolidations processing by monitoring the Intercompany Out of Balance Report, reviewing other reports as deemed necessary to ensure the propriety of intercompany balances and the effect of the eliminations on consolidated financial statement line items and administering the Eliminations Procedures (Refer to attached Appendix E for the Eliminations Procedures);
- Ensure the BU IPO's facilitate the accurate and timely settlement of all Duke Energy affiliate transactions in accordance with related contractual documentation or tariffs, either through cash settlement, reclassification to intercompany advances, intercompany notes receivable or payable or reclassification to equity;
- Provide training of the Policy to all business unit personnel involved in the recording of intercompany transactions.

D. **Business Unit Intercompany Process Owners**

- Ensure assigned business units are in compliance with the Policy;
- Maintain the Intercompany Schedule of Disputed Items for assigned corporate/business unit and ensure that all disputed items are resolved per the Policy;
- Ensure all intercompany balances are accurately and timely eliminated during the consolidations processing by monitoring the Intercompany Out of Balance Report, reviewing other reports as deemed necessary to ensure the propriety of intercompany balances and the effect of the eliminations on consolidated financial statement line items and

administering the Eliminations Procedures for assigned business/corporate units (Refer to attached Appendix E for the Eliminations Procedures);

- Ensure the accurate and timely settlement of all assigned Duke Energy affiliate transactions in accordance with related contractual documentation or tariffs, either through cash settlement, reclassification to intercompany advances, intercompany notes receivable or payable or reclassification to equity.
- Notify the BU IPO of the Seller/Sender business unit and the Enterprise IPO when the Purchaser/Receiver business unit is capitalizing any intercompany transactions

E. **Seller/Sender and Purchaser/Receiver**

- Seller/Sender is responsible for contacting the Purchaser/Receiver by phone, email or any other reasonable method prior to recording intercompany transactions to verify the accuracy and mutual agreement of all charges, volumes, values, and the account chartfields and shall make every effort to resolve any discrepancies prior to recording intercompany transactions to the general ledger. Exceptions by the Seller/Sender in contacting the Purchaser/Receiver prior to recording intercompany transactions may be granted for routine transactions (e.g. allocations) and must be approved in advance by the Enterprise IPO;
- Seller/Sender shall record all intercompany transactions by the deadline as distributed in the Calendar;
- Seller/Sender is responsible for properly documenting all transactions prior to recording journal entries in accordance with The Journal Entry Creation and Approval Requirements for Non-System Generated Journals Policy, which encompasses the Create/ Review guidelines;

    - For intercompany cash sweeps or other cash-related transactions between Duke Energy Corp and any other business unit, the Corporate Accounting Department will be responsible for all journal entries and all Seller/Sender activities no matter whether Duke Energy is sending or receiving cash;
    - Purchaser/Receiver is responsible for reviewing and verifying all charges received and notifying the Seller/Sender of any charges that were not recorded as previously agreed;
    - Purchaser/Receiver is responsible for updating the Intercompany Schedule of Disputed Items and working with the Seller/Sender to ensure all disputed items are resolved by close of workday 1 of the following accounting period.

VI. **Appendices**

- Appendix A - Intercompany Dispute Resolution Procedure
- Appendix B - Methods for Recording Intercompany Transactions
- Appendix C - Intercompany Accounts and Definitions
- Appendix D - Manual Balancing Approval Request Form
- Appendix E - Eliminations and Out of Balance Materiality Procedures
- Appendix F - Investment and Equity Transactions Procedures

Appendix A – Intercompany Dispute Resolution Procedure

Philosophy

This procedure was developed to establish the framework for resolving intercompany discrepancies on a timely basis, and should accompany the *Accounting for Intercompany Transactions Policy*. For the purpose of this procedure, intercompany transactions are defined as both intra-business unit transactions (transactions within a consolidated reporting segment) and inter-business unit transactions (transactions between consolidated reporting segments).

This procedure is applicable to all corporate/business units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company").

Procedure

The attached *Intercompany Schedule of Disputed Items* was created to track intercompany disputes and is maintained by the Enterprise Intercompany Process Owner ("IPO"). This individual is the process owner for the *Intercompany Schedule of Disputed Items* and performs the following duties on a monthly basis:

- Collects all intercompany disputes from each *BU IPO* and prepares a consolidated *Intercompany Schedule of Disputed Items;*
- Distributes the final *Intercompany Schedule of Disputed Items* to the appropriate parties, including the Corp Controller and BU Controller's for review and sign off;
- Acts as liaison and decision maker between corporate/business units when resolution of disputed items cannot be reached before workday 1 of the subsequent accounting period;
- If necessary, facilitates a monthly meeting with Corp Controller and each BU Controller to discuss resolution of any outstanding disputes that were not resolved before workday 1 of the subsequent accounting period.

The Purchaser/Receiver is responsible for populating the *Intercompany Schedule of Disputed Items* and submitting it to the assigned BU IPO by the deadline distributed in the Calendar. The Purchaser/Receiver shall work with the Seller/Sender to resolve all items on the *Intercompany Schedule of Disputed Items* prior to workday 1 of the subsequent accounting period. The Seller/Sender is responsible for recording any identified adjustments in the General Ledger in accordance with the *Intercompany Dispute Resolution Policy.*

Intercompany Schedule of Disputed Items

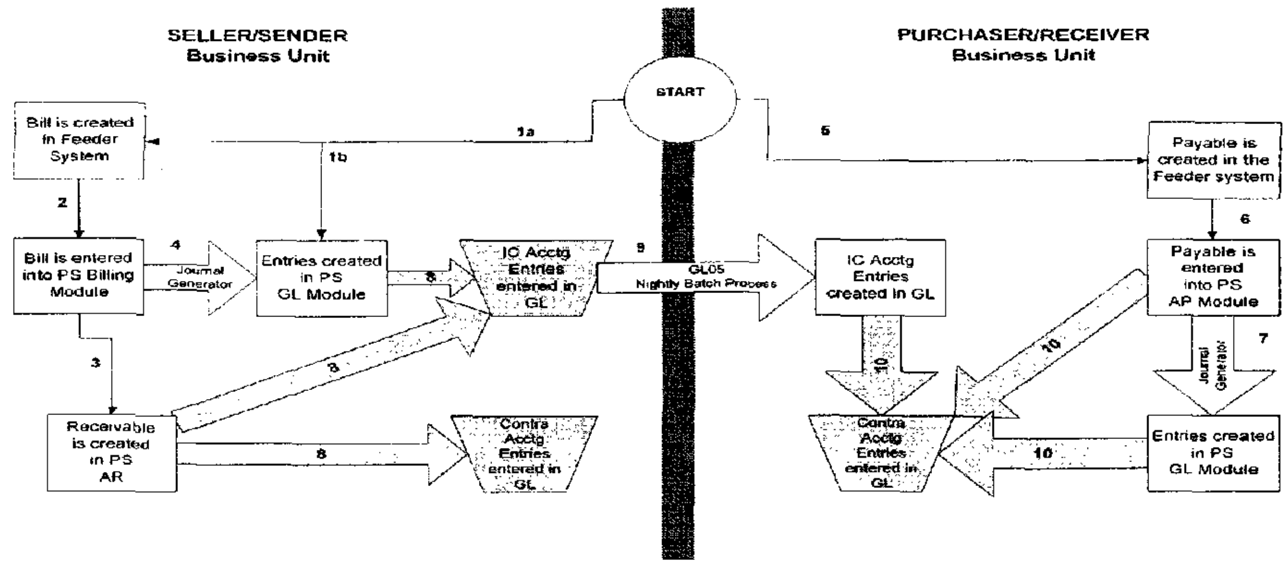
Intercompany Schedule of Disputed Items

Duke Energy

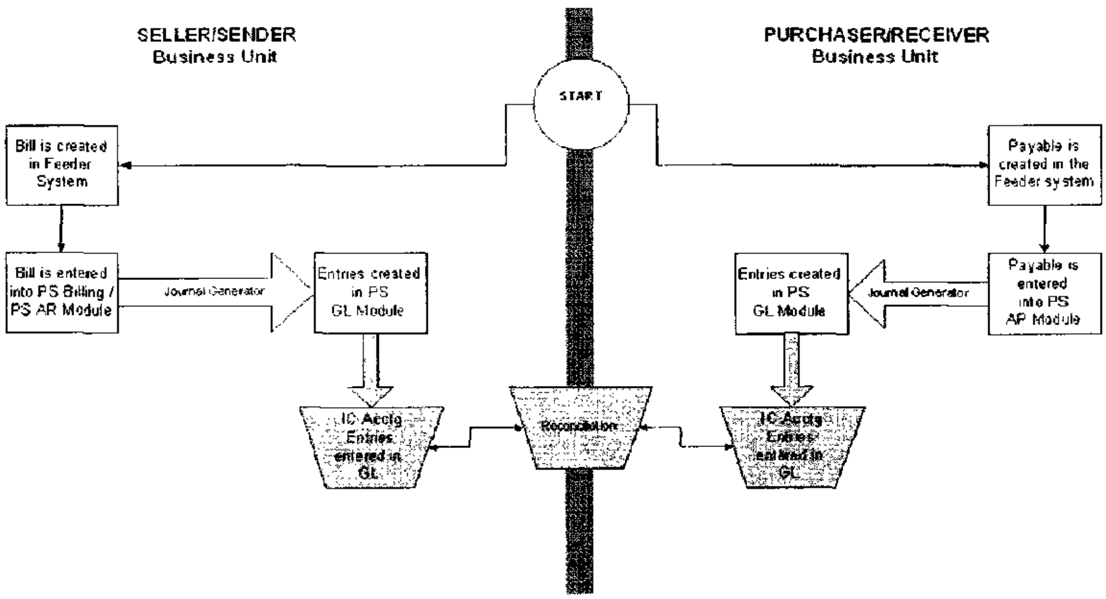
Accounting Month/Year	Production Month/Year	Invoice Number	Selling / Sending Business Unit	Selling / Sending BU Accountant Name	Purchasing / Receiving Business Unit	Purchasing / Receiving BU Accountant Name	Original Billed / Charged Amount	Disputed Amount	Reason for Dispute	Proposed Resolution / Actions Taken	Status

Appendix B – Methods for Recording Intercompany Transactions

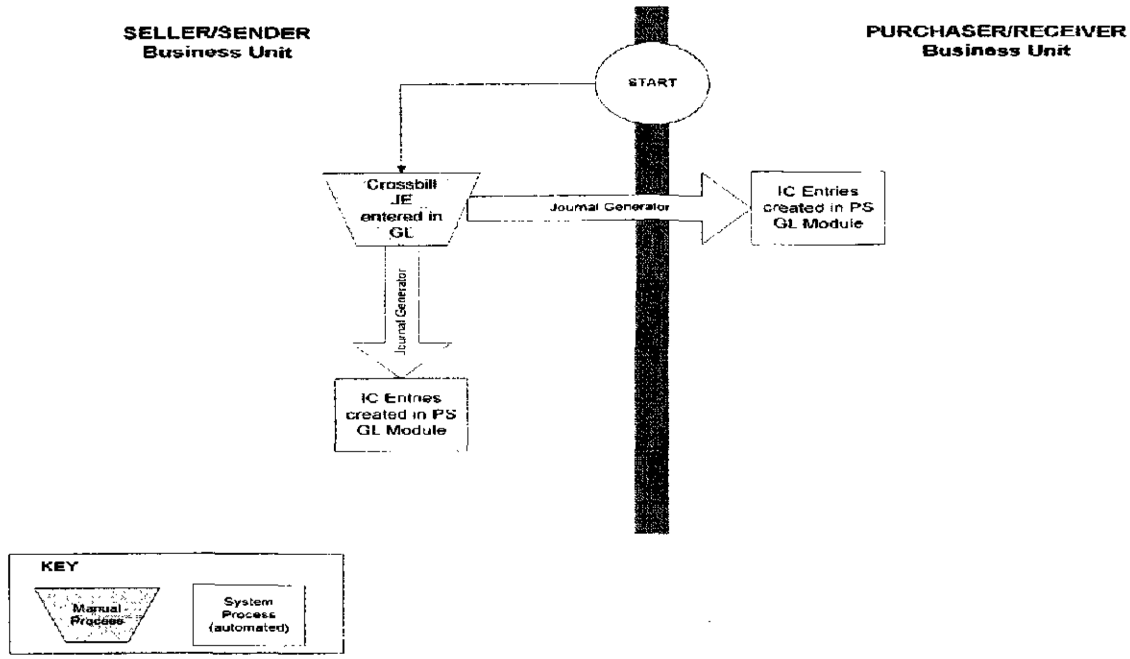
Auto-generating Intercompany



Manual Balancing


SELLER/SENDER
Business Unit
PURCHASER/RECEIVER
Business Unit
START
Bill is created in Feeder System
Payable is created in the Feeder system
Bill is entered into PS Billing / PS AR Module
Journal Generator
Entries created in PS GL Module
Entries created in PS GL Module
Journal Generator
Payable is entered into PS AP Module
IC Acctg Entries entered in GL
Reconciliation
IC Acctg Entries entered in GL

Automated Crossbill



Appendix C – Intercompany Accounts and Definitions

Designated intercompany accounts shall be used when recording intercompany transactions to the general ledger. Designated intercompany accounts can be found on the Finance page of the Duke Energy portal under 2007 Financial ReEngineering Job Aid and Reference Material. Additionally, intercompany accounts can be identified by their placement within intercompany GAAP nodes. Intercompany GAAP nodes generally contain "cons," "consol," "con" or "IC" in the title.

The chart of accounts structure can also be found on the Finance page of the Duke Energy portal under the Corporate HFM Account and BU Tables link. This structure also identifies all intercompany accounts.

Contra accounts shall be used when reclassifying intercompany transactions that were originally recorded using the Auto-generating intercompany process. These are the only accounts to be used for reclassifying entries for analysis, FERC or GAAP reporting requirements, etc. Contra accounts can also be found in the chart of accounts, described above. Contra accounts are designated as such in the account description and are included in 3rd party GAAP nodes.

Appendix D – Manual Balancing Method Approval Request Form

DATE / TIME:

ORIGINATING BUSINESS UNIT:

OTHER BUSINESS UNIT(S) IMPACTED:

CHANGE DESCRIPTION:

REASON FOR CHANGE REQUEST:

1. CHANGE DETAILS
   - IS CHANGE TEMPORARY OR PERMANENT:
   - IF TEMPORARY, ACCTG PERIOD(S) IMPACTED
   - IS CHANGE RECURRING, OR ONE TIME:

2. MITIGATING CONTROLS DESCRIPTION:
(ATTACH COPY OF PROCEDURE BELOW)

3. REMEDIATION EFFORTS TO COMPLY WITH NON MANUAL BALANCING METHOD IN FUTURE:

4. ADDITIONAL COMMENTS:

SUBMITTED BY:	PHONE:

ORIGINATING BU APPROVAL:	
BU 1 APPROVAL:	
BU 2 APPROVAL:	
BU 3 APPROVAL:	
CORPORATE CONTROLLER APPROVAL (IF REQUIRED BY POLICY):	
ENTERPRISE IPO APPROVAL:	

MISCELLANEOUS COMMENTS:	ATTACHMENTS:

Appendix E – Eliminations and Out of Balance Materiality Procedures

Philosophy

This procedure was developed to establish the framework for ensuring intercompany balances are eliminated from the consolidated financial statements of Duke Energy in accordance with USGAAP and should accompany the *Accounting for Intercompany Transactions Policy*. For the purpose of this procedure, intercompany transactions are defined as both intra-business unit transactions (transactions within a consolidated reporting segment) and inter-business unit transactions (transactions between consolidated reporting segments).

This procedure is applicable to all corporate/business units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company").

Procedure

Intercompany Out of Balance Reports

During the monthly close process the Enterprise IPO or his/her designee will be responsible for generating the *Intercompany Out of Balance Reports* and publishing them to the Duke Energy database for use by each of the BU IPO's during reconciliation (see below for a list of reports).

Out of balances represent the net dollar impact of transactions or account balances between two or more business units or business segments that are not equal and do not fully eliminate during consolidation. Out of balances may result from many events, including mistakes, communication gaps, timing, etc.

Both the Enterprise IPO and the BU IPO's will be responsible for ensuring all out of balances are resolved or deemed immaterial each month by the date distributed in the Calendar (see below for intercompany out of balance materiality considerations).

When necessary, to facilitate the reconciliation of any identified out of balances between affiliates, the Enterprise IPO or his/her designee will be responsible for researching transaction details and notifying the BU IPO's when all issues have been resolved.

Prior to the deadline distributed in the Calendar, the Enterprise IPO will provide a copy of the final reconciled *Intercompany Out of Balance Reports* to the BU Controllers, or their designee, for final review and sign off.

Elimination Impact to Consolidated Financial Statement Line Items

Each Intercompany Process Owner shall be responsible for reviewing other reports as deemed necessary to ensure the accuracy and completeness of intercompany balances and the effect of the eliminations on consolidated financial statement line items.

Examples of other reports that could be reviewed include trial balances or sub-ledgers. Each Intercompany Process Owner shall submit final reports or confirmation of procedures performed to BU Controllers, or their designee, for review and final sign off.

The Enterprise IPO shall be responsible for reviewing other reports for the Duke Energy reporting segment and legal consolidation level, along with the Company's legal consolidation level and obtaining final sign off from the Corp Controller, or his designee.

Elimination of Energy Trading Contracts
In the normal course of business, two Duke Energy consolidated affiliates may enter into energy trading contracts or other derivatives, and may choose to record the contract using either accrual
or mark-to-market accounting, as applicable. For example, Commercial Power may enter into a contract to purchase natural gas from US FE&G. Commercial Power may record this contract using accrual accounting, while US FE&G may mark the contract to market through its current earnings.

During the consolidations processing, the effects of these intercompany contracts shall be eliminated, and not reflected in Duke Energy's Consolidated Financial Statements. Refer to the *Reclassification of Realized Income Statement Activity in Consolidation – Net vs. Gross Policy* for additional details.

Elimination of Intercompany Profit

When a Business Unit is capitalizing services received from an affiliate, the intercompany profit recognized by the affiliate providing the service must be eliminated in the consolidated financial statements as follows:

- For Duke Energy's internal and external segment reporting, the "gross" intercompany profit shall be reflected in the earnings results of the business unit providing the service. The elimination of any intercompany profit that has been capitalized by an affiliate receiving the service shall be reflected in the "other" segment for internal and external reporting (i.e., If US FE&G charges services to Commercial Power, and Commercial Power capitalizes the amounts paid for the services, US FE&G's segment results will include the full profit on the transaction. However, the profit US FE&G recognized on the transaction will be offset (i.e., eliminated) in the "Other" segment for internal and external segment reporting);
- It is the responsibility of the Business Unit receiving the service to notify both the affiliate providing the service and the Enterprise IPO that the amounts are being capitalized;
- The Enterprise IPO will ensure all such transactions are properly reflected in internal management reports and the consolidated financial statements by coordinating with the appropriate corporate departments;
- An exception to this policy is allowed to comply with USGAAP; specifically if SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*, indicates the profit should not be eliminated.

Intercompany Out of Balance Materiality Considerations

A. Quantitative Factors
The threshold for resolving and adjusting intercompany out of balances in the current period is two tiered and measured in:

- Duke Energy Corporation and Duke Energy Carolinas materiality threshold for intercompany out of balances is < $2 million. All other SEC Registrants' have a materiality threshold of <$1 million.

- Segment to segment materiality threshold for intercompany out of balances is < $1 million

Intercompany out of balance conditions below these materiality thresholds shall be resolved and appropriate journal entries recorded before workday 1 of the following accounting period.

The segment to segment threshold relates to a relationship between two business segments that results in intercompany transactions (e.g. US FE&G to Commercial Power). For monitoring materiality, segment to segment includes all intersections on the summary out of balance report issued by the Enterprise IPO.

Investment/Equity out of balances resulting from split ownership relationships that do not fully eliminate at a segment level due to a parent business unit included in another segment do not need to be resolved as long as the net out of balance at the Duke Energy consolidated level is below the materiality threshold.

Materiality thresholds provided herein are for intercompany out of balances only. These materiality thresholds should not be considered the appropriate materiality levels for any other aspect of financial closing or reporting activities.

B. Qualitative Factors
The out of balance materiality thresholds defined above do not apply if certain qualitative factors are present. Staff Accounting Bulletin No. 99 describes qualitative factors as non-monetary factors that when considered may change the materiality of the transaction due to their impact on other metrics. For example, an intercompany out of balance below the quantitative materiality threshold shall be recorded if omission would:

- mask a change in earnings or other trends
- change a loss into income or vice versa
- concern a segment or other portion of Duke Energy's business that has been identified as playing a significant role in operations or profitability
- affect compliance with regulatory requirements
- affect compliance with loan covenants or other contractual requirements
- have the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- involve concealment of an unlawful transaction

C. Roles and Responsibilities

The following represent additional responsibilities for the parties noted as a result of applying the intercompany out of balance materiality thresholds:

Corporate Controller is responsible for setting and approving intercompany out of balance materiality thresholds.

BU Controllers are responsible for considering SAB No. 99 qualitative factors and SAB 108 before signing-off the *Intercompany Out of Balance Report*.

BU Controllers may also alter materiality thresholds for intra-segment activity as long as their aggregate position is maintained in compliance with Duke Energy's intercompany out of balance materiality threshold.

The Enterprise IPO has the following responsibilities associated with the intercompany out of balance materiality thresholds:

- Monitors and controls compliance with intercompany materiality standards for the Company's consolidated financial statements
- Determines when all remaining enterprise-wide intercompany out of balances are immaterial, and thus no further resolution is required
- Communicates when this is achieved with all IPOs
- Can require business units to resolve amounts below the segment to segment materiality threshold within the close cycle in order to improve the enterprise-wide out of balance position
- Ensures split ownerships fully eliminate at the Company's consolidated level, or that any out of balance associated with split ownerships is immaterial
- Facilitates the resolution of segment to segment out of balances as requested by an Intercompany Process Owner to address material impacts for separate business unit reporting requirements
- Facilitates resolution of immaterial out of balances outside of the close period (i.e. after pencils down)

The BU IPOs have the following responsibilities associated with the intercompany out of balance materiality thresholds:

- Ensures their BU is in compliance with the materiality thresholds
- Communicates with individuals within their BU regarding transactions that need resolved, and when materiality thresholds have been achieved such that no further resolution is required
- Works with BU area to ensure SAB No. 99 qualitative factors are considered before ceasing to resolve intercompany out of balances
- Communicates with the Enterprise IPO regarding split ownerships that do not need to be resolved, items below the segment to segment threshold that need to be resolved to achieve separate reporting needs and when their BU area believes all remaining out of balances are immaterial

Intercompany Out of Balance Reports

The Intercompany Out of Balance Reports sourced from PeopleSoft are located in the following directory:
lmcltpsfax01\psrptprd\Consolidating\Out of Balance\Intercompany\month.

Descriptions of these reports are as follows:

Total OOB Inc Stmt AM or PM: This report is a complete listing of all income statement intercompany accounts and should be used to determine the intercompany out of balances on the income statement between Segments and Business Units.

Total OOB Balance Sheet AM or PM: This report is a complete listing of all balance sheet intercompany accounts and should be used to determine the intercompany out of balances on the balance sheet between Segments and Business Units.

Hyperion Financial Management (HFM) gives the user more flexibility to produce intercompany reports by querying the consolidation tool. These tools can be found in the HFM application within the intercompany subfolder under the reports folder.

The final summary Out of Balance Report distributed by the Enterprise IPO contains all intercompany income statement, balance sheet and investment in and equity out of balances between the Segments and at Duke Energy.

Appendix F – Investment and Equity Transactions Procedures

Philosophy

This procedure was developed to establish the framework for ensuring intercompany balances are eliminated from the consolidated financial statements of Duke Energy in accordance with USGAAP and should accompany the *Accounting for Intercompany Transactions Policy*. For the purpose of this procedure, intercompany transactions are defined as both intra-business unit transactions (transactions within a consolidated reporting segment) and inter-business unit transactions (transactions between consolidated reporting segments).

This procedure is applicable to all corporate/business units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company").

Procedure

Duke Energy's business strategies cause frequent changes in a subsidiary's equity and the related parent entity's investment balances. These changes may be due to legal entities created, dissolved or restructured, or due to equity related transactions like dividends or capital infusions. These events result in intercompany transactions between a parent and its subsidiary. The procedures described below are to alleviate the likelihood of these transactions causing intercompany out of balances.

Investment and Equity Transactions

Changes to a consolidated subsidiary's equity balances and the related parent's investment balance should only include the following types of transactions:

Capital infusion – Cash or other net assets invested or contributed by a parent to a subsidiary

Return of capital – Distribution of cash or other net assets of a subsidiary to its parent as a return of investment

Dividends – Distribution of all or part of the income of a subsidiary to its parent as a return on investment

Net income or earnings – A periodic measure of performance, including revenues, expenses, gain or loss on sales, income from discontinued operations, etc.

Cumulative translation adjustment (CTA) – The cumulative effect from the process of translating a subsidiary's financial statements from its functional currency into U.S. dollars

Other comprehensive income (OCI) – All changes in equity during a period except those resulting from investments by or distributions to owners. OCI includes net income and CTA.

Dissolution or restructuring of legal entities - Changes in a parent's ownership share of a subsidiary as a result of a sale, closure, acquisition or reallocation of equity account balances

Duke Energy's Hyperion Financial Management (HFM) consolidation software automatically records entries associated with the current period's net income, cumulative translation adjustment and other comprehensive income on the parent's books for each subsidiary. As such, generally no intercompany out of balances should result from these transactions.

Capital infusions, returns of capital, dividends or other changes to a parent's investment balance due to legal entity dissolutions or restructurings are recorded using the Manual Balancing method. The *Creation, Dissolution, or Restructuring of Legal Entities & Subsidiaries Policy* address the process and roles/responsibilities associated with changes in the Duke Energy legal entity or segment reporting structure. Generally, these transactions are initiated by the subsidiary and then move through the legal chain.

However, the responsibilities of the Seller/Sender defined in this intercompany Policy may not correspond to individuals knowledgeable of the likely changes. As such, it is critical that all parties proactively communicate the transactions to be recorded with other business unit or corporate individuals responsible for making the corollary entry on other books.
All equity-related transactions, including dissolutions or restructurings, shall be recorded, reconciled, eliminated and discrepancies resolved in accordance with the dates established by the Corporate Controller and distributed in the Calendar.

There should be no adjustments recorded to a subsidiary's equity through the enterprise HFM or PeopleSoft "adjusting business units" or "elimination/parent business units" for internal or external reporting purposes. Exceptions can be submitted to the Enterprise IPO who will facilitate approval from the Corporate Controller or his designee.

If there is doubt as to whether a transaction is appropriate for the investment/equity accounts, consult with the Enterprise IPO or the Corporate Accounting Research Group (CARG).

Accounting for Regulated Entities (SFAS No. 71)

Applicability:	Applies to Enterprise
Originator:	Corporate Controller
Approval:	Corporate Controller
Effective Date:	12/01/2004
Revision Date:	12/17/2007
Reissue Date:	12/17/2007

<u>Index</u>

Statement of Purpose and Philosophy

The purpose of this policy is to provide guidelines related to the accounting and disclosures of regulated entities under SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," ("SFAS No. 71") and other related accounting pronouncements. Duke Energy is committed to preparing and providing financial information with the utmost integrity. To facilitate this corporate value, the Corporate Controller's Department will approve policies to ensure the accuracy of books and records (as detailed in the Code of Business Ethics).

Accounting references have been provided for much of the Accounting Policy discussion. For additional accounting references including interpretations, see <u>Accounting Policy Support</u>.

Policy Expectations and Scope

This policy is applicable to all business/corporate units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company") which have cost-based regulated operations. This policy contains a high-level summary of the key requirements of U. S. generally accepted accounting principles ("GAAP") as it applies to Duke Energy, including any significant interpretations or policy elections made by Duke Energy, but is not intended to be a substitute for consulting with the detail requirements of authoritative GAAP literature for specific issues or matters that may arise. This policy should help ensure consistent application of the accounting rules for regulated entities across the consolidated Duke Energy group.

Materiality

FASB Statements note that "The provisions of this Statement need not be applied to immaterial items." Accordingly, materiality should be considered when applying this policy. However, materiality must be assessed at the business/corporate unit level (as well as being assessed at the SEC sub-registrant level), and at the consolidated level(s), and involves consideration of both quantitative as well as qualitative factors. Any questions regarding materiality should be directed to the Corporate Controller's Department.

Accountability: Roles and Responsibilities

Corporate Controller's Department –

- Maintain an accounting policy for accounting for regulated entities available on the Duke Energy portal to help ensure that business/corporate units are aware of the criteria/applicability of applying the provisions of SFAS No. 71 and other related accounting pronouncements for cost-based rate regulated entities.
- Establish and communicate the reporting timetable for regulatory accounting information needed for SEC filings and accumulate the information reported by the applicable regulated entities for periodic reporting and disclosure purposes (e.g., Form 10-K, Form 10-Q, etc.).
- Provide guidance on the consideration of materiality as may be requested by the business/corporate units.

Business/Corporate Unit –

- Ensure all reporting requirements for regulated entities are accumulated and reported to the Corporate Controller's Department in accordance with the established reporting timetable.
- Ensure proper support/documentation exists for all regulatory assets/liabilities.
- Ensure proper support exists for continued application of SFAS No. 71 at each balance sheet date, if applicable.
- Document discontinuance of SFAS No. 71 when it is appropriate for any portion of their business
- Monitor all regulatory assets for recoverability.
- Monitor all regulatory liabilities for probability of settlement.
- Ensure proper calculation of the Allowance for Funds Used During Construction ("AFUDC").

Standards/Requirements/Background Information

This section primarily contains references to, and excerpts from, the most significant or applicable GAAP authoritative literature. Matters specific or unique to Duke Energy are primarily discussed in the "Accounting Policy" section below.

Standards

Guidance on accounting for regulated entities is provided primarily but not exclusively by the following:

- SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation"
- SFAS No. 90, "Regulated Enterprises – Accounting for Abandonments and Disallowance of Plant Costs – An Amendment of FASB Statement No. 71"
- SFAS No. 92, "Regulated Enterprises – Accounting for Phase-in Plans – An Amendment of FASB Statement No 71"
- SFAS No. 101, "Regulated Enterprises – Accounting for the Discontinuation of Application of FASB Statement No. 71"
- SFAS No, 109, "Accounting for Income Taxes"
- EITF 90-8,"Capitalization of Costs to Treat Environmental Contamination"

- EITF 92-07, "Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue programs"
- EITF 93-4, "Accounting for Regulatory Assets"
- EITF 97-04, "Deregulation of the Pricing of Electricity – Issues Related to the Application of FASB Statement No. 71 and No. 101"
- SEC Staff Accounting Bulletin ("SAB") Topic 10, "Utility Companies"
- Current Text Section Re6, "Regulated Operations"

Background–

Per SFAS No. 101, "Regulated Enterprises – Accounting for the Discontinuance of Application of FASB Statement No. 71":

41. .... The application of Statement 71, as amended, is not optional. An enterprise's operations that meet the criteria for application of Statement 71 are required to be reported consistent with Statement 71, and an enterprise whose operations cease to meet the criteria for application of Statement 71 is required to discontinue application of Statement 71 as prescribed in this Statement.

In December 1982, the Financial Accounting Standards Board (FASB) issued SFAS No. 71. Per SFAS No. 71,

Summary –

In general, the type of regulation covered permits rates (prices) charged to customers to be set at levels intended to recover the estimated costs of providing regulated services or products, including the cost of capital (*i.e., interest costs and a provision for earnings on shareholders' investments*).

For a number of reasons, revenues intended to cover some costs may be collected through rates either before or after the costs are actually incurred. If regulation provides assurance that incurred costs will be recovered in the future, this Statement requires entities to capitalize those costs. If current recovery is provided for costs that are expected to be incurred in the future, this Statement requires entities to recognize those current receipts as liabilities.

Introduction –

1. Regulation of an enterprise's prices (hereinafter referred to as *rates*) is sometimes based on the enterprise's costs. Regulators use a variety of mechanisms to estimate a regulated enterprise's allowable costs,1 and they allow the enterprise to charge rates that are intended to produce revenue approximately equal to those allowable costs. Specific costs that are allowable for rate-making purposes result in revenue approximately equal to the costs.

[1]The term *allowable costs* is used throughout this Statement to refer to all costs for which revenue is intended to provide recovery. Those costs can be actual or estimated. In that context, allowable costs include interest cost and amounts provided for earnings on shareholders' investments.

2. In most cases, allowable costs are used as a means of estimating costs of the period during which the rates will be in effect, and there is no intent to permit recovery of specific prior costs. The process is a way of setting prices—the results of the process are reported in general-purpose financial statements in accordance with the same accounting principles that are used by unregulated enterprises.

3. Regulators sometimes include costs in allowable costs in a period other than the period in which the costs would be charged to expense by an unregulated enterprise. That procedure can create assets (future cash inflows that will result from the rate-making process), reduce assets (reductions of future cash inflows that will result from the rate-making process), or create liabilities (future cash outflows that will result from the rate-making process) for the regulated enterprise. For general-purpose financial reporting, an incurred cost for which a regulator permits recovery in a future period is accounted for like an incurred cost that is reimbursable under a cost-reimbursement-type contract.

4. Accounting requirements that are not directly related to the economic effects of rate actions may be imposed on regulated businesses by orders of regulatory authorities and occasionally by court decisions or statutes. This does not necessarily mean that those accounting requirements conform with generally accepted accounting principles. For example, a regulatory authority may order an enterprise to capitalize2 and amortize a cost that would be charged to income currently by an unregulated enterprise. Unless capitalization of that cost is appropriate under this Statement, generally accepted accounting principles require the regulated enterprise to charge the cost to income currently.

2 *Capitalize* is used in this Statement to indicate that the cost would be recorded as the cost of an asset. That procedure is often referred to as "deferring a cost," and the resulting asset is sometimes described as a "deferred cost."

<u>Scope</u>

5. This Statement applies to general-purpose external financial statements of an enterprise that has regulated operations that meet all of the following criteria:

a. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.3

3 (footnote omitted)

b. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.

c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

6. If some of an enterprise's operations are regulated and meet the criteria of paragraph 5, this Statement shall be applied to only that portion of the enterprise's operations.

7. Authoritative accounting pronouncements that apply to enterprises in general also apply to regulated enterprises. However, enterprises subject to this Statement shall apply it instead of any conflicting provisions of standards in other authoritative pronouncements.4

[4]For example, a regulator might authorize a regulated enterprise to incur a major research and development cost because the cost is expected to benefit future customers. The regulator might also direct that cost to be capitalized and amortized as an allowable cost over the period of expected benefit. If the criteria of paragraph 9 of this Statement were met, the enterprise would capitalize that cost even though FASB Statement No. 2, *Accounting for Research and Development Costs,* requires such costs to be charged to income currently. Statement 2 would still apply to accounting for other research and development costs of the regulated enterprise, as would the disclosure requirements of Statement 2.

....

<u>*General Standards of Accounting for the Effects of Regulation* –</u>

9. Rate actions of a regulator can provide reasonable assurance of the existence of an asset.4a An enterprise shall capitalize all or part of an incurred cost5 that would otherwise be charged to expense if both of the following criteria are met:

4a Costs of abandoned plants shall be accounted for in accordance with paragraphs 3-6 of FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs.* Phase-in plans shall be accounted for in accordance with FASB Statement No. 92, *Regulated Enterprises—Accounting for Phase-in Plans.*

5 An *incurred cost* is "a cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for" (Eric L. Kohler, *A Dictionary for Accountants,* 5th ed. [Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1975], p. 253).

a. It is probable6 that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.

6 The term *probable* is used in this Statement consistent with its use in FASB Statement No. 5, *Accounting for Contingencies.* Statement 5 defines *probable* as an area within a range of the likelihood that a future event or events will occur. That range is from probable to remote, as follows:

Probable. The future event or events are likely to occur.

Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

Remote. The chance of the future event or events occurring is slight.

b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

If at any time the incurred cost no longer meets the above criteria, that cost shall be charged to earnings.

10. Rate actions of a regulator can reduce or eliminate the value of an asset. If a regulator excludes all or part of a cost from allowable costs, the carrying amount of any asset recognized pursuant to paragraph 9 of this Statement shall be reduced to the extent of the excluded cost. Whether other assets have been impaired shall be judged the same as for enterprises in general6a and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* shall apply.

6a Disallowances of costs of recently completed plants, whether direct or indirect, shall be accounted for in accordance with paragraph 7 of Statement 90.

10A. If a regulator allows recovery through rates of costs previously excluded from allowable costs, that action shall result in recognition of a new asset. The classification of that asset shall be consistent with the classification that would have resulted had those costs been initially included in allowable costs.

11. Rate actions of a regulator can impose a liability on a regulated enterprise. Such liabilities are usually obligations to the enterprise's customers. The following are the usual ways in which liabilities can be imposed and the resulting accounting:

a. A regulator may require refunds to customers.7 Refunds that meet the criteria of paragraph 8 (accrual of loss contingencies) of FASB Statement No. 5, *Accounting for Contingencies,* shall be recorded as liabilities and as reductions of revenue or as expenses of the regulated enterprise.

7 Refunds can be paid to the customers who paid the amounts being refunded; however, they are usually provided to current customers by reducing current charges.

b. A regulator can provide current rates intended to recover costs that are expected to be incurred in the future with the understanding that if those costs are not incurred future rates will be reduced by corresponding amounts. If current rates are intended to recover such costs and the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose,8 the enterprise shall not recognize as revenues amounts charged pursuant to such rates. Those amounts shall be recognized as liabilities and taken to income only when the associated costs are incurred.

8 The usual mechanism used by regulators for this purpose is to require the regulated enterprise to record the anticipated cost as a liability in its regulatory accounting records.

c. A regulator can require that a gain or other reduction of net allowable costs be given to customers over future periods. That would be accomplished, for rate-making purposes, by amortizing the gain or other reduction of net allowable costs over those future periods and reducing rates to reduce revenues in approximately the amount of the amortization. If a gain or other reduction of net allowable costs is to be amortized over future periods for rate-making purposes, the regulated enterprise shall not recognize that gain or other reduction of net allowable costs in income of the current period. Instead, it shall record it as a liability for future reductions of charges to customers that are expected to result.

12. Actions of a regulator can eliminate a liability only if the liability was imposed by actions of the regulator.

....

78. If rates are designed to be adjusted automatically for changes in operating expenses (e.g., costs of purchased fuel), the regulator's intent could be either to permit recovery of the incurred cost or merely to provide for recovery of similar future costs. Normal operating expenses such as fuel costs usually are provided for in current rates. In that case, the presumption is that the rate increase is intended to permit recovery of similar future costs. That presumption, which would preclude capitalizing the incurred cost, can be overcome only if it is clear that the regulator's intent is to provide recovery of the incurred cost.

79. Rate actions of a regulator can also impose a liability on a regulated enterprise in the following ways:

a. A regulator can order a regulated enterprise to refund previously collected revenues.

b. A regulator can provide rates intended to recover costs that are expected to be incurred in the future. Paragraphs 38 and 39 illustrate that possibility. The resulting increased charges to customers are liabilities and not revenues for the enterprise—the enterprise undertakes to provide the services for which the increased charges were collected, and it is obligated to return those increased charges if the future cost does not occur. The obligation will be fulfilled either by refunding the increased charges through future rate reductions or by paying the future costs with no corresponding effect on future rates. The resulting increases in charges to customers are unearned revenues until they are earned by their use for the intended purpose.

c. For rate-making purposes, a regulator can recognize a gain or other reduction of overall allowable costs over a period of time. Paragraphs 35-37 illustrate that possibility. By that action, the regulator obligates the enterprise to give the gain or other reduction of overall allowable costs to customers by reducing future rates. Accordingly, the amount of the gain or cost reduction is the appropriate measure of the obligation.

Accounting Policy

The following topics are discussed in this section

1. Abandonments

From SFAS No. 90, "Regulated Enterprises – Accounting for Abandonments and Disallowance of Plant Costs – An Amendment of FASB Statement No. 71");

3. When it becomes probable1 that an operating asset or an asset under construction will be abandoned, the cost of that asset shall be removed from construction work-in-process or plant-in-service. The enterprise shall determine whether recovery of any allowed cost is likely to be provided with (a) full return on investment during the period from the time when abandonment becomes probable to the time when recovery is completed or (b) partial or no return on investment during that period. That determination should focus on the facts and circumstances related to the specific abandonment and should also consider the past practice and current policies of the applicable

regulatory jurisdiction on abandonment situations. Based on that determination, the enterprise shall account for the cost of the abandoned plant as follows:

[1]The term probable is used in this Statement consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*, to mean that a transaction or event is likely to occur.

a. *Full return on investment is likely to be provided.* Any disallowance of all or part of the cost of the abandoned plant that is both *probable* and *reasonably estimable*, as those terms are used in FASB Statement No. 5, *Accounting for Contingencies*, and the related FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, shall be recognized as a loss, and the carrying basis of the recorded asset shall be correspondingly reduced. The remainder of the cost of the abandoned plant shall be reported as a separate new asset.

b. *Partial or no return on investment is likely to be provided.* Any disallowance of all or part of the cost of the abandoned plant that is both *probable* and *reasonably estimable*, as those terms are used in Statement 5 and Interpretation 14, shall be recognized as a loss. The present value of the future revenues expected to be provided to recover the allowable cost of that abandoned plant and return on investment, if any, shall be reported as a separate new asset. Any excess of the remainder of the cost of the abandoned plant over that present value also shall be recognized as a loss. The discount rate used to compute the present value shall be the enterprise's incremental borrowing rate, that is, the rate that the enterprise would have to pay to borrow an equivalent amount for a period equal to the expected recovery period. In determining the present value of expected future revenues, the enterprise shall consider such matters as (1) the probable time period before such recovery is expected to begin and (2) the probable time period over which recovery is expected to be provided. If the estimate of either period is a range, the guidance of Interpretation 14 shall be applied to determine the loss to be recognized. Accordingly, the most likely period within that range shall be used to compute the present value. If no period within that range is a better estimate than any other, the present value shall be based on the minimum time period within that range.

The following discussion is a brief summary of paragraphs 3 of SFAS No. 90. When it becomes probable that an operating plant or plant under construction will be abandoned, the associated cost should be removed from plant-in-service or construction work in progress. A separate, new asset should be established. No loss should be recognized unless it is probable and estimable. Losses should be estimated based on the present value using the incremental borrowing rate of the future revenue stream, if any. Further guidance on accounting for an abandonment can be found in paragraphs 6 and 42-53 of SFAS No. 90 and FASB Technical Bulletin No. 87-2, "Computation of a Loss on an Abandonment".

This accounting should include any plant asset balances related to asset retirement costs recorded under SFAS No. 143, "Accounting for Asset Retirement Obligations".

<u>2. Accrued Compensated Absences (e.g. Vacation)</u>

Per SFAS No. 71;

48. Statement 43 specifies criteria for accrual of a liability for employees' compensation for future absences. For rate-making purposes, compensation for employees' absences may be included in allowable costs when the compensation is paid.

49. The liability, if any, would be accrued in accordance with Statement 43 because rate actions of the regulator cannot eliminate obligations that were not imposed by the regulator (paragraph 12). By including the accrued compensation in future allowable costs on an as-paid basis, the regulator provides reasonable assurance of the existence of an asset. The asset is the probable future benefit (increased revenue) that will result from the regulatory treatment of the subsequent payment of the liability (paragraph 9). Accordingly, the enterprise also would record the asset that results from the regulator's actions.

Any liability accrued for compensated absences (e.g. vacation) under SFAS No. 43 related to regulated entities are recorded as a regulatory asset if the requirements of paragraph 9 of SFAS No. 71 are met.

All vacation days that employees are entitled to in the coming year, including personal holidays and unused vacation eligible to be carried over, should be accrued as a liability as of the end of the current year. This policy is consistent with the fact that an employee can come to work on the first day of the calendar, then take time off for their full year's worth of vacation, then return to work and terminate employment without having to reimburse the company for that time off. The recorded liability should include fringe benefits and payroll taxes at the expected loading percentage for the following year.

To the extent the liability is for either the regulated qperations of U.S. Franchised Electric & Gas ("USFEG") or for the portion of the service companies that are allocable to the regulated operations, these costs should be deferred in a regulatory asset account. The regulatory asset should reside on the same balance sheet as the associated liability for vacation. Thus, the regulatory asset for the portion of the service company's vacation accrual allocable to regulated operations should reside on the service company's balance sheet.

The regulatory asset for vacation costs should be reported as a current asset. The vacation accrual should be reported as a current liability.

3. Allowance for Funds Used During Construction or "AFUDC"

Per SFAS No. 71;

15. In some cases, a regulator requires an enterprise subject to its authority to capitalize, as part of the cost of plant and equipment, the cost of financing construction as financed partially by borrowings and partially by equity. A computed interest cost and a designated cost of equity funds are capitalized, and net income for the current period is increased by a corresponding amount. After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for rate-making purposes. In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets shall be capitalized for financial

reporting purposes instead of the amount of interest that would be capitalized in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*.9 Those amounts shall be capitalized only if their subsequent inclusion in allowable costs for rate-making purposes is probable. The income statement shall include an item of other income, a reduction of interest expense, or both, in a manner that indicates the basis for the amount capitalized.

[9]Statement 34 requires capitalization of interest cost on certain qualifying assets. The amount capitalized is the portion of the interest cost incurred during the period that theoretically could have been avoided if the expenditures had not been made.

Per SFAS No. 92;

8. If specified criteria are met, paragraph 9 of Statement 71 requires capitalization of an incurred cost that would otherwise be charged to expense. An allowance for earnings on shareholders' investment4 is not "an incurred cost that would otherwise be charged to expense." Accordingly, such an allowance shall not be capitalized pursuant to paragraph 9 of Statement 71.

[4]The phrase "an allowance for earnings on shareholders' investment," as used in this Statement, is intended to have the same meaning as the phrase "a designated cost of equity funds," used in paragraph 15 of Statement 71.

9. In specified circumstances, paragraph 15 of Statement 71 requires capitalization of an allowance for earnings on shareholders' investment (a designated cost of equity funds) during construction. Paragraph 5 of this Statement requires capitalization of an allowance for earnings on shareholders' investment for qualifying phase-in plans. If an allowance for earnings on shareholders' investment is capitalized for rate-making purposes other than during construction or as part of a phase-in plan, the amount capitalized for rate-making purposes shall not be capitalized for financial reporting.

67. An AICPA Issues Paper, *Application of Concepts in FASB Statement of Financial Accounting Standards No. 71 to Emerging Issues in the Public Utility Industry*, received by the Board in November 1984, recommended that the Board amend paragraph 9 of Statement 71 to require capitalization of any allowable cost when the criteria of that paragraph are met. Many respondents to the Exposure Draft made the same recommendation. Paragraph 9 requires capitalization only of "an incurred cost that would otherwise be charged to expense." Thus, paragraph 9 does not permit capitalization of an allowance for earnings on shareholders' investment—an allowable cost but not an incurred cost that would otherwise be charged to expense. An allowance for earnings on shareholders' investment provided by a regulator is an imputed cost. Capitalization of that cost would increase currently reported income, a result which some Board members believe is inappropriate. The Board believes that income related to an allowance for earnings on shareholders' investment generally should result from revenue realization, not from capitalization.

Where the regulator allows for such cost inclusion and recovery, AFUDC is generally comprised of two components, commonly referred to as AFUDC borrowed or AFUDC debt and AFUDC equity. Total AFUDC (debt and equity) replaces capitalized interest as determined by SFAS No. 34, "Capitalization of Interest Cost" (see paragraph 9 of SFAS No. 71). AFUDC equity is only allowed to be accrued for GAAP financial statements in the following circumstances: (paragraphs 15 and 82-84 of SFAS No. 71, paragraphs 8, and 64-68 of SFAS No. 90 and paragraphs 8-9, 55-56 and 67-69 of SFAS No. 92)

1. Plant, including nuclear fuel, while under construction (if not included in rate base) NOTE: to the extent plant while under construction is included in rate base, that amount of plant does not accrue AFUDC.
2. As part of a qualifying phase-in plan (see the discussion of "Phase-In Plans" below; this is a highly unlikely circumstance for Duke Energy)

Because the interest component of AFUDC represents an actual cash expense in the form of interest payments, it is included in capital expenditures in the external GAAP Statement of Cash Flows. Although equity returns are eventually converted into payments of cash in the form of dividends, there is no actual cash expense associated with AFUDC equity (the "non-cash" entry to record AFUDC equity is essentially to debit assets and credit income). Therefore, AFUDC equity is not included in capital expenditures in the Statement of Cash Flows. As a non-cash component of income, the equity component of AFUDC is subtracted from net income in arriving at cash flows from operations.

AFUDC equity is an after-tax calculation, and is recorded in the "Other income and expenses, net," in the consolidated statement of operations. The recording of AFUDC Equity in the consolidated statement of operations does not result in the recording of deferred tax expense (resulting in a lowering of the overall effective tax rate for book purposes as there is no income tax expense recorded against the GAAP AFUDC income).

However, deferred tax liability balances (also referred to as accumulated deferred income taxes (ADIT)) will result from book-tax differences. The entry recording ADIT on the component of AFUDC equity that is capitalized is balanced by an equal and offsetting entry to regulatory asset such that the amount of AFUDC equity capitalized as plant plus the associated regulatory asset times the deferred tax rate equals the ADIT recorded.

In the year that the plant including capitalized AFUDC equity is depreciated or amortized, the corresponding depreciation expense of the amortized AFUDC equity does not result in a tax deduction and no deferred tax expense is recorded. Instead, a 'balance sheet' amortization of the ADIT and regulatory asset is recorded. This balance sheet amortization maintains the relationship between plant, regulatory asset and ADIT as previously discussed. As a result, the overall effective tax rate for book purposes is higher than the statutory income tax rate.

AFUDC debt is recorded gross of income tax expense. As a result, deferred tax expense is recorded on the income statement. The amortization of AFUDC debt and equity is presented within depreciation expense or for nuclear fuel, within fuel expense. The amortization of AFUDC debt is presented before tax with an offsetting credit to income (deferred) tax expense.

If the commission has so ordered and the costs are required to be refunded, an AFUDC rate may be applied to regulatory liabilities (instead of an accrual of interest). The accrual of AFUDC also requires a calculation of deferred taxes.

If the commission has so ordered, Duke Energy may accrue AFUDC on other assets for regulatory purposes. For GAAP financial statement purposes, the AFUDC equity component is not recognized. (Revenues billed will include a component for the recovery of AFUDC equity.) If so, the GAAP financial statements will show less income during the initial period of accrual of AFUDC equity than for regulatory purposes and more income during the subsequent period of recovery than for regulatory purposes of the previously accrued AFUDC equity.

If Duke Energy wishes to record AFUDC equity and AFUDC debt after the time the interest expense was initially incurred, confirmation from the regulators of their agreement that such costs are still recoverable is required prior to recording a catch-up entry.

4. Asset Retirement Obligations (ARO)

Substantially all the AROs established at the implementation of SFAS No. 143, "Accounting for Asset Retirement Obligations", were for Duke Energy Carolinas's nuclear plants. For rate-making for Duke Energy Carolinas, a component of depreciation expense is recorded for the decommissioning of the contaminated portion of the nuclear plants. The decommissioning of the contaminated portion of the nuclear plants meets the definition of an ARO and therefore a regulatory asset for ARO costs is recorded. The regulatory asset for ARO represents the additional expense that otherwise would have been recorded under SFAS No. 143, "Accounting for Asset Retirement Obligations." Duke Energy Carolinas has received commission orders in NC and SC allowing the Company to set up a regulatory asset.

The company has also accrued AROs for the removal of gas mains, for remediation of landfills at various sites and for Asbestos removal. These AROs are deferred as regulatory assets or regulatory liabilities.

See also the section on Removal Costs.

5. Clean Air Expenditures in North Carolina

The costs of pollution control facilities constructed to satisfy the requirements of the clean air legislation in North Carolina are currently (i.e., through 2007) being recorded as an amortization expense when accrued. Expenditures with the offsetting entry recorded in regulatory liabilities. Cash expenditures for pollution control facilities constructed to satisfy the requirements of the clean air legislation in North Carolina are recorded as a debit to regulatory liability to the extent that a credit balance exists for these specific expenditures or to construction work in progress ("CWIP") Construction Work in Progress otherwise. The credit to the balance sheet for this amortization expense is to CWIP to the extent that a debit balance exists in CWIP for these specific facilities or to regulatory liability otherwise.

The Company has considerable flexibility to vary the amortization expenses associated with the North Carolina clean air legislation, as long as a minimum cumulative amortization about approximately $1.05 billion is recorded by the end of 2007.

Accounting for clean air expenditures in North Carolina may change effective 1/1/2008 to reflect the results of changes in the regulatory approach by the North Carolinas Utilities Commission (NCUC).

6. Current Assets and Current Liabilities

From Current Text Section B05, "Balance Sheet Classification: Current Assets and Current Liabilities:"

.105 For accounting purposes, the term *current assets* ...... comprehends in general such resources as .... trade accounts, notes, and acceptances receivable; .... installment or deferred accounts and notes receivable if they conform generally to normal trade practices and terms within the business ..... and prepaid expenses such as insurance, interest, rents, taxes, unused royalties, current paid advertising service not yet received, and operating supplies.

.108 The term *current liabilities* is ..... intended to include obligations for items ...... such as payables incurred ...... in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services".
Current assets and current liabilities, in general, are those assets and liabilities due in one year. However, no portion of regulatory assets or liabilities that are associated with plant (such as the net regulatory assets related to income taxes or the regulatory liability on the gross-up on investment tax credits) are booked as current assets or liabilities.

Within the appropriate line item on the balance sheet, the balances of regulatory assets and liabilities should be grouped by jurisdiction and business unit. Netting should not be done between either jurisdictions or business units. (For example, for a business unit, unbilled fuel can be an asset in one jurisdiction and a liability in another jurisdiction. It would be inappropriate to offset these balances. Likewise, it would be inappropriate to offset a debit and a credit balance for two different business units operating in the same jurisdiction unless the netting requirements of FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts – An Interpretation of APB Opinion No. 10 and FASB Statement No. 105" ("FIN 39") are met.)

Regulatory assets and liabilities for unbilled fuel and the regulatory asset for vacation accrual are recorded as current assets or liabilities.

Refer to the section entitled "Emissions Allowances" for discussion of the appropriate balance sheet classification for certain intangible assets.

7. Debt issuance costs

Per SFAS No. 71,

Early Extinguishment of Debt

35. Opinion 26 requires recognition in income of a gain or loss on an early extinguishment of debt in the period in which the debt is extinguished. For rate-making purposes, the difference between the enterprise's net carrying amount of the extinguished debt and the reacquisition price may be amortized as an adjustment of interest expense over some future period.

36. If the debt is reacquired for an amount in excess of the enterprise's net carrying amount, the regulator's decision to increase future rates by amortizing the difference for rate-making purposes provides reasonable assurance of the existence of an asset (paragraph 9). Accordingly, the regulated enterprise would capitalize the excess cost and amortize it over the period during which it will be allowed for rate-making purposes.

37. If the debt is reacquired for an amount that is less than the enterprise's net carrying amount, the regulator's decision to reduce future rates by amortizing the difference for rate-making purposes imposes a liability on the regulated enterprise (paragraph 11(c)). Accordingly, the enterprise would record the difference as a liability and amortize it over the period during which permitted rates will be reduced.

Under U.S. GAAP, unamortized debt issuance costs are immediately expensed for retired debt and modified debt arrangements which are considered "substantially different" under the provisions of EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments". However, if the conditions in paragraphs 9 and 35 to 37 of SFAS No. 71 are met, debt issuance costs related to regulated entities which would be expensed under U.S. GAAP should be deferred as a regulatory asset and amortized. Because the requirements for SFAS No. 71 have been met, for Duke Energy Carolinas, the period of amortization is the life of the replacement debt if the debt has been replaced. If the debt has not been replaced, the amortization period is the remaining original life of the extinguished debt. The amortization period should be reviewed in conjunction with any guidance provided by the relevant commission.

The costs of extinguishment include the costs of any associated interest rate swaps that are cancelled when the debt is extinguished.

<u>*8. Disallowances of Plant Costs*</u>

Per SFAS No. 90,

7. When it becomes probable that part of the cost of a recently completed plant will be disallowed for rate-making purposes and a reasonable estimate of the amount of the disallowance can be made,2 the estimated amount of the probable disallowance shall be deducted from the reported cost of the plant and recognized as a loss. If part of the cost is explicitly, but indirectly, disallowed (for example, by an explicit disallowance of return on investment on a portion of the plant), an equivalent amount of cost shall be deducted from the reported cost of the plant and recognized as a loss.

2 footnote omitted

When a direct disallowance of a recently completed plant is probable and estimable, a loss should be recorded, dollar for dollar, for the disallowed amount. This accounting can be different than the requirement under SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" where an undiscounted cash flow approach is used to determine if impairment exists, and, if so impairment loss is measured by comparing the carrying value of a long-lived asset to its fair value. Future depreciation charges should be based on the written down asset basis. Refer to the accounting policy entitled "Accounting for Asset Impairments, Assets Held for Sale and Discontinued Operations, Including Equity Method Investments (SFAS No. 144 and APB No. 18)" for additional guidelines.

When there is an explicit but indirect disallowance, the present value of the future revenue stream allowed by the regulator should be determined by discounting the expected future revenues using the last allowed rate of return. This amount should be compared to the recorded plant amount and the difference recorded as a loss. An explicit but indirect disallowance occurs when, in certain circumstances, no return or a reduced return is permitted on all or a portion of the new plant for an extended period of time.

See also paragraphs 7, 26-34 and 54-63 of SFAS No. 90.

Where costs were previously disallowed and written off in accordance with SFAS No. 90, but subsequently allowed in ratemaking, the costs should be restored as plant. If an impairment was recorded pursuant to SFAS No. 144, and the regulator allows recovery, then a regulatory asset should be recognized.

9. Discontinuation of Application of SFAS No. 71

SFAS No. 101, "Regulated Enterprises — Accounting for the Discontinuation of Application of FASB Statement No. 71" addresses situations which may cause an enterprise to no longer meet the criteria for applying SFAS No. 71. Per SFAS No. 101;

4. Failure of an enterprise's operations to continue to meet the criteria in paragraph 5 of Statement 71 can result from different causes. Examples include the following:

a. Deregulation

b. A change in the regulator's approach to setting rates from cost-based rate making to another form of regulation

c. Increasing competition that limits the enterprise's ability to sell utility services or products at rates that will recover costs

d. Regulatory actions resulting from resistance to rate increases that limit the enterprise's ability to sell utility services or products at rates that will recover costs if the enterprise is unable to obtain (or chooses not to seek) relief from prior regulatory actions through appeals to the regulator or the courts.

5. When an enterprise determines that its operations in a regulatory jurisdiction no longer meet the criteria for application of Statement 71, that enterprise shall discontinue application of that Statement to its operations in that jurisdiction. If a separable portion of the enterprise's operations within a regulatory jurisdiction ceases to meet the criteria for application of Statement 71, application of that Statement to that separable portion shall be discontinued. That situation creates a presumption that application of Statement 71 shall be discontinued for all of the enterprise's operations within that regulatory jurisdiction. That presumption can be overcome by establishing that the enterprise's other operations within that jurisdiction continue to meet the criteria for application of Statement 71.

6. When an enterprise discontinues application of Statement 71 to all or part of its operations, that enterprise shall eliminate from its statement of financial position prepared for general-purpose external financial reporting the effects of any actions of regulators that had been recognized as assets and liabilities pursuant to Statement 71 but would not have been recognized as assets and liabilities by enterprises in general, and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* shall apply, except for the provisions for income statement reporting in paragraphs 25 and 26 of that Statement. However, the carrying amounts of plant, equipment, and inventory measured and reported pursuant to Statement 71[1] shall not be adjusted unless those assets are impaired, in which case the carrying amounts of those assets shall be reduced to reflect that impairment. Whether those assets have been impaired shall be judged in the same manner as for enterprises in general. The net effect of the adjustments required by this Statement shall be included in income of the period in which the discontinuation occurs and shall be classified as an extraordinary item.

[1]The carrying amounts of plant, equipment, and inventory for enterprises applying Statement 71 differ from those for enterprises in general only because of the allowance for funds used during construction, intercompany profit, and disallowances of costs of recently completed plants. If any other amounts that would not be includable in the carrying amounts of plant, equipment, or inventory by enterprises in general (such as postconstruction operating costs capitalized pursuant to paragraph 9 of Statement 71) are included in or netted against the carrying amounts of plant, equipment, or inventory, those amounts shall be accounted for as this Statement prescribes for the effects of actions of a regulator.

7. An enterprise that discontinues application of Statement 71 shall no longer recognize the effects of actions of a regulator as assets or liabilities unless the right to receive payment or the obligation to pay exists as a result of past events or transactions and regardless of future transactions.

SFAS No. 71 can be discontinued for a variety of reasons. Factors to consider may include a persistent and significant under-earning of the allowed rate of return for an extended period of time, legislation deregulating some portion (typically generation or production) of the business, a rate structure based on long term rate freezes, cost caps or market based regulation of rates.

With respect to rate freezes, as long as that portion of the business continues to be subject to the jurisdiction of the regulator as evidenced by routine reporting of results to the regulator and as long as that portion of the business continues to earn a reasonable rate of return, then SFAS No. 71 should be continued.

Once SFAS No. 71 is no longer applicable, the balance sheet effects of any actions of regulators that had been recognized as regulatory assets and regulatory liabilities pursuant to SFAS No. 71 should be eliminated. However, the carrying amounts of plant, equipment, and inventory measured and reported pursuant to SFAS No. 71 reflecting AFUDC, intercompany profit and disallowances of costs of recently completed plants should not be adjusted unless those assets are impaired (under SFAS No. 144 or other authoritative literature). If impaired, the carrying amounts of those assets should be reduced to reflect that impairment. The net effect of the above adjustments should be recorded in the period of the change and classified as an extraordinary item in the income statement. (SFAS No. 101, paragraph 6).

If the discontinuance of SFAS No. 71 is due to deregulatory legislation, typically a portion of the business is deregulated and the remaining portion is regulated. Sometimes, the remaining portion is entitled to cash flows related to the deregulated portion of the business. In that case, the elimination of the regulatory assets and liabilities for that portion of the business that is deregulated should not be written off until 1) they are recovered through the collection of regulated cash flows (in the case of assets) or settled (in the case of liabilities), 2) they are individually impaired or the regulator eliminates the obligation or 3) the separable portion of the business from which regulated cash flows are derived no longer meets the criteria for SFAS 71. (EITF Issue No. 97-04 "Deregulation of the Pricing of Electricity – Issues Related to the Application of FASB Statement No. 71 and No. 101")

Duke Energy Ohio's electric generation assets are not cost-based rate regulated under SFAS No. 71. In addition, although there is a tracker mechanism for Duke Energy Ohio's fuel, emission allowance and purchased power costs allocable to native load, these costs do not qualify for accounting under SFAS No. 71.

10. Emission Allowances

Emission allowances are accounted for as intangible assets by Duke Energy. All amounts should be reflected within non-current assets (i.e., reclassifying the amount of the coming year's amortization of an intangible asset to current assets is inappropriate).

Vintage swaps (exchanges of one vintage year for another vintage of the same type of allowance) require the recognition of a gain on loss under SFAS No. 153, "Exchange of Nonmonetary Assets," unless the gain or loss should be deferred as a regulatory asset or liability. If the gain or loss is deferred, the gain or loss is recorded as an adjustment to intangible assets with an offsetting adjustment to regulatory assets or liabilities.

Proceeds from the EPA's auction of emission allowances may also be deferred as a regulatory liability depending on the applicable state regulatory jurisdiction's rate making.

11. Impairments

A rate-regulated enterprise has four primary categories of long-lived assets, each of which is analyzed in a slightly different fashion for the purpose of determining an impairment: 1) Regulatory assets, 2) disallowances of recently completed plants, 3) abandonments and 4) other assets.

Regulatory assets are covered by SFAS 71, while abandonments and disallowances are covered by SFAS 90. SFAS 144 applies to impairment reviews of definite-lived long-lived assets, while SFAS 142 applies to impairment reviews of goodwill and other indefinite-lived intangibles. Other assets are covered by other areas of GAAP depending upon the specific nature of the asset – e.g., equity method investments are covered by APB 18, other investments are covered by SFAS 115 and EITF Issue 03-1, notes receivable are covered by SFAS 114, etc. Also refer to the accounting policy entitled "Accounting for Asset Impairments, Assets Held for Sale and Discontinued Operations, Including Equity Method Investments (SFAS No. 144 and APB No. 18)" for additional guidelines.

12. Income Taxes and Investment Tax Credit for Regulated Entities

Per SFAS No. 109, "Accounting for Income Taxes";

29. Regulated enterprises that meet the criteria for application of FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation,* are not exempt from the requirements of this Statement. Specifically, this Statement:

a. Prohibits net-of-tax accounting and reporting

b. Requires recognition of a deferred tax liability (1) for tax benefits that are flowed through to customers when temporary differences originate and (2) for the equity component of the allowance for funds used during construction

c. Requires adjustment of a deferred tax liability or asset for an enacted change in tax laws or rates.

If, as a result of an action by a regulator, it is probable that the future increase or decrease in taxes payable for items (b) and (c) above will be recovered from or returned to customers through future rates, an asset or liability is recognized for that probable future revenue or reduction in future revenue pursuant to paragraphs 9-11 of Statement 71. That asset or liability also is a temporary difference for which a deferred tax liability or asset shall be recognized.

Duke Energy presents regulatory assets and liabilities and AFUDC equity on a "gross-of-tax" basis on the balance sheet. "Gross-of-tax" usually means that the regulatory asset or liability is a temporary difference on which deferred taxes are provided. However, some regulatory assets (the AFUDC equity component of plant, for example) and some regulatory liabilities (tax rate reductions or deferred investment tax credits, for example) must be grossed up to reflect the taxation of the revenue required to recover the asset or settle the liability. A regulatory asset for the gross up of AFUDC Equity (AFUDC Equity is included in property, plant and equipment) is booked with the tax effect in the balance sheet account accumulated deferred income taxes ("ADIT"). The ADIT represents both the deferred taxes on the AFUDC Equity in PP&E and the deferred taxes on the regulatory asset for the gross up. See also SFAS No. 109, paragraphs 57-58 and 252-255.

Duke Energy does a balance sheet amortization of "Net Regulatory Asset Related to Income Taxes" and ADIT (see discussion below in section captioned "Net Regulatory Asset Related to Income Taxes"). The result is that AFUDC equity income and the depreciation or amortization of AFUDC equity is presented net of tax on the income statement and are reconciling items in the statutory to effective tax rate reconciliation.

Per SFAS No. 101;

116. The requirements for accounting for investment tax credits are contained in Opinions 2 and 4. In Opinion 2, the Accounting Principles Board (APB) concluded that:

a. The investment tax credit reduces the cost of the related asset, and for that reason, it should be deferred and amortized over the productive life of the related asset.

c. Display of the deferral as deferred income is also permitted provided that the investment tax credit is accounted for as a reduction of the cost of the asset, that is, amortized over the productive life of the asset.

For electric operations, investment tax credits are deferred and reported as a credit on the balance sheet rather than a reduction in PP&E. Investment tax credits are amortized as a component of income tax expense over the life of the associated plant. This amortization impacts the Company's reported effective tax rate.

A regulatory liability for the gross up of investment tax credits on the balance sheet is booked with an offsetting amount in ADIT. The offsetting ADIT represents the deferred taxes on the Investment Tax Credit and the deferred taxes on the regulatory liability for the gross up.

Per SFAS No. 109;

18. *The objective is to measure a deferred tax liability or asset using the enacted tax rate(s)* expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.

ADIT balances should reflect the enacted tax rates expected to apply to taxable income. If a change in tax rates (or allocations of income between state jurisdictions for state income taxes) occurs, ADIT should be adjusted to the new tax rate. The change in the ADIT balance should be evaluated to determine if a regulatory asset or liability for the change in tax rates should be recorded. If a regulatory asset or liability is recorded, it should be grossed up to a before tax amount and ADIT on the regulatory asset or liability should be recorded at the new tax rate. Further guidance on tax rates can be found in SFAS No. 109 paragraphs 18, 27, 89-91, 233-237 and 252-255.

Duke Energy has deferred changes in tax rates on 'protected' property and utilized either the South Georgia or the average rate assumption methodology ("ARAM") to amortize the excess taxes into income. The resulting amortization impacts the Company's reported effective tax rate.

The regulated Duke Energy companies have entered into a tax sharing agreement. As a result, income taxes for regulated utilities, even if their form of organization is an 'LLC', should reflect income tax expense and income tax liabilities. However, income tax payments as determined by the tax sharing agreement should not be assumed to be the same as GAAP income tax expense. Any difference should be accounted for as a capital transaction between the parent and the subsidiary.

On an SEC sub-registrant level, the accounting for income taxes essentially represents the income taxes that each sub-registrant would incur if each sub-registrant were a separate company filing its own tax return as a C-Corporation.

As it relates to taxes, Duke Energy records interest expense, within the interest expense line item of the income statement, and interest income and penalties within the "Other Income and Expenses, net", line item of the income statement. Income tax accruals for unrecognized tax benefits on regulated operations are recorded as a regulatory asset if the requirements of paragraph 9 of SFAS No. 71 are met.

13. Incurred Costs vs. Allowable Costs

"Incurred" costs (e.g., as discussed in paragraph 9 of SFAS No. 71) only include those costs that would otherwise be charged to expense. Incurred costs do not include an AFUDC equity return or a reduction in revenue. For example, a one-year reduction in rates would likely not represent an "incurred" cost and therefore not qualify for recording as a regulatory asset, even if the regulator allowed multi-year amortization for regulatory reporting purposes. Likewise, the accrual of AFUDC equity on a regulatory asset would not likely represent an "incurred" cost. See section above entitled "Allowance for Funds Used During Construction or "AFUDC" for guidance on accruals related to equity returns.

In the context of SFAS 71, "allowed" costs is a broader concept of costs than "incurred" costs. Allowed costs include all costs from which (regulated) revenue is intended to provide recovery (see SFAS 71, paragraph 1). Regulators often defer allowed costs for ratemaking purposes with the intent that revenues from regulated operations cover these allowed costs in a later time period. A deferral for regulatory purposes does not necessarily equate to a change in rates. Instead, a deferral may mean that costs are deferred for the purpose of assessing earned rates of returns in regulatory reports.

14. Intercompany Profit

Per SFAS No. 71;

Intercompany Profit[10]

10 The term *intercompany profit* is used in this Statement to include both profits on sales from one company to another within a consolidated or affiliated group and profits on sales from one operation of a company to another operation of the same company.

16. Profit on sales to regulated affiliates shall not be eliminated in general-purpose financial statements11 if both of the following criteria are met:

[11]ARB No. 51, *Consolidated Financial Statements*, requires that profit on sales of assets remaining in the consolidated group be eliminated in consolidated financial statements. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, effectively extends that requirement to affiliated entities reported on the equity method.

a. The sales price is reasonable.

b. It is probable that, through the rate-making process, future revenue approximately equal to the sales price will result from the regulated affiliate's use of the products.

Profits on intercompany sales to regulated affiliates should not be eliminated in consolidated results if the requirements of paragraph 16 of SFAS No. 71 are met.

Intercompany profit on sales from a regulated entity (under SFAS No. 71) to an unregulated affiliate should be eliminated in consolidated results. See also SFAS 71, paragraph 17 and 85-86.

15. Mark-to-market results for certain derivative instruments under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities"

Changes in the fair value of derivative instruments designated as cash flow hedges are recorded in Accumulated Other Comprehensive Income (AOCI), a separate component of shareholders' equity on the balance sheet, while changes in the fair value of derivative instruments not designated as cash flow hedges or fair value hedges are recorded immediately in earnings ("mark-to-market" derivatives).

For derivative instruments related to regulated entities, the changes in fair value of "mark-to-market" commodity derivatives and cash flow hedges that would otherwise flow through the income statement should be recorded as a regulatory asset or liability, rather than AOCI or earnings, as long as the criteria in paragraphs 9 or 11 of SFAS No. 71, as applicable, are met. Depending upon the specific facts and circumstances, a formal "rate order" may not be required in order to meet the criteria of SFAS No. 71 to classify the balance as either a regulatory asset or liability.

Refer to the accounting policy entitled "Accounting for Risk Management and Hedging Activities" for additional guidelines related to the accounting for derivative instruments.

16. Major Maintenance of Plant

The cost of repairs, replacements and major maintenance projects which do not extend the useful life or increase the expected output of property, plant and equipments, is expensed as is it incurred. Extending the useful life refers to the life of the property as it was originally constructed or acquired. Restoring serviceability, maintaining, or preserving the life as originally constructed does not 'extend the useful life'.

Significant refurbishment or other expenditures deemed to be "life extending" may be capitalized if the original components have been refurbished, repaired, rebuilt, re-generated, or substantially replaced such that the unit of property has been returned to its original operating capability with an estimated life as if new. Indicators of "life extension" treatment include the cost of the work being 50% or more of the original cost of the property and manufacturer rewarranty and/or re-certification being provided.

Work performed at regular intervals (months or years, number of hours in operation, miles driven, cold starts, etc.) per manufacturer specifications or other available guidance, it should be considered normal repair and maintenance and therefore expensed.

All maintenance costs except those that extend the life, increase the output or in some other way constitute a substantial betterment or substantial addition to the asset should be expensed. Work performed specifically for the purpose of preventing failure, restoring serviceability or maintaining life of plant, rearranging or changing the location should be expensed. The magnitude of the costs does not change what would otherwise be a current period expense into an asset.

Major maintenance activities may involve tasks which support both capital tasks (e.g., replacement of retirement units) and expense tasks (e.g., inspections, machining of parts). For instance, a turbine inspection will require disassembly and reassembly of the turbine in order to perform replacements, inspections, machining of parts, etc. When generic tasks, such as disassembly and reassembly, are required in order to perform both capital and expense tasks, the cost associated with the generic task shall be allocated to capital and expense using the labor cost of the capital and expense tasks as the basis for allocation.

See also Plant Property and Equipment.

17. Net Regulatory Asset Related to Income Taxes

AFUDC Equity is capitalized to Property, Plant, and Equipment including Nuclear Fuel (PP&E) on an after tax basis (See section above entitled "Allowance for Funds Used During Construction or "AFUDC"" for a discussion of AFUDC Equity). Capitalized AFUDC Equity is considered to be a temporary difference because it is recognized as income in one period and recognized in later periods as depreciation or amortization expense. Duke's policy is to take the amount of undepreciated AFUDC Equity in PP&E and gross it up to a before tax amount. The gross-up is presented as net regulatory asset related to income taxes, which is a temporary difference. An equal and offsetting amount is credited to Accumulated Deferred Income Taxes (ADIT) on the balance sheet. This ADIT represents ADIT on the undepreciated AFUDC Equity remaining in PP&E plus the ADIT on the net regulatory asset related to income taxes. The result is that the AFUDC Equity in PP&E is effectively converted from a net of tax amount to a before tax amount. For example, if there is $100 of undepreciated AFUDC Equity in PP&E and the tax rate is 40%, Duke Energy debits net regulatory asset related to income taxes for $67 and credits ADIT for $67. ADIT of $67 represents ADIT on AFUDC in PP&E of $40 (40% of $100) and ADIT on net regulatory asset related to income taxes of $27 (40% of $67). See SFAS No. 109, paragraph 253. Also see section above entitled "Income taxes and Investment Tax Credit for Regulated Entities" for further discussion of accounting for income taxes in a rate-regulated environment.

18. Net Revenue - ISO/RTOs

Sales to an independent system operator ("ISO") or RTO (Independent System Operator and Regional Transmission Organization) and purchases from an ISO or RTO in the day-ahead market market for the same hour should be netted. Likewise, sales to an ISO/RTO and purchases from an ISO/RTO in the real-time market should also be netted.

If the net result is the sale of megawatt hours ("mWhs"), the net dollars should be reported as revenue, even if a net payment results. If the net result is the purchase of mWhs, the net dollars should be reported as expense, even if net income results. If the net result is zero mWhs, gains should be reported as revenue and losses as expense.

19. Nuclear property and liability reserves

As a result of prior rate-making, Duke Energy Carolinas has reserves set aside for property damage and for liability under the Price-Anderson Act, and is required to be accountable to the regulatory commissions for these amounts. Since a nuclear accident is a remote possibility as defined by SFAS No. 5, these amounts represent regulatory liabilities under SFAS 71, paragraph 11(b).

20. Nuclear decommissioning trust fund

In accordance with regulatory requirements, Duke Energy has established an external trust fund that holds investments, including debt and equity securities, designated to cover costs to decommission Duke Energy Carolinas' nuclear plants when the operating licenses ultimately expire. Decommissioning of the non-contaminated portion is a removal cost (see separate section below entitled "Removal Costs"). Decommissioning of the contaminated portion is an ARO under SFAS No. 143 because it represents a legal obligation, while decommissioning of the non-contaminated portion is not a legal obligation and therefore not an ARO under SFAS No. 143.

In accordance with regulatory requirements, Duke Energy has outsourced the management of the investments in the trust to one or more third parties. Under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", investments in marketable securities, such as debt and equity securities, are classified as trading, held-to-maturity, or available-for-sale. With respect to the nuclear decommissioning trust fund, all the marketable securities held in the trust are classified as available-for-sale. Duke Energy management does not have the ability to hold the securities to maturity, due to the outsourcing of the investment management procedures, nor do the securities qualify for the trading designation as they are not bought and held principally for selling them in the near term. Consequently, under the guidance in SFAS No. 115, the investments are carried at fair value in the consolidated balance sheets.

Net realized and unrealized earnings of the decommissioning fund set aside for contaminated costs are recorded as a regulatory asset (debit/credit nuclear decommissioning trust fund, credit/debit regulatory asset). The reason the amount is recorded as a regulatory asset is that at this time, the ARO costs (decommissioning expense) allowed for setting rates is less than the cumulative amount of asset retirement costs expensed for GAAP purposes.

Realized and unrealized earnings/losses of the decommissioning fund set aside for clean costs are recorded as a regulatory liability (debit/credit nuclear decommissioning trust fund, credit/debit regulatory asset). The company has a liability to its customers related to the costs that are booked for setting rates versus the cost of removal which is not a GAAP recognized cost until incurred.

21. Pensions and Other Postretirement Benefits

The accrual of the net pension asset, net pension liability and other post retirement benefits liability (i.e., the "funded status") on the balance sheet pursuant to SFAS No. 158 is offset by an entry to regulatory asset or liability to the extent allocable to Duke's regulated operations rather than accumulated other comprehensive income ("Accumulated Other Comprehensive Income (AOCI"). The regulatory asset or liability recorded pursuant to SFAS No. 158 should be on the books of the same company where the associated net pension asset, net pension liability or other post retirement benefits liability is recorded.

The regulatory asset for other post retirement benefits net of deferred taxes, is equal to the other post retirement liability, net of deferred taxes, allocated to Duke's regulated operations. The before tax regulatory asset for other post retirement benefits does not equal the before tax net liability for other post retirement benefits as a component of the before tax net liability represents a permanent difference. The reason the before tax amount for the regulatory asset does not equal the before tax amount for the post retirement benefit liability is that there is a non-taxable component of the benefit liability represented by the non-taxable funding by the federal government for medical costs.

Refer to the accounting policy entitled "Accounting for Defined Benefit Pension and Other Post-Retirement Benefit Plans" for additional guidelines.

22. Phase-In Plans (SFAS No. 92)

From SFAS No. 92:

3. The term *phase-in* is used in this Statement to refer to any method of recognition of allowable costs (footnote omitted) in rates that meets all of the following criteria:

a. The method was adopted by the regulator in connection with a major, newly completed plant of the utility or one of its suppliers or a major plant scheduled for completion in the future (hereinafter referred to as a "plant").

b. The method defers the rates intended to recover allowable costs beyond the period in which those allowable costs would be charged to expense under GAAP applicable to enterprises in general.

c. The method defers the rates intended to recover allowable costs beyond the period in which those rates would have been ordered under ratemaking methods routinely used prior to 1982 by that regulator for similar allowable costs of that regulated enterprise.

4. If a phase-in plan is ordered by a regulator in connection with a plant on which no substantial physical construction had been performed before January 1, 1988, none of the allowable costs that are deferred for future recovery by the regulator under the plan2 for rate-making purposes shall be capitalized for general-purpose financial reporting purposes (hereinafter referred to as "financial reporting").

[2]"Allowable costs that are deferred for future recovery by the regulator under the plan" consist of all allowable costs deferred for rate-making purposes under the plan beyond the period in which those allowable costs would be charged to expense under generally accepted accounting principles applicable to enterprises in general.

Since it is unlikely that Duke will have a phase-in on a plant constructed prior to January 1, 1988, Duke Energy should not be deferring any costs as a result of phase-in plans.

Phase-in plans do not include the deferral of costs between the commercial operation date of a major new plant and a change in rates to reflect commercial operation of that plant. Such incurred costs can be deferred provided they meet the requirements of SFAS No. 71 paragraph 9 and do not include an amount for AFUDC equity. (See paragraphs 38-41 of SFAS No. 92)

23. Property, Plant and Equipment

In accordance with the FERC Uniform System of Accounts ("USA"), Duke Energy uses composite depreciation to depreciate its utility plant for both FERC and GAAP purposes. Composite depreciation is a method whereby one depreciation rate is applied to the entire asset group. For example, the foundation and structure of a building may last 50 years, whereas the electrical and plumbing components may have lives of 20 years. These component assets would be grouped together, and a composite depreciation rate of approximately 33 1/3 years, as an example, may be used for the entire asset group. When Duke Energy retires its regulated property, plant and equipment, it charges the original cost plus the cost of retirement, less salvage value, to accumulated depreciation and amortization. When it sells entire regulated operating units, or retires or sells non-regulated properties, the cost is removed from the property account and the related accumulated depreciation and amortization accounts are reduced. Any resulting gain or loss is recorded in earnings, unless otherwise required by the applicable regulatory body.

Duke capitalizes Contributions in Aid of Construction ("CIAC") as reductions in utility plant in accordance with the USA and prevalent industry practice for GAAP reporting purposes. Prepayments of extra facilities fees are treated as deferred revenue and not as CIAC.

Preliminary survey and development costs that meet the requirements of paragraph 9 of SFAS No. 71 are recorded as a regulatory asset until a decision has been made to either start or abandon the project. If a decision has been made to start the project, the costs are transferred to construction work in progress. Otherwise, the costs are expensed unless the costs continue to meet the requirements of paragraph 9 of SFAS No. 71.

Investment tax credits, for electric plant, are recorded as deferred credits instead of as reductions in PP&E (See section above entitled "Income Taxes and Investment Tax Credit for Regulated Entities"). Duke Energy does not record any regulatory assets or regulatory liabilities as PP&E. (See section above entitled "Allowance for Funds Used During Construction or "AFUDC"".) The cost of removal component of depreciation is reported on the GAAP balance sheet as a regulatory liability although for regulatory purposes, this liability is credited to Accumulated Depreciation. (See section below on Removal Costs.)

The income statement effects of SFAS No. 143 "Accounting for Retirement Obligations", are deferred into a regulatory asset or regulatory liability. (See section on Asset Retirement Obligations.)

Changes in Units of Property are a change in an accounting estimate effected by a change in accounting principle as defined by SFAS No. 154, "Accounting Changes and Error Corrections – A Replacement of APB Opinion No. 29."

Per SFAS 154, "Accounting Changes and Error Corrections":

22.................... If a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented.

Per SAB Topic 1 M "Materiality", materiality considerations include an effect that increases management's compensation.

A retirement is the removal from service, sale, abandonment or other withdrawal from service. Refurbishing a piece of property and then returning it to service in the same location is not a retirement. Returning the item to service after refurbishment in a different location is not a retirement because the item has not been removed from service.

A piece of plant that is removed from service should not be placed in inventory (for GAAP accounting) if it has been classified as a capital spare part. Such spare parts do not meet the definition of inventory. If the spare parts are essential for emergency needs, are associated with specific plant-in-service, and are not subject to use as normal periodic replacements, they may be recorded in the depreciable plant-in-service accounts. Spare parts which are subject to use as normal periodic replacements (such as meters and transformers) should be recorded as inventory.

All property will be considered as consisting of either property units or minor items of property. If not identified as a property unit, the item is considered a minor item.

- If a property unit is added, the cost is capitalized.
- If a property unit is replaced with new property unit, the old unit is retired and the new unit

is capitalized.

- If a minor item of property is added to a property unit, costs are expensed unless there is a "substantial addition" to the property unit,
- If a minor item of property is replaced independently of the property unit of which it is a part, the cost is expensed, unless there is a "substantial betterment" of the property unit.
- All remaining expenditures are expensed.

Substantial Addition - The new minor item being added to the property unit must cost at least 25% of the current price for that unit, or, using an appropriate and reasonable functional metric, there must be at least a 25% addition.

Substantial Betterment - Improvement to a property unit though replacement of a minor item of property that makes the unit more useful or more efficient or that increases capacity. Capitalize only the portion that adds at least 25% betterment. (Subtract the current cost of the original minor item from the betterment.)

A trade-in/salvage arrangement with a vendor where pre-arrangements exist for the repurchase of the same or previously-owned refurbished Duke Energy property will not change the accounting treatment from expense to capital.

The repair/refurbishment/overhaul of existing equipment where the company has purchased an additional item to insert in its place while the work is ongoing shall be accounted for as follows:

1. Purchase of the additional property unit(s) shall be recorded in materials inventory at cost.
2. When work begins the property unit(s) are issued out of materials inventory and charged to the appropriate capital project.
3. The existing property unit(s) are removed, retired from plant-in-service, and placed in materials inventory at original cost (trended to the appropriate vintage date). This occurs whether the unit(s) are kept on-site or shipped to a vendor. If shipped to a vendor, appropriate supporting documentation noting the physical location of the units must be maintained.
4. Refurbishment costs incurred are expensed currently unless the refurbishment results in a substantial betterment or economic life extension of the unit of property.

Costs that "have a definite relation to construction shall be capitalized. The addition to direct construction costs of arbitrary percentages or amounts to cover assumed overhead costs is not permitted." Capitalization is only appropriate when such costs are specifically identifiable with a particular project and are identifiable in the accounting records. Indirect costs capitalized should be incremental (costs that would not have been incurred had the project not been developed.)

The following is a summary of costs for overhead departments which if not feasible to be direct charged, can be included in a cost pool that may be used for capitalization. Overhead cost pools include employee fringe and benefit allocations. Direct costs to a capital project also include employee fringe and benefit allocations.

Accounting: (Asset, Controller, Accounting Support): Only Asset Accounting departmental costs are eligible for capitalization. No other costs are eligible for capitalization unless direct charged.

Executive: No costs are eligible for capitalization unless direct charged.

Information Technology: (mainframe, server, workstation, data center and support services): eligible for capitalization.

Human Resources: No costs are eligible for capitalization unless direct charged.

Facilities: real estate and project management: No costs are eligible for capitalization unless direct charged.

Finance: (treasury, insurance claims, budgeting, reporting): No costs are eligible for capitalization unless direct charged.

Based on the available guidance, the presumption is that these costs are to be expensed unless there is a direct or very close indirect relationship to the construction project. FERC states only costs that "have a definite relation to construction shall be capitalized. The addition to direct construction costs of arbitrary percentages or amounts to cover assumed overhead costs is not permitted." GAAP states capitalization is only appropriate when such costs are specifically identifiable with a particular project and are identifiable in the accounting records. GAAP also states indirect costs capitalized should be incremental (costs that would not have been incurred had the project not been developed.)

The burden of proof is on the Company to support costs are directly identifiable with the construction project. Identified costs are based on what activities are performed in support of construction projects, and not simply based on what department personnel are associated with. In defining these costs the following factors should be considered:

a. Specific information should be available (such as timecards) to support the allocation of overhead costs to specific projects.
b. The costs incurred should be incremental costs. That is, in the absence of the project or projects under development or construction, these costs would not be incurred.
c. The impact of capitalization of such indirect costs on the results of operations should be consistent with the pervasive principle of matching costs with related revenue.

Payroll timesheets and/or special studies of where personnel spend their time are methods which could provide acceptable support.

For additional guidance, see: USFEG Capitalization Guidelines

24. Rate Changes

Per SFAS No. 71;

79. Rate actions of a regulator can also impose a liability on a regulated enterprise in the following ways:

a. A regulator can order a regulated enterprise to refund previously collected revenues.

b. A regulator can provide rates intended to recover costs that are expected to be incurred in the future. Paragraphs 38 and 39 illustrate that possibility. The resulting increased charges to customers are liabilities and not revenues for the enterprise—the enterprise undertakes to provide the services for which the increased charges were collected, and it is obligated to return those increased charges if the future cost does not occur. The obligation will be fulfilled either by refunding the increased charges through future rate reductions or by paying the future costs with no corresponding effect on future rates. The resulting increases in charges to customers are unearned revenues until they are earned by their use for the intended purpose.

Rate reductions for previously collected revenue (refunds) should be accrued as regulatory liabilities in accordance with SFAS No. 71, paragraph 11(a). Other rate reductions should likely not be accrued.

Rate changes for cost tracked items (such as a fuel or purchased power expense) are booked as revenue is billed (typically monthly). The mismatch between fuel or purchased power revenue and the associated expense is booked as an adjustment to revenue or expense.

The effects of regulatory-ordered future rate reductions that do not qualify as regulatory liabilities under FAS 71, par. 11 should not be accrued in advance but rather should be recognized as reduced revenue in future periods.

25. Reapplication of SFAS No. 71

Reapplication of SFAS No. 71 as a result of reregulation is the result of a change in accounting principle as a result of a changed circumstance. The effect of such a change is recognized in current earnings and is not a cumulative effect of a change in accounting principle. Caution should be applied to avoid the recognition of regulatory assets before they are considered probable of recovery. Reapplication of SFAS No. 71 may be considered an "extraordinary item" for income statement classification purposes depending on facts and circumstances.

26. Regulatory Accounting vs. U. S. GAAP

Per SFAS No. 111, "Rescission of FASB Statement No. 32 and Technical Corrections"

25. The chart below summarizes the GAAP hierarchy for financial statements of nongovernmental entities under SAS 69, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles.*"

Established Accounting Principles

Category *(a)*-FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins

Category *(b)*-FASB Technical Bulletins, cleared 5 AICPA Industry Audit and Accounting Guides, and cleared AICPA Statements of Position

Category *(c)*-Consensus positions of the FASB Emerging Issues Task Force and cleared AICPA AcSEC Practice Bulletins

Category *(d)*-AICPA Accounting Interpretations, FASB Implementation Guides (Q&As), and widely recognized and prevalent industry practices

Other Accounting Literature

Other accounting literature, including FASB Concepts Statements; APB Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles.

Regulatory accounting pronouncements (e.g., accounting from regulatory bodies such as FERC or state public utility commissions) should not be assumed to comply with U.S. GAAP reporting requirements (SFAS 71, paragraphs 4 & 54). However, per the excerpts from SFAS No. 111 above, pronouncements of regulatory agencies and prevalent industry practice represent lower level GAAP. Therefore, the

- FERC Uniform System of Accounts,
- FERC Accounting Interpretations, Releases and Rulemakings,
- State Commission Accounting Orders, Rate Orders or other pronouncements and
- prevalent industry practice

provide GAAP guidance as long as they are consistent with SFAS No. 71 and are not in conflict with any higher level GAAP. Industry practice cannot take precedence over authoritative literature.

SFAS No. 71 applies to most of the operations of the USFEG business segment. However, there are some exceptions. For example, the regulated operations exclude all of the wholesale operations, as the rates for the wholesale operations are not under cost-based regulation, with the exception of the transmission operations which continue to be rate regulated.

27. Regulatory Assets

Regulatory assets should be amortized over future periods consistent with the related recovery through customer revenues or reductions in the related deferred taxes. Regulatory assets should not be netted against a corresponding GAAP liability unless the netting requirements of FIN 39 are met. Regulatory assets should not be included as a part of plant, property and equipment including nuclear fuel (PP&E) or inventory. (See discussion on AFUDC, Intercompany profit and Disallowances for further guidance.)

Evidence should be maintained for all regulatory assets supporting that the asset is both probable of recovery and estimable and that the cost being deferred is a specific cost and not a provision for similar future costs.

An incurred cost that does not meet the asset recognition criteria in paragraph 9 at the date the cost is incurred should be subsequently recognized as a regulatory asset if it meets those criteria at a later date.

Items which meet the requirements of paragraph 9 of SFAS No. 71 and would otherwise be recorded as accumulated other comprehensive income ("Accumulated Other Comprehensive Income (AOCI") (see pensions and other post retirement benefits for example) are recorded as regulatory assets.

28. Regulatory Liabilities

Regulatory liabilities should be amortized over future periods consistent with the related decrease in customer revenues, increase in expense to which the regulatory liability was originally created, or reductions in the related deferred taxes. Regulatory liabilities should not be netted against a corresponding GAAP asset unless the netting requirements of FIN 39 are met. Regulatory liabilities should not be included as a part of plant, property and equipment including nuclear fuel (PP&E) or inventory. (See the sections above on *AFUDC* and *Disallowances of Plant Costs* for further guidance.)

Regulatory liabilities are usually created when the criteria of paragraph 11 (a), (b) or (c) are met.

Items which meet the requirements of SFAS No. 71 and would otherwise be recorded as AOCI are recorded as regulatory liabilities (see pensions and other post retirement benefits for example).

29. Removal Costs

For certain regulated Duke entities, the depreciation component of rates includes an estimate for costs of removal. Costs of removal may include both the "non-legal" retirement obligations, such as estimated costs for non-nuclear facilities and the non-contaminated portion for decommissioning nuclear power plants as well as certain costs associated with retirement of gas pipeline systems. Under SFAS No. 143, these costs cannot be accrued as retirement obligations until incurred because they do not represent legally-obligated costs. (The contaminated portion for decommissioning Duke's nuclear power facilities is an ARO liability.) Therefore, pursuant to SFAS No. 71, paragraph 11(b), the balance for these non-legal costs is recorded as a regulatory liability for GAAP reporting although regulated financial statements may be required, in some cases, to classify these credits within accumulated depreciation.

30. Reporting and Disclosure Requirements

Per SFAS No. 71;

19. For refunds that are recognized in a period other than the period in which the related revenue was recognized and that have a material effect on net income, the enterprise shall disclose the effect on net income and indicate the years in which the related revenue was recognized. Such effect may be disclosed by including it, net of related income taxes, as a line item in the income statement. However, that item shall not be presented as an extraordinary item.

Significant refunds that are recognized in a period other than the period in which the related revenue was recognized and that have a material effect on net income should be disclosed. The years for which the related revenue was recognized should be indicated. The effect may be disclosed, net of related income taxes, as a line item in the income statement. However, it should not be presented as an extraordinary item.

The amount of any revenue adjustments resulting from rate-making processes related to prior interim periods should be disclosed under the following circumstances.

From SFAS No. 16, "Prior Period Adjustments", paragraph 13:

a. The effect of the adjustment or settlement is material in relation to income from continuing operations of the current fiscal year or in relation to the trend of income from continuing operations or is material by other appropriate criteria, and

b. All or part of the adjustment or settlement can be specifically identified with and is directly related to business activities of specific prior interim periods of the current fiscal year, and

c. The amount of the adjustment or settlement could not be reasonably estimated prior to the current interim period but becomes reasonably estimable in the current interim period.

If the revenue adjustment occurs in *other than the first quarter*, prior interim periods of the current year should be restated to include the portion of the revenue adjustment. The portion of the refund that is directly related to business activities during prior years will be included in the first quarter of the current year. Disclosures will be made of both a) the change in income and b) the income on

- continuing operations,
- net income and
- related per share amounts

See also, SFAS No. 16, paragraphs 14-15.

Losses recorded related to abandonments or disallowances should not be reported as extraordinary items.

Per SFAS No. 101;

6. When an enterprise discontinues application of Statement 71 to all or part of its operations, ... The net effect of the adjustments required by this Statement shall be included in

income of the period in which the discontinuation occurs and shall be classified as an extraordinary item.

8. For the period in which an enterprise reflects the discontinuation of application of Statement 71 to all or a separable portion of its operations, the enterprise shall disclose the reasons for the discontinuation and identify the portion of its operations to which the application of Statement 71 is being discontinued.

If SFAS No. 71 is discontinued for any portion of the regulated business, the reason for the discontinuance and the portion of the operations for which SFAS No. 71 is discontinued should be disclosed. The discontinuance should be treated as an extraordinary item.

As part of Duke Energy's significant accounting policies, Duke Energy discloses, in a separate footnote all regulatory assets and liabilities which would be written off if SFAS No. 71 were no longer applicable. Regulatory assets and liabilities exclude AFUDC (borrowed and equity) capitalized as part of plant, property and equipment including nuclear fuel, intercompany profit in PP&E or inventory or disallowances. Disclosures include:

- the nature of the cost deferred,
- the amount deferred,
- where each item is presented on the balance sheet,
- the recovery period and
- whether a return is being provided.

The SEC's SAB Topic 10C, "Jointly Owned Electric Utility Plants," requires a utility participating in a jointly owned power station to disclose the extent of its interests in such plant(s). Disclosure should include a table showing separately for each interest the amount of utility plant in service, accumulated depreciation, the amount of plant under construction and the proportionate share. Amounts presented for plant in service maybe further subdivided into subcategories such as production, transmission and distribution. Information concerning two or more generating plants on the same site may be combined if appropriate.

Disclosure should address the participant's share of direct expenses included in operating expenses on the income statement (fuel, maintenance and other operating). If the share of direct expenses is all charged to purchased power, then disclosure of this amount, as well as the proportionate amounts related to specific operating expenses in the joint plant records, should be indicated.

The following is a comment from the SEC, along with the Company's response, from a comment letter received in 2007 from the SEC's review of the 2006 form 10-K of Duke Energy Carolinas:

"Please revise future disclosure to indicate the amount of unbilled revenues recorded at period end. To the extent applicable, please explain any material differences in amounts recorded between periods.

The Company will revise future disclosure to indicate the amount of unbilled revenues recorded at period end. To the extent applicable, the Company will explain any material differences in amounts recorded between periods."

Accordingly, these disclosures should be made in all future SEC filings for all Duke Energy SEC registrants.

Long term purchase power contracts are disclosed in MD&A as a component of the table of contractual obligations.

31. Unbilled Fuel

The adjustment made to match billed fuel revenue and fuel expense is reported as an adjustment to revenue or fuel expense in order to match billed fuel revenue and fuel expense. Fuel expense is defined by each regulatory jurisdiction and may include portions of purchased power expense or exclude components of fuel expense as reported in the GAAP financial statements. The matching of fuel revenue and fuel expense ignores the fuel component of Unbilled Revenues (meters not read). Depending on the jurisdictional balance, the balance sheet amount is recorded as either a current (regulatory) asset or a current (regulatory) liability.

32. Unbilled Revenue (meters not read)

An amount for electricity or gas delivered but not yet billed is accrued each month based on estimates of the amounts delivered since the last meter reading date to the end of the reporting period. Revenue is recognized as the only activities before conversion into cash are meter reading, billing and cash collection. The revenue recognized is gross of meter reading, billing and cash collection costs due to the immateriality of such items.

The accrual of a receivable for unbilled revenue includes the amount recoverable through the fuel clause or the purchased gas clause. Unbilled revenue for each jurisdiction is recorded as a current asset.

Accounting for Risk Management and Hedging Activities

Applicability:	Applies to Enterprise
Originator:	Corporate Controller
Approval:	Corporate Controller
Effective Date:	12/01/2004
Revision Date:	12/17/2007
Reissue Date:	12/17/2007

Statement of Purpose and Philosophy

The purpose of this policy is to provide guidelines related to the accounting and disclosure of derivatives and other instruments or contracts related to certain risk management functions (e.g., risks associated with commodity prices, credit exposure, interest rates, and foreign currency) and hedging activities. Duke Energy is committed to preparing and providing financial information with the utmost integrity. To facilitate this corporate value, the Corporate Controller's Department will approve policies to ensure the accuracy of books and records (as detailed in the Code of Business Ethics).

Policy Expectations and Scope

This policy is applicable to all business/corporate units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company"). This policy contains a high-level summary of the key requirements of U. S. generally accepted accounting principles ("GAAP") as it applies to Duke Energy, including any significant interpretations or policy elections made by Duke Energy, but is not intended to be a substitute for the detailed requirements of authoritative GAAP literature for specific issues or matters that may arise. This policy should help ensure consistent application of the accounting for derivative instruments and hedging activities across the consolidated Duke Energy group.

The scope of this policy is related to risk management functions surrounding derivative instruments and hedging activities, including any contracts whose terms and conditions qualify as derivative instruments even though the initial intent of the contract may not have been related to "risk management." This policy does not cover other risk management activities such as credit risk, allowances for bad debt, insurance contracts, etc. This policy does not apply to equity investments or ownership of stock. In addition, this policy is intended to address matters of significance at the Duke Energy Corporation consolidated reporting level. Additional details or procedural information may exist at the individual business or corporate unit level.

Materiality

FASB Statements note that, "The provisions of this Statement need not be applied to immaterial items." Accordingly, materiality should be considered when applying this policy. However, materiality must be assessed at the Business/Corporate Unit (as well as being assessed at the SEC sub-registrant level), and at the consolidated level(s), and involves consideration of both quantitative as well as qualitative factors. Any questions regarding materiality should be directed to the Corporate Controller Department.

Accountability: Roles and Responsibilities

Corporate Controller Department -

- Maintain an accounting policy for risk management and hedging activities (primarily for derivative instruments) available on the Duke Energy portal to help ensure that business/corporate units are aware of the criteria in order to assess whether (1) a financial instrument or other contract is a derivative and (2) a derivative qualifies for the normal purchases and normal sales exception or hedge accounting.
- Accumulate the information reported by the business/corporate units for periodic reporting and disclosure purposes (e.g. Form 10-K, Form 10-Q, etc.), including SEC market risk disclosures, and ensure that GAAP, including SEC, disclosure requirements are met.
- Provide guidance/assistance to business/corporate units on the classification and disclosure of derivative instruments, derivative instrument transactions for which accrual accounting (as defined below in the section entitled "Accounting for Types of Instruments by Activity") is available, trading and marketing activities, and certain other risk management activities.
- Establish and communicate the reporting timetable for risk management and hedging information needed for SEC filings.
- Provide guidance on the consideration of materiality as may be requested by the business/corporate units.

Business/Corporate Unit -

- Ensure all reporting requirements for derivative instruments, hedges, trading and risk management activities are reported to the Corporate Controller's Department in accordance with the established reporting timetable.
- Ensure proper support/documentation exists for the determination of whether: i) a contract or certain components of a contract meet the definition of a derivative or an embedded derivative, ii) a derivative instrument qualifies and the exemption is elected for the normal purchases and normal sales exception, and iii) hedge accounting is utilized to establish a hedging relationship.
- Ensure proper support/documentation exists for the determination of the fair value of derivative assets and liabilities at each reporting period.
- Ensure proper support/documentation exists for other risk management activities, such as hedge de-designation, calculated value reserve methodology, presentation, etc.
- Coordinate with the Corporate Controller department to ensure that all disclosure requirements are met in SEC filings.

Standards/Requirements/Background Information

This section primarily contains references to, and excerpts from, the most significant or applicable GAAP authoritative literature. Matters specific or unique to Duke Energy are primarily discussed in the "Accounting Policy" section below.

Standards

The various accounting standards that significantly impact the accounting recognition and disclosure of derivative instruments included the following:

- SFAS No. 133 (as amended), *Accounting for Derivative Instruments and Hedging Activities*
- EITF Issue 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent"
- EITF Issue 02-03, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*
- EITF Issue No. 03-11, *Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not 'Held for Trading Purposes' as Defined in Issue No. 02-3*
- Issue papers from the Derivatives Implementation Group ("DIG"), a committee formed by the FASB to address interpretation issues involving SFAS No. 133. Issue papers from the Derivatives Implementation Group (DIG) that are of the most relevance to Duke Energy include:
    - DIG Issue No. A6, *Definition of a Derivative: Notional Amounts of Commodity Contracts*
    - DIG Issue No. A10, *Assets That Are Readily Convertible to Cash*
    - DIG Issue No. A18, *Application of Market Mechanism and Readily Convertible to Cash Subsequent to the Inception of Acquisition of a Contract*
    - DIG Issue No. A19, *Definition of a Derivative: Impact of a Multiple-Delivery Long-Term Supply Contract on Assessment of Whether an Asset Is Readily Convertible to Cash*
    - DIG Issue No. C15, *Scope Exceptions: Normal Purchases and Normal Sales Exception for Option-Type Contracts and Forward Contracts in Electricity*
    - DIG Issue No. C20, *Scope Exceptions: Interpretation of the Meaning of Not Clearly and Closely Related in Paragraph 10(b) regarding Contracts with a Price Adjustment Feature*
    - DIG Issue No. E7, *Hedging-General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges*
    - DIG Issue No. G2, *Cash Flow Hedges: Hedged Transactions That Arise from Gross Settlement of a Derivative ("All in One" Hedges)*
    - DIG Issue No. G7, *Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut method Is Not Applied*
    - DIG Issue No. G10, *Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative*
- SFAS No. 157, *Fair Value Measurements ("SFAS No. 157")*

SFAS No. 157 was issued in September 2006 and is effective for Duke Energy, as it relates to valuations of derivative instruments and hedging activities, beginning on January 1, 2008. While this new guidance could have significant impact on Duke Energy's valuation of derivative instruments, it is not addressed in this policy at this time since it is not yet effective. The definition of fair value discussed in this accounting policy applies to measurements on or before December 31, 2007. Effective January 1, 2008, refer to the accounting policy entitled "Fair Value Measurements" for fair value guidance consistent with the principles of SFAS No. 157.

Background:

Types of Activities:

The Company primarily operates in various facets of the electric and natural gas industries including, but not limited to, the ownership and operation of power plants, electricity transmission and distribution lines in the Americas, and retail natural gas services in Ohio and Kentucky. Duke Energy is exposed to market risks associated with changes in commodity prices, credit exposure, interest rates, and foreign currency exchange rates. The Company's historical risk management and trading operations can be grouped into two broad categories - economic hedging and proprietary trading. Currently, the Company does not engage in any proprietary trading activities, but references to this activity are being retained in this policy as the company has trading activity in its discontinued operations for 2005 and 2006, and certain legacy trading contracts continue to wind-down.

Economic Hedging

In connection with its operations, the Company has certain firm commitments and anticipated forecasted transactions that bear commodity price, interest rate and/or foreign currency exchange rate risk. To mitigate this exposure, the Company often enters into a forward type contract for the purpose of reducing the risk of price fluctuation upon settlement, delivery or execution of a particular transaction. Depending on the nature of the hedged transaction and the instrument used, the Company may or may not designate the instrument as a hedge in accordance with SFAS No. 133. The Company's economic hedging activities will be classified in the consolidated financial statements as either 1) "hedging" if they are designated and documented as such in accordance with SFAS No. 133 and meet all the hedge criteria in SFAS No. 133; 2) "other" or "undesignated" if they represent an economic hedge but are not formally designated and documented or do not qualify as a hedge for accounting purposes under SFAS No. 133; or 3) excluded from the consolidated financial statements until settlement occurs either because the forward type contracts used represent normal purchases and normal sales of the Company, as defined in SFAS No. 133 (as amended), or the contract does not qualify as a derivative (e.g., an operating lease or an executory contract, which are described in greater detail below).

Proprietary trading (as previously noted, the Company does not currently engage in proprietary trading)

Related, in part, to the Company's presence in the natural gas and electricity marketplace, the Company has historically entered into certain contracts to take a market view, capture market price or put capital at risk. This type of activity may use some of the same types of instruments as hedging activity described above and is generally short-term in nature. EITF Issue No. 02-3 clarified that classification of derivatives as held for "trading purposes" is based on the intent of the issuer or holder and shall be consistent with paragraph 12(a) of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," which characterizes trading as "active and frequent buying and selling . . . with the objective of generating profits on short-term differences in price." On an ongoing basis, reclassifications into and out of the "trading" category, as defined in SFAS No. 115, should be rare. The SFAS No. 115 definition of trading involves holding an instrument for a short period of time, such as hours or days rather than months or years or to its maturity, in the case of debt instruments. Designation of a contract as proprietary trading activity is performed at the business/corporate unit level by the appropriate personnel and documented within the business/corporate unit's risk management system as such. Paragraph 16 of EITF 02-3 states that "A derivative held for trading purposes may be designated as a hedging instrument, prospectively, if all of the applicable criteria in Statement 133 have been met". As noted above, the Company currently does not engage in any significant proprietary trading activities.

Types of Instruments:

1. *Derivative Instruments*

As provided in SFAS No. 133[1], a derivative instrument is a financial instrument[2] or other contract with all three of the following characteristics:

a. It has (1) one or more **underlyings** and (2) one or more **notional amounts** or payment provisions or both.
b. It requires **no initial net investment** or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
c. Its terms require or **permit net settlement**, it can readily be settled by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

SFAS No. 133 contains the following additional information on the determination of an underlying and a notional:

7. *Underlying, notional amount, and payment provision.* An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable *including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract*. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

57. a. *Underlying.* An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative. An underlying usually is one or a combination of the following:
(1) A security price or security price index
(2) A commodity price or commodity price index
(3) An interest rate or interest rate index
(4) A credit rating or credit index
(5) An exchange rate or exchange rate index
(6) An insurance index or catastrophe loss index
(7) A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index.

However, an underlying may be any variable whose changes are observable or otherwise objectively verifiable. Paragraph 10(e) specifically excludes a contract with settlement based on certain variables unless the contract is exchange-traded. A contract based on any variable that is not specifically excluded is subject to the requirements of this Statement if it has the other two characteristics identified in paragraph 6 (which also are discussed in paragraph 57(b) and paragraph 57(c) below).

SFAS No. 133 contains the following additional information on the determination of whether a contract contains an initial net investment:

8. *Initial Net Investment.* Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus premium or minus a discount) or that is determined by applying the notional amount to the underlying. If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount (according to some interpretative guidance, greater than 15% is considered to more than a nominal amount, however, considerable judgment is required in determining if an initial net investment amount is significant enough to avoid triggering the no initial net investment characteristic), than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 6(b) is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount[4a] of the contract.

4a The effective notional amount is the stated notional amount adjusted for any leverage factor.

57. b. *Initial net investment.* A derivative requires no initial net investment or a smaller initial net investment than other types of contracts that have a similar response to changes in market factors. For example, entering into a commodity futures contract generally requires no net investment, while purchasing the same commodity requires an initial net investment equal to its market price. However, both contracts reflect changes in the price of the commodity in the same way, (that is, similar gains or losses will be incurred). A swap or forward contract also generally does not require an initial net investment unless the terms favor one party over the other. An option generally requires that one party make an initial net investment (a premium) because that party has the rights under the contract and the other party has the obligations. The phrase *initial net investment* is stated from the perspective of only one party to the contract, but it determines the application of the Statement for both parties.

SFAS No. 133 contains the following additional information on the determination of whether a contract contains the characteristics of net settlement:

9. *Net settlement.* A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:

a. Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.

b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

c. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash[5] or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative.

[5]FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, states that assets that are readily convertible to cash "have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price" (paragraph 83(a)). For contracts that involve multiple deliveries of the asset, the phrase in an active market that can rapidly absorb the quantity held by the entity should be applied separately to the expected quantity in each delivery.

57. c. *Net settlement.* A contract that meets any one of the following criteria has the characteristic described as net settlement:

(1) Its terms implicitly or explicitly require or permit net settlement. For example, a penalty for nonperformance in a purchase order is a net settlement provision if the amount of the penalty is based on changes in the price of the items that are the subject of the contract. Net settlement may be made in cash or by delivery of any other asset, whether or not it is readily convertible to cash. A fixed penalty for nonperformance is not a net settlement provision.

(2) There is an established market mechanism that facilitates net settlement outside the contract. The term *market mechanism* is to be interpreted broadly. Any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement. The evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be performed at inception and on an ongoing basis throughout a contract's life.

(3) It requires delivery of an asset that is readily convertible to cash. The definition of *readily convertible to cash* in FASB Concepts Statement No. 5, *Recognition and measurement in Financial Statements of Business Enterprises*, includes, for example, a security or commodity traded in an

active market and a unit of foreign currency that is readily convertible into the functional currency of the reporting entity. A security that is publicly traded but for which the market is not very active is readily convertible to cash if the number of shares or other units of the security to be exchanged is small relative to the daily transaction volume.

The determination of the existence of the three characteristics identified above is often difficult to assess and requires judgment. Appendices A and B outline primary commodity contract types in existence within Duke Energy's operations and the analysis as to whether such contracts represent derivatives. As discussed further below, certain contracts that meet the requirements for a derivative can be excluded from the financial statements (not recorded at fair market value) until settlement occurs pursuant to the normal purchases and sales exception in SFAS No. 133 if certain criteria are met.

The following is a summary of the primary accounting categorization of derivative instruments as they apply to Duke Energy:

- *Normal purchases and normal sales (NPNS)* – An elective accounting treatment for contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. It must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery (except for "capacity contracts" for power sale and purchase agreements under paragraph 10(b)(4) of SFAS No. 133). If a derivative contract qualifies for the normal purchases and normal sales exception and is documented as such, it is not subject to the requirements of SFAS No. 133 and shall be accounted for under the accrual method of accounting (as defined in "Accounting for Types of Instruments by Activity" below) and therefore is excluded from the consolidated financial statements until settlement occurs. Duke Energy also enters into power purchase or sales agreements that are also **capacity contracts*** and these contracts may qualify for the normal purchases and normal sales exception even if they are subject to unplanned netting or bookout. The discussion in the "Key Terms" section details how the "clearly and closely related" provisions of normal purchases and normal sales differ from the "clearly and closely related" provisions of embedded derivatives (paragraph 12 of SFAS No. 133). To date, Duke Energy has applied the NPNS exemption to certain electricity contracts.

- *Commodity Cash Flow Hedges* - Some Duke Energy subsidiaries are exposed to market fluctuations in the prices of various commodities related to their ongoing power generating and natural gas distribution activities. Duke Energy closely monitors the potential impacts of commodity price changes and, where appropriate, may enter into contracts to protect margins for a portion of future sales and generation revenues and fuel expenses. Duke Energy uses commodity instruments, such as swaps, futures, forwards and options, as cash flow hedges for natural gas, coal, emission allowances and electricity capacity transactions.

- *Commodity Fair Value Hedges* - Some Duke Energy subsidiaries are exposed to changes in the fair value of some unrecognized firm commitments to sell or purchase generated power or natural gas due to market fluctuations in the underlying commodity prices or the changes in the fair value of recorded assets or liabilities, such as natural gas held in inventory. Duke Energy actively evaluates changes in the fair value of such unrecognized firm commitments due to commodity price changes and, where appropriate, may use various instruments to hedge its market risk. These commodity instruments, such as swaps, futures and forwards, serve as fair value hedges for the firm commitments associated with generated power, natural gas or related product inventories.

- *Interest Rate (Fair Value or Cash Flow) Hedges* - Changes in interest rates expose Duke Energy to cash flow risk as a result of its issuance of variable-rate debt and expected issuance of fixed rate debt and to fair value risk as a result of its issuance of fixed-rate debt. Duke Energy manages its interest rate exposure by limiting its variable-rate and fixed-rate exposures to percentages of total capitalization and by monitoring the effects of market changes in interest rates. Duke Energy also may enter into financial derivative instruments, including, but not limited to, interest rate swaps, swaptions and U.S. Treasury lock agreements to manage interest rate risk exposure.

- *Foreign Currency (Fair Value, Net Investment or Cash Flow) Hedges* - Duke Energy is exposed to foreign currency risk from investments in international affiliates and businesses owned and operated in foreign countries as well as transactions denominated in foreign currency for Duke Energy's US operations. To mitigate risks associated with foreign currency fluctuations, contracts may be denominated in or indexed to the U.S. dollar and/or local inflation rates, or investments may be hedged through debt denominated or issued in the foreign currency. Duke Energy may also use foreign currency derivatives, where possible, to manage its risk related to foreign currency fluctuations. Please refer to the discussion in paragraph 40A of SFAS No. 133 for guidance pursuant to intercompany foreign currency derivatives.

- *Other Derivative Contracts (Trading)* - Duke Energy is exposed to the impact of market fluctuations in the prices of natural gas, electricity and other energy-related products marketed and purchased as a result of proprietary trading activities. Duke Energy's exposure to commodity price risk is influenced by a number of factors, including contract size, length, market liquidity, location and unique or specific contract terms. Currently, the Company does not engage in any significant trading activities.

- *Undesignated* - Duke Energy uses derivative contracts to manage the market risk exposures that arise from energy supply, structured origination, marketing, risk management, and commercial optimization services to large energy customers, energy aggregators and other wholesale companies, and to manage interest rate and foreign currency exposures. Derivative contracts that are not properly documented and designated, do not qualify for the normal purchases and normal sale exception or do not qualify for hedge accounting are automatically marked to market as undesignated derivatives. This category also includes derivatives which are 'offset' with FAS 71 regulatory assets or regulatory liabilities.

2. *Lease Contracts*

Certain contracts may meet the requirements to be accounted for as leases. The accounting for these contracts is outside of the scope of this policy.

Leases can be either capital or operating leases. A lease is defined in accounting literature[2] as any agreement that transfers the right to use an asset usually for a specified period. EITF Issue No. 01-8 has clarified that contracts which convey the *right to use* specific property, plant and equipment, as defined, may meet the definition of a lease and be subject to SFAS No. 13. This definition is applicable even though the legal owner of the asset still provides substantial services. It should be noted that the agreement does not have to be specifically identified as a lease to be treated as such. EITF Issue 01-8 clarified that "leases that are within the scope of Statement 13 are not derivative instruments subject to Statement 133, although a derivative embedded in a lease may be subject to the requirements of Statement 133". Therefore, if a contract is considered a lease, mark-to-market accounting as a derivative is not permitted except for any derivatives which are embedded in the contract (see *embedded derivative* discussion below).

3. Executory Contracts

An executory contract generally involves a purchase/sale of an asset or the providing of services and is distinct in that it does not have all three characteristics of a derivative, as defined above. If a contract is not a lease or a derivative, it is considered an executory contract.

Accounting for Types of Instruments by Activity:

Duke Energy uses two comprehensive accounting models for its risk management activities (associated with commodity prices, credit exposure, interest rates, and foreign currency risks) in reporting its consolidated financial position and results of operations as required by GAAP: a "mark-to-market" (MTM) model and an "accrual" model. Non-derivative instruments are accounted for as executory contracts, which is normally consistent with the normal purchases and normal sales methodology discussed below. The use in this policy of the terms MTM and accrual accounting models, as defined below, may not be consistent with how others use these terms.

Mark-to-Market

Under the MTM accounting method, which is the default for accounting for derivative instruments under SFAS No. 133, an asset or liability is recognized at fair value on the Consolidated Balance Sheet and the change in the fair value of that asset or liability is immediately recognized in the Consolidated Statement of Operations. This accounting method is applied only to derivative contracts that are not subject to hedge accounting or the normal purchases and normal sales exception (as described below). The guidance in EITF Issue No. 03-11, EITF Issue No. 02-03 and EITF Issue No. 99-19 should be considered for the appropriate income statement classification and presentation of derivative contracts. For entities subject to SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," any changes in the fair value of MTM derivatives should be recorded as a regulatory asset or liability, rather than in earnings, as long as the criteria in paragraphs 9 and 11 of SFAS No. 71, as applicable, are met. Refer to the accounting policy entitled "Accounting for Regulated Entities (SFAS No. 71)" for additional guidelines.

Accrual

An accounting method whereby there is no recognition in the Consolidated Statements of Operations for changes in fair value of a contract until the service is provided or the associated delivery period occurs (settlement) except to the extent a cash flow or fair value hedge is ineffective. For a derivative instrument that is initially subject to MTM accounting, Duke Energy may apply either hedge accounting or the normal purchases and normal sales exception in accordance with SFAS No. 133. The use of hedge accounting (to the extent effective) and the normal purchases and normal sales exception provide effectively for the use of the accrual model from an income statement perspective. (Both hedge and MTM accounting require that the fair value of the derivative be reflected on the balance sheet.) The guidance in EITF Issue No. 03-11 and EITF Issue No. 99-19 should be considered for the appropriate income statement classification and presentation of derivative contracts. For entities subject to SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," any changes in the fair value of derivatives designated as cash flow hedges should be recorded as a regulatory asset or liability, rather than in Accumulated Other Comprehensive Income (AOCI) or net income, as long as the criteria in paragraphs 9 and 11 of SFAS No. 71, as applicable, are met.

Hedge accounting treatment may be used when Duke Energy hedges the exposure to variability in future cash flows. These future cash flows could be result from contracts to buy or sell a commodity, at a fixed price for future delivery corresponding with anticipated physical sales or purchase, incur interest payments or transact in a foreign currency (cash flow hedge). In addition, hedge accounting treatment may be used when Duke Energy holds firm commitments, asset or liability positions and enters into transactions that "hedge" the risk that the fair value may change (fair value hedge). To the extent that the fair value of the hedge instrument offsets the hedged item, there is no impact to the Consolidated Statements of Operations prior to settlement of the hedge.

However, a certain degree of hedge ineffectiveness may be recognized in the Consolidated Statements of Operations for a variety of reasons. Those reasons include decisions to hedge only a component of the risk (spot price vs forward price, benchmark interest rate vs total interest rate exposure), deterioration of counterparty credit, the use of options to hedge only one direction of the change in fair value and differences in the location or timing of the delivery or flow of cash.

The normal purchases and normal sales exception, as provided in SFAS No. 133 as amended and interpreted by DIG Issue C15 as amended, indicates that no recognition of the contract's fair value in the Consolidated Financial Statements is required until settlement of the contract (in Duke Energy's case, the delivery of power or for capacity contracts, the availability of capacity). All criteria for obtaining the normal purchases and normal sales exclusion must be met initially and on an ongoing basis. Obtaining the normal purchases and normal sales exception is an election and is not automatic as the contract must be specifically designated and documented as meeting the normal purchases and normal sales exception.

From an income statement perspective, leases and executory contracts are also accounted for using the accrual method.

Accounting Policy

Duke Energy shall evaluate each financial instrument or other contract to determine whether it is a *derivative instrument* based on the three characteristics as prescribed in paragraph 6 of SFAS No. 133 and as discussed above. Financial instruments or other contracts meeting the definition of a derivative shall be accounted for under either the MTM or accrual method of accounting. As such, all derivative instruments not designated and qualifying for the normal purchases and normal sales exception under SFAS No. 133, shall be recorded on the Consolidated Balance Sheets at their fair value as (current or non-current) "Unrealized Gains or Unrealized Losses on Mark-to-Market and Hedging Transactions." Duke Energy shall document, based on the three criteria that constitute a derivative instrument, whether each financial instrument or contract used in commodity risk management or trading activities meets the definition of a derivative. Contracts shall also be evaluated for embedded derivatives.

The determination of whether a contract is a derivative or has an embedded derivative under SFAS No. 133 is an ongoing process and should be periodically reassessed, especially when facts and circumstances change significantly. For example, a commodity purchase contract may not be a derivative due to the underlying commodity not being readily convertible to cash; however, if the commodity subsequently was considered to be readily convertible to cash, the contract would be considered a derivative and subject to the provisions of SFAS No. 133. Certain aspects of contracts, such as the level of transaction costs, are assessed only at inception of the contract or when a contract subsequently meets the definition of a derivative for reasons other than the level of transaction costs.

Appendix A contains further interpretative guidance for use in determining whether a contract meets the definition of a derivative.

Normal Purchases and Normal Sales Exception

Contracts which meet the definition of a derivative may qualify for the normal purchases and normal sales exception if it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery, except as discussed below for 'capacity contracts.' If a contract qualifies for the normal purchases and normal sales exception, as defined in paragraphs 10(b) and 58(b) of SFAS No. 133, and the exemption is elected, the instrument shall be accounted for under the accrual method of accounting and shall be excluded from the consolidated financial statements until settlement occurs.

Power purchase or sales agreements which are not subject to bookout apply paragraph 10(b)(1) (for those contracts without optionality) or paragraph 10(b)(3) (for those contracts with optionality) in order to determine whether they can qualify for the normal purchases and normal sales exception. However, if a power purchase or sales agreement (whether a forward contract, an option contract, or a combination of both) for the purchase or sale of electricity is subject to unplanned netting (or being booked out or are scheduled to be booked out), they can qualify for the normal purchases and normal sales exception under paragraph 10(b)(4) if all of the following applicable criteria of paragraph 58(b) are met and the contract meets the definition of a "capacity contract," as discussed below: [paragraph 58(b) of SFAS No. 133 as amended]

(1) For both parties to the contract:

(a) The terms of the contract require physical delivery of electricity...... For an option contract, physical delivery is required if the option contract is exercised.
(b) The power purchase or sales agreement is a *capacity contract.*......

(2) For the seller of electricity: The electricity that would be deliverable under the contract involves quantities that are expected to be sold by the reporting entity in the normal course of business.
(3) For the buyer of electricity:

(a) The electricity that would be deliverable under the contract involves quantities that are expected to be used or sold by the reporting entity in the normal course of business.

(b) The buyer of the electricity under the power purchase or sales agreement is an entity that is engaged in selling electricity to retail or wholesale customers and is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base.
(c) The contracts are entered into to meet the buyer's obligation to maintain a sufficient capacity, including a reasonable reserve margin established by or based on a regulatory commission, local standards, regional reliability councils, or regional transmission organizations.

For a power purchase or sale contract (whether a forward contract, an option contract, or a combination of both) that meets the definition of a "capacity contract" under paragraph 540, all of the above criteria (1-3 of paragraph 58(b)) must be evaluated by both parties in order to qualify for the normal purchases and normal sales exception under paragraph 10(b)(4). For a power purchase or sale contract that contains optionality, the characteristics of an option contract that is a capacity contract and a traditional option contract, which are set forth in the appendix of DIG Issue C15, should be considered in the evaluation of whether the contract meets the definition of a "capacity contract."

For power purchase or sale agreements that qualify for the normal purchases and normal sales exception as described above, the Company shall document the designation as normal purchases and normal sales and the basis for concluding that the agreement meets the requirements for the normal purchases and normal sales exception. The documentation must be in place at the time of application of the normal purchases and normal sales exclusion, which would normally be at inception of the contract. The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract. Failure to comply with the documentation requirements precludes the application of the normal purchases and normal sales exclusion to the contract, even if the contract would otherwise have qualified. For power purchase or sale agreements that qualify for the normal purchases and normal sales exclusion under either paragraph 10(b)(1) or 10(b)(3), the Company is required to document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. For power purchase or sale agreements that qualify for the normal purchases and normal sales exclusion under paragraph 10(b)(4), the Company is required to document the basis for how the contracts meet the criteria in paragraph 58(b).

For those contracts qualifying for the normal purchases and normal sales exception, if the underlying of the price adjustment feature is based on an index or other variable that is not "clearly and closely related" to the asset to be delivered under the contract, the normal purchases and normal sales exception cannot be obtained (refer to "Key Terms" and the guidance provided by DIG Issue C20). Contracts with inflation indexes should be documented that the index is clearly and closely related in order to meet the normal purchases and normal sales exception.

Consistent with the transition provisions in SFAS No. 149, contracts that were being accounted for under the normal purchases and normal sales exception under SFAS No. 133 as of June 30, 2003 shall continue to be accounted for under the normal purchase and normal sales exception as long as the requirements for applying the exception are met.

All criteria for obtaining the normal purchases and normal sales exception must be met initially and on an ongoing basis. Obtaining the normal purchases and normal sales exclusion is an election and is not automatic as the contract must be specifically designated and documented as meeting the normal purchases and normal sales exclusion. However, any derivative contract which is not initially designated as a normal purchases and normal sales may meet the exclusion on a prospective basis once all criteria for obtaining the exclusion, including documentation, is met. However, once a contract is documented and designated as a normal purchases and normal sales, it is the Company's policy that the contract may not be electively de-designated (the contract could be de-designated as a normal purchases and normal sales by failing to meet the criteria for such designation—see below under "De-designation of the Normal Purchases and Normal Sales Exception for Cause").

De-designation of the Normal Purchases and Normal Sales Exception for Cause:

If contracts cease to meet the normal purchases and normal sales exception, the fair value of the contracts shall be recognized on the Consolidated Balance Sheets and the contracts shall be accounted for using the MTM method unless immediately designated as a cash flow or fair value hedge (accrual method of accounting). Thus, once a normal purchases and normal sales contract has been de-designated for cause, the MTM of the derivative is immediately recorded to earnings and "hedge" accounting can be obtained on a prospective basis. The initial MTM of a contract coming off of the normal purchases and normal sales exception will always impact earnings, unless the entity holding the derivative is subject to SFAS No. 71.

Hedge Accounting

Qualifying energy commodity and other derivatives may be designated as either a hedge of a forecasted transaction or future cash flows (cash flow hedge) or a hedge of a firm commitment, a recognized asset or liability (fair value hedge). For all hedge contracts, Duke Energy shall provide formal documentation of the hedge in accordance with SFAS No. 133. In addition, at inception and on a quarterly basis Duke Energy shall formally assess whether the hedge contract is highly effective in offsetting changes in cash flows or fair values of hedged items. Duke Energy shall document hedging activity by transaction type (futures/swaps) and risk management strategy (commodity price risk /interest rate risk/foreign currency risk).

The effective portion of changes in the fair value of a derivative designated and qualified as a <u>cash flow hedge</u> shall be included in the Consolidated Statements of Common Stockholders' Equity and Comprehensive Income (Loss) as AOCI until earnings are affected by the hedged item. Duke Energy shall discontinue hedge accounting prospectively when it has determined that a derivative no longer qualifies as an effective hedge, the Company electively removes the hedge designation, or when it is no longer probable that the hedged forecasted transaction will occur. When hedge accounting is discontinued because the derivative no longer qualifies as an effective hedge or the Company elects to discontinue hedge accounting, the derivative shall be subject to the MTM accounting method prospectively. Gains and losses related to discontinued hedges that were previously accumulated in AOCI shall remain in AOCI until the underlying hedged forecasted transaction is reflected in earnings. However, if it is probable that the hedged forecasted transaction will not occur by the end of the originally specified time period as documented or within an additional 2 months (assuming no extenuating circumstances), the amount in AOCI should be reclassified to earnings immediately. (paragraph 33 of SFAS No. 133)

For derivatives designated as fair value hedges, Duke Energy shall recognize the gain or loss on the derivative instrument, including any hedge ineffectiveness, as well as the offsetting loss or gain on the hedged item in earnings in the current period.

All derivatives designated and accounted for as hedges shall be classified in the same category as the item being hedged in the Consolidated Statements of Cash Flows. However, if a derivative contains an other-than-insignificant financing element, other than a financing element inherently included in an at-the-market derivative with no prepayments (that is, the forward points in an at-the-money forward contract), then the borrower shall report all cash inflows and outflows associated with that derivative in a manner consistent with financing activities as described in paragraphs 18-20 of SFAS No. 95, *Statement of Cash Flows*. A derivative that at its inception includes off-market terms or requires an up-front cash payment, or both often contains a financing element. Identifying a financing element within a derivative is a matter of judgment that depends on the facts and circumstances.

In addition, all components of each derivative gain or loss shall be included in the assessment of hedge effectiveness, unless otherwise noted.

A derivative held for trading purposes may be designated as a hedging instrument, prospectively, if all of the applicable criteria in SFAS No. 133 have been met.

In order to obtain hedge accounting, at inception of the hedge, there shall be formal documentation of the hedging relationship and the risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value (fair value hedge) or in hedging the exposure to the hedged transaction's variability in cash flows (cash flow hedge) attributable to the hedged risk will be assessed.

Hedge accounting shall be discontinued prospectively for an existing hedge if any *one* of the following occurs: i) the hedging relationship is no longer expected to be highly effective in achieving offsetting cash flows (offsetting changes in fair value for a fair value hedge) attributable to the hedged risk during the period that the hedge is designated; ii) the derivative expires or is sold, terminated, or exercised; iii) if any of the criteria for cash flow or fair value hedge accounting are no longer met; or iv) the Company removes the designation of the hedge.

Hedge Effectiveness

Under SFAS No. 133, a derivative designated as a hedging instrument will qualify for cash flow or fair value hedge accounting so long as the hedging relationship can be shown to be "highly effective" (see discussion under "Initial Assessment" below) in offsetting cash flows (changes in fair value) attributable to the hedged risk. To demonstrate this relationship, an effectiveness assessment is required prior to the inception of the hedge and ongoing effectiveness shall be assessed at least every three months thereafter. There shall be a reasonable basis for how the business or corporate unit plans to assess the hedging instrument's effectiveness. The assessment of hedge effectiveness for a particular hedging relationship shall be consistent with the originally documented risk management strategy for that particular hedging relationship and clearly documented at the inception of the hedging relationship. At the inception of the hedge, the entity shall define and document the method it will use to assess hedge effectiveness, both prospectively and retrospectively. The methods for prospective considerations and retrospective considerations may be the same or different, but only one method may be used for evaluating each consideration. This method must be used consistently throughout the term of the hedging relationship. Methods shall not be changed from one period to the next unless the hedge designation is terminated and a new hedge is put in place.

If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, it could be concluded that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis (i.e., no ineffectiveness).

An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries (referred to as the shortcut method). No ineffectiveness in a hedging relationship of interest rate risk involving a recognized interest bearing asset or liability and an interest rate swap may be assumed if certain conditions are met. Please refer to paragraph 68 of SFAS No. 133 for a discussion of the conditions that are required to be met to apply the shortcut method and paragraphs 114 and 132 of SFAS No. 133 for guidance to apply the shortcut method to fair value hedges and cash flow hedges, respectively. The SEC Staff addressed accounting for hedges at the AICPA/SEC Conference in December, 2006. The SEC Staff emphasized that it is important to thoroughly analyze and document all sources of ineffectiveness when applying hedge accounting. The SEC Staff cautioned that documentation must analyze preferably quantitatively all mismatches in terms in order to show that the mismatch is indeed immaterial. When the hedge documentation fails to do so, the SEC believes this has the same accounting result as not electing hedge accounting. One either documented a hedge or one did not document a hedge. As a result, the evaluation of an error in previously issued financial statements is equal to the entire mark-to-market on the derivative designated as a hedge and not just the overlooked ineffective portion of the hedge. The SEC Staff's position effectively increases significantly the possibility of a restatement as the error is more likely to be material to results. There are several methods for documenting and assessing hedge ineffectiveness. In addition to the 'long-haul' approach, other simplified methods include the 'shortcut', 'critical terms match', the 'hypothetical derivative' and 'variable cash flows' method. Some companies have been compelled to restate their financial statements as a result of failure to properly follow the requirements for these methods of assessing ineffectiveness. Many of the problems identified have involved the use of the 'shortcut' or 'critical terms match' method for interest rate swaps.

- Initial Assessment:

The initial assessment is a prospective consideration made prior to or simultaneous with initiating a hedge relationship and its applicability shall be evaluated on an ongoing basis. This analysis shall be able to justify the expectation that the hedge will be highly effective over the period being hedged *(the hedged period) in achieving offsetting changes in the cash flows or offsetting changes in fair* value of the hedged item. For purposes of SFAS No. 133, the condition of "highly effective" is achieved when the change in the fair value or cash flows of the hedging instrument offsets 80% - 125% of the change in the fair value or cash flows of the hedged item. It is common practice at Duke Energy to elect to use regression for the initial assessment of hedge effectiveness. In order to conclude that the hedging relationship is highly effective using a regression analysis, the regression examines the relationship between *changes* in the value of the derivative and the hedged item, at *least 30 data points should be used in the analysis*, R2 *should* be *equal to or greater than 0.8, the* slope should be between a negative 0.8 and 1.25, and the t and F statistics should be evaluated at a 95 percent confidence level in accordance with guidance provided by the SEC staff. R2 measures the ability of the independent variable to explain the variation in the dependent variable. R2 can vary between 0 and 1. The higher the value the higher the indication that the independent variable can explain variation in the dependent variable. The t and F statistics are used to indicate correlation or a linear relationship between independent and dependent variables. A high t statistic generally indicates that correlation or a linear relationship exists between the independent and dependent variables. To achieve a 95% confidence level, the significance of F should be less than 5%. If the significance of F is less than 5% there is less than 5% probability that no linear relationship is present. The initial assessment need not be performed for each and every hedge but only when a new hedge strategy is proposed. However, the data used in the regression shall be updated at least on a quarterly basis (as new hedges are entered into). In addition, the initial assessment of effectiveness for a particular hedge strategy shall be evaluated if the ongoing assessment for a particular relationship, as discussed below, repeatedly indicates an ineffective hedge. Certain contracts may have a high correlation for a particular forward month while similar contracts for other forward months may not have a high correlation. The assessment both initially and ongoing should be undertaken on a forward month by forward month basis.

- Ongoing Assessment

Ongoing assessment is a retrospective assessment made at least on a quarterly basis to determine if a specific hedge relationship has been highly effective in having achieved offsetting changes in cash flows or the hedged item's fair value throughout the particular period being assessed (on a historical basis). The assessment may be based on cumulative dollar offset, regression or other statistical analysis of past changes in cash flows or fair value or other relevant information. If the relationship does not fall within the overall change effective range (R2=> 0.8), then hedge accounting for the period shall not be applied (all changes in fair value of the derivative during the period are recorded immediately in earnings). Failure of the 'ongoing assessment' test does not necessarily prevent the derivative in question from being considered as an ongoing hedge so long as the initial assessment continues to indicate a highly effective relationship. For cash flow hedges, if in subsequent periods, the relationship comes back into the highly effective range, by virtue of the ongoing regression analysis, the "ineffective" portion of gain or loss recorded in earnings in prior periods (or some part thereof) may be recaptured and recorded in current period OCI. For fair value hedges, if the relationship returns to the highly effective range, the hedged item (i.e., unrecognized firm commitment or recognized asset or liability) shall resume hedge accounting on a prospective basis along with the hedging instrument. For internal reporting, the ongoing assessment shall be performed at least quarterly.

Additionally, in assessing ineffectiveness, the likelihood of counterparty default should be considered. If the likelihood that the counterparty will not default ceases to be probable, the Company would be unable to conclude that the hedging relationship is expected to be highly effective and hedge accounting should be discontinued prospectively.

Ineffectiveness

SFAS No. 133 requires for any changes in fair value of a derivative instrument related to hedge ineffectiveness to be immediately recorded in earnings. DIG Issue No. K4, *Miscellaneous: Income Statement Classification of Hedge Ineffectiveness and the Component of a Derivative's Gain or Loss Excluded from the Assessment of Hedge Effectiveness*, has the following provisions related to the classification in the income statement of hedge ineffectiveness:

Statement 133 does not provide guidance on the required income statement classification of the amount of hedge ineffectiveness...While Statement 133 does not specify whether certain income statement categories are either permitted or appropriate, the Statement does contain specific disclosure requirements for those items.

Therefore, the Company should ensure that similar hedged items which result in periodic ineffectiveness are classified in the Statement of Operations in a consistent manner.

De-designation of a Hedge by Choice

- Cash Flow Hedges

When de-designating or re-designating a cash flow hedge, that part of any change in fair value of the derivative that resides in AOCI shall remain in AOCI and shall not be immediately transferred to earnings until settlement of the original forecasted transaction that was being hedged. That part of the change in fair value of the derivative that was previously recorded in earnings (ineffectiveness, if any) shall remain in earnings. Prospectively, the derivative shall be MTM unless re-designated as another hedge.

- Fair Value Hedges

When de-designating a fair value hedge, changes in fair value of the hedged item shall no longer be recorded and the asset or liability reflecting the fair value as of the date of de-designation shall remain on the balance sheet until the hedged item affects earnings. The hedging instrument, which is now a freestanding derivative, shall be MTM. The Company, at its discretion, may re-designate the derivative as another fair value or cash flow hedge at which time hedge accounting will commence, prospectively.

De-designation of a Hedge for Cause

- Cash Flow Hedges

If it becomes probable that a forecasted transaction in a cash flow hedge will NOT occur within the originally specified time period or within an additional two-month period of time thereafter, then the hedge shall be terminated and the net gain or loss in AOCI shall be immediately reclassified into earnings. There is one exception to this rule. In rare cases, the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside of the control or influence of the reporting entity may cause the forecasted transaction to be probable on a date beyond the additional two-month period of time. In such a case, the original hedge must be terminated but the related derivative gain or loss in AOCI shall continue to remain in AOCI until the forecasted transaction occurs. A pattern of determining that hedged forecasted transactions are NOT *probable of occurring* shall call into question the ability to accurately predict forecasted transactions and the propriety of applying hedge accounting for similar forecasted transactions in the future.

- Fair Value Hedges

If it becomes probable that a firm commitment that is being hedged in a fair value hedge relationship will NOT occur, then the hedge relationship shall be terminated. This will result in the hedged item being accounted for as if the contract was not in a hedge relationship subsequent to the termination of the hedge relationship. Any asset or liability previously recognized as an adjustment to the carrying amount of the firm commitment shall be immediately derecognized with a gain or loss being recognized in earnings.

If the fair value hedge is no longer expected to be "highly effective" in achieving offsetting changes in fair value to the hedged risk, adjustments to the carrying amount of the firm commitment shall not be recognized subsequent to the last date on which the hedge was considered "highly effective," unless a specific event or change in circumstances can be identified which caused the hedge to no longer be "highly effective" whereby the date of the specific event or change in circumstances will be utilized to prospectively discontinue hedge accounting.

Service Contracts

Most service contracts are not considered derivatives under SFAS No. 133 due to the scope exclusion in paragraph 10(e)(2). A service does not involve the delivery of a fungible asset and, therefore, is not readily convertible to cash as defined in paragraph 83(a) of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Paragraph 10(e)(2) of SFAS No. 133 excludes from its scope any contract which is not exchange-traded as long as the underlying is the price or value of a nonfinancial asset which is not readily convertible to cash.

Embedded Derivative Instruments

Contracts that do not in their entirety meet the definition of a derivative instrument or contracts excluded from the scope of SFAS No. 133, may contain embedded derivative instruments. An embedded derivative typically includes implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument (i.e., some or all of the cash flows will be modified based on one or more underlyings). For example, although lease agreements are excluded from the scope of SFAS No. 133, a lease agreement may contain an embedded derivative such that the embedded derivative instrument will be subject to the requirements of SFAS No. 133.

An embedded derivative instrument shall be separated from the host contract (e.g. lease contract, debt contract, etc.) and accounted for as a derivative instrument per SFAS No. 133 if all the following occur: i) the economic characteristics and risks of the embedded derivative instrument are not *clearly and closely related** to the economic characteristics and risks of the host contract; ii) the contract ("*the hybrid instrument*") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value with changes in value recorded in earnings as they occur (under otherwise applicable generally accepted accounting principles); and iii) a separate instrument with the same terms as the embedded derivative instrument would meet the three characteristics to qualify as a derivative instrument as discussed above. Please refer to the guidance in paragraph 61 of SFAS No. 133 in determining whether the economic characteristics and risks of an embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract.

Foreign Currency Derivatives

Duke Energy may use foreign currency derivatives to manage its risk related to foreign currency fluctuations. A derivative instrument can be designated as hedging the changes in the fair value of an *unrecognized firm commitment*, a recognized asset or liability (or a specific portion thereof), or an available for sale debt security for which a foreign currency transaction gain or loss, attributable to foreign currency exchange rates, is recognized in earnings, per SFAS No. 52. As such, fair value hedge accounting as discussed above may be available for these types of derivative instruments for which a foreign currency transaction gain or loss is recorded in earnings. An available-for-sale equity security can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates and qualify for fair value hedge accounting only if the fair value hedge criteria per SFAS No. 133 are met and the following two conditions are satisfied: i) the security is not traded on an exchange (or other established marketplace) on which trades are denominated in the investor's functional currency, and ii) dividends or other cash flows to holders of the security are all denominated in the same *foreign currency* as the currency expected to be received upon sale of the security. Per paragraph 38 of SFAS No. 133, the change in fair value of the hedged available-for-sale equity security attributable to foreign exchange risk shall be reported in earnings and not in AOCI.

Cash flow hedge accounting, as discussed above, may be available for a derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with a forecasted transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency), a recognized asset or liability, an unrecognized firm commitment, or a forecasted intercompany transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary). The specific requirements are addressed in paragraph 40 of SFAS No. 133.

A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss per SFAS No. 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation. The gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with SFAS No. 52; the provisions of SFAS No. 133 for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation. The translation results for a hedge of a net investment in a foreign operation shall remain in AOCI until the foreign operation is sold or liquidated. The notional amount of the derivative instruments should not exceed the amount of the net investment in the foreign operation.

If the above transactions qualify for hedge accounting, the respective hedge accounting documentation requirements discussed above shall be applied consistently.

Federal Energy Regulatory Commission (FERC) Order 627 (Regulated Entities)

FERC Order 627 provides guidance to entities under FERC jurisdiction related to the accounting and reporting of certain types of financial instruments and hedging activities. Entities subject to FERC guidelines should consider the provisions of FERC Order 627 when accounting for their risk management and hedging activities.

Note: The following discussion of valuation and fair value applies to measurements on or before December 31, 2007. Effective January 1, 2008, the definition of fair value is amended under the guidance of SFAS No. 157, "Fair Value Measurements." Effective January 1, 2008, refer to the accounting policy entitled "Fair Value Measurements," for relevant guidance.

Valuation

All derivative instruments not designated and qualifying for the normal purchases and normal sales exception under SFAS No. 133, shall be recorded on the Consolidated Balance Sheets at their **fair value** at each reporting period as "Unrealized Gains or Unrealized Losses on Mark-to-Market and Hedging Transactions." Fair value accounting is applied within the context of an overall valuation framework. All new and existing transactions shall be valued using approved valuation techniques and market data, including reserves for liquidity and counterparty credit and discounted using an appropriate discount rate. When available, quoted market prices or prices obtained through external sources shall be used to measure a contract's fair value. However, market quotations for energy commodity contracts may not be available for illiquid periods or certain delivery locations. If no active trading market exists for a commodity or for a contract's duration, holders of these contracts must calculate fair value using internally developed valuation techniques or models. Key components used in these valuation techniques shall include price curves, volatility, correlation, interest rates and tenor. While volatility and correlation are the most subjective components, the price curve is generally the most significant component affecting the ultimate fair value for a contract subject to MTM accounting. Prices for illiquid periods or locations shall be established by extrapolating prices for correlated products, locations or periods. These relationships shall be routinely re-evaluated based on available market data, and changes in price relationships shall be reflected in price curves prospectively. Consideration should also be given to the analysis of market fundamentals when developing illiquid prices. A deviation in any of the components affecting fair value may significantly affect overall fair value.

Validation of a contract's calculated fair value shall be performed by the Corporate and/or Business Unit Risk Management Group. This group performs pricing model validation, back testing and stress testing of valuation techniques, prices and other variables. Validation of a contract's fair value may be done by comparison to actual market activity and negotiation of collateral requirements with third parties.

The following represents a general view on a hierarchy of valuation data and information (this hierarchy is pre-SFAS 157 as discussed above):

- Category 1: Quoted price in an active market with sufficient liquidity.
- Category 2: Comparable or proxy instrument with a quoted price in an active market with sufficient liquidity, if there is a high degree of correlation between the proxy and instrument being valued.
- Category 3: Conventional model based on direct "market" inputs.
- Category 4: Conventional model based on indirect "market" inputs. Examples of indirect market inputs include simple interpolation of market price curves, volatility assumptions, and proxy market inputs (e.g., observable gas prices and observable heat rates for electricity prices, if there is a high degree of correlation on the proxy market prices).
- Category 5: *Proprietary model based on more subjective inputs.* Some examples of more subjective inputs include estimates of volatility for options, econometric forward curves based on expected supply and demand of commodities, and extrapolation of price curves for terms beyond active market quotes.

The Company's policy, through December 31, 2007, is to follow the above hierarchy when determining the most appropriate sources of data for determining fair value of its hedging contracts. Therefore, sources in Category 1 would be the most useful, while sources of fair value in Category 5 would be the least useful in determining fair value.

Inception or "Day One" Gains

An unrealized gain or loss at inception of the contract should not be recognized unless evidenced by quoted market prices or other current market transactions for energy trading contracts with similar terms and counterparties. In other words, it is presumed that the transaction price is the best evidence of fair value at that time. This presumption can be overcome if the fair value of the derivative instrument is derived from a quoted market price in an active market or is based on a valuation technique for which all but an insignificant amount of the inputs constitutes observable market data. When the valuation of a contract is entirely in Category 5, inception profit recognition would not be appropriate. Determination of profit recognition when a contract includes elements of

Category 5 should be carefully evaluated to determine whether profit recognition is appropriate. Factors to weigh in the consideration include: (1) magnitude of fair value based on information in Category 5, (2) sensitivity of overall fair value to Category 5 factors, (3) qualitative assessment of Category 5 assumptions, and (4) other relevant factors. Full profit recognition at inception would be inappropriate if information from Category 5 has a more than de minimus impact on the fair value of the contract. The inception value determined by Duke Energy's internal models that cannot be recognized at inception shall be deferred on the balance sheet and amortized to earnings in a systematic and rationale manner to capture the appropriate value in earnings over time.

Reserves to Calculated Values for Derivative Instruments

The following reserves, as appropriate, shall be used to adjust calculated values to arrive at estimates of fair value used to record derivative instruments (as a reminder, for valuation measurements performed in periods ending after December 31, 2007, refer to the accounting policy entitled "Fair Value Measurements"):

1. Credit Reserves - costs associated with probable, future counterparty defaults. This category of reserves should be calculated based on current credit exposures with each respective counterparty that has an overall asset position.
2. Discount Reserve - costs associated with discounting future cash flows in accordance with time-value of money valuation principles. Note that the discount reserve is only required when all or a portion of the fair value of the derivative instrument are derived based upon cash flows.
3. Liquidity Reserve – the cost of closing out a position relative to the overall market. At times, a discount will be required in order for the market to readily absorb certain positions. A reserve should be established for liquidity factors that are present in all markets.
4. Other Contractually-Specific Reserves – Each business unit may identify additional risk categories for which reserves to calculated values should be established. While the above specific reserves are well documented as to their purpose and methodology, it must be understood additional risks may exist (e.g.,legal/enforceability risk, etc.) which are not captured by one or more of the reserves indicated above.

Netting Arrangements

For reasons including reducing credit exposure, Duke Energy often seeks to enter into payment netting agreements with counterparties that permit Duke Energy to offset receivables and payables with such counterparties. Where Duke Energy's derivative instruments are subject to a master netting agreement and the criteria of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* ("FIN 39") are met, Duke Energy shall present its derivative assets and liabilities, and accompanying receivables and payables, on a net basis (by counterparty) in the Consolidated Balance Sheets. Effective January 1, 2008, consistent with FASB Staff Position FIN39-1: Amendment of FASB Interpretation No. 39, it is also appropriate to offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments executed with the same counterparty under the same master netting arrangement that have been offset in accordance with paragraph 10 of FIN 39.

All-In-One Hedging

Under the provisions of DIG Issue No. G2, *Cash Flow Hedges: Hedged Transactions That Arise from Gross Settlement of a Derivative ("All-in-One" Hedges)*, an entity may designate a derivative instrument (which will result in gross settlement) as the hedging instrument in a cash flow hedge, which is referred to as an "all-in-one" hedge. For example, a forward purchase contract of a commodity (if the purchase contract meets the definition of a derivative under SFAS No. 133) could be designated as the hedging instrument in a cash flow hedge of the variability of amounts to be paid under the forecasted transaction or the commodity purchase. Contracts which are subject to net settlement (e.g., "bookout") cannot be designated as an "all-in-one" hedge.

As another example, some Duke Energy subsidiaries may be exposed to market fluctuations in the prices of emission allowances (EAs) that can impact the future cash flows to be generated from forecasted sales of EAs (forecasted sales of EAs typically represent the excess of allocated EAs over the forecasted generation emission levels for a vintage year). Duke Energy closely monitors the potential impacts of EA price changes and, where appropriate, may enter into firm commitment sales contracts to protect margins for a portion of forecasted sales. In situations where we will actually deliver the allowances under a forward sale commitment and receive the full, gross revenue from the buyer under the forward contract, the forecasted transaction and the hedge instrument are deemed to be the same instrument and will be perfectly correlated, provided the creditworthiness of the counterparty does not deteriorate to an extent that performance by the counterparty is jeopardized. DIG Issue G2 addresses the accounting for hedged transactions that arise from gross settlement of a derivative. Forward sales (firm commitments) of EAs can qualify as all-in-one cash flow hedges if the contract requires delivery of a non-financial asset (e.g., EAs) in exchange for cash and the forecasted transaction and the derivative used to hedge it are the same contract. The assessment of hedge effectiveness should be determined based on changes in the entire fair value of the derivative instrument (i.e., the contract). We believe the hedging relationship will be 100% effective at the inception and throughout the term of the hedging relationship, provided the creditworthiness of the counterparty does not deteriorate to an extent that performance by the counterparty is jeopardized. To prove out the hedging relationship is perfectly effective, it should be documented each quarter until delivery of the EAs that a) counterparty creditworthiness has not deteriorated to an extent that performance (payment) by the counterparty is jeopardized and b) the forecast of excess EAs is greater than the amount of forward sales contracts for EAs at a high confidence level. Once a firm commitment forward sales contract is entered into, the fair value of the firm commitment should be measured and recorded within AOCI each reporting period until the transaction occurs, at which time AOCI should be recognized in the income statement. Until such time a firm commitment forward sales contract is entered into, nothing is to be recorded for the forecasted forward sales.

Impairment Considerations

SFAS No. 133 contains impairment considerations for both fair value and cash flow hedges. Paragraph 27 of SFAS No. 133 has impairment provisions for the asset or liability which is designated as the hedged item (e.g. a fixed-rate asset):

27. An asset or liability that has been designated as being hedged and accounted for pursuant to paragraphs 22–24 remains subject to the applicable requirements in generally accepted accounting

principles for assessing impairment for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 22 of this Statement. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment requirements to the hedged asset or liability.

DIG Issue No. F4, *Fair Value Hedges: Interaction of Statement 133 and Statement 114 (SFAS No. 114,* "Accounting by Creditors for Impairment of a Loan, an amendment of FASB Statements No. 5 and 15"), has interpretative guidance on impairment considerations for fair value hedges and supports including the adjusted carrying amount of the hedged item in the impairment considerations of the hedged item.

Paragraphs 34 and 35 of SFAS No. 133 contain the following impairment provisions for cash flow hedges:

34. Existing requirements in generally accepted accounting principles for assessing asset impairment or recognizing an increased obligation apply to an asset or liability that gives rise to variable cash flows (such as a variable-rate financial instrument), for which the variable cash flows (the forecasted transactions) have been designated as being hedged and accounted for pursuant to paragraphs 30 and 31. Those impairment requirements shall be applied each period after hedge accounting has been applied for the period, pursuant to paragraphs 30 and 31 of this Statement. The fair value or expected cash flows of a hedging instrument shall not be considered in applying those requirements. The gain or loss on the hedging instrument in accumulated other comprehensive income shall, however, be accounted for as discussed in paragraph 31.

35. If, under existing requirements in generally accepted accounting principles, an impairment loss is recognized on an asset or an additional obligation is recognized on a liability to which a hedged forecasted transaction relates, any offsetting net gain related to that transaction in accumulated other comprehensive income shall be reclassified immediately into earnings. Similarly, if a recovery is recognized on the asset or liability to which the forecasted transaction relates, any offsetting net loss that has been accumulated in other comprehensive income shall be reclassified immediately into earnings.

Therefore, as paragraph 34 of SFAS No. 133 prohibits the fair value or expected cash flows from the hedging instrument in being considered in impairment considerations for other assets, the cash flows utilized for SFAS No. 144 recoverability purposes (for long-lived assets such as property, plant & equipment) should exclude cash flows related to hedging activities. However, if an asset or liability to which a hedged forecasted transaction relates is impaired under the provisions of SFAS No. 144 or other applicable GAAP and an impairment charge is recorded in earnings, any net gain deferred in AOCI related to cash flow hedges for the impaired asset or liability would be recognized in earnings. The amount of such net gain recognized is limited to the greater of the impairment charge recognized or the net gain deferred in AOCI.

Financial Statement Presentation and Disclosures

Balance Sheet Classification

Derivative instruments should be recorded at their fair value and classified as either current or noncurrent in accordance with the provisions of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, as follows:

Current Assets...are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business, which if not clearly defined, is one year.

Current Liabilities...obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.

Therefore, derivative instruments which do not meet the above criteria to be classified as a current asset or liability should be classified as a noncurrent asset or liability in the balance sheet. Classification of a derivative instrument between current and noncurrent should be based primarily upon the rights and obligations of the derivative instrument as well as the contractual maturity date of the derivative instrument. As an example, the fair value of an interest rate swap should be split between current and non-current consistent with the timing of the fair value of the expected cash flows under the swap.

Income Statement Classification

Effective January 1, 2003, in connection with the implementation of the remaining provisions of EITF Issue No. 02-03, Duke Energy designated all energy commodity derivatives as either trading or non-trading. For each of the Duke Energy's derivatives, the accounting method and presentation of gains and losses, or revenue and expense in the Consolidated Statements of Operations is shown below. See definition of "mark-to-market" and "accrual" methods earlier in this policy under ***Accounting for Types of Instruments by Activity***.

Classification of Contract	**Accounting Method**	**Presentation of Gains & Losses or Revenue & Expense**
Trading derivatives	Mark-to-market	Net basis in Operating Revenues - Non-regulated electric, natural gas, and other
Non-trading derivatives:		
Cash flow hedge	Accrual	Gross basis in the same income statement category as the related hedged item
Fair value hedge	Accrual	Gross basis in the same income statement category as the related hedged item

Normal purchase or normal sale	Accrual	Gross basis upon settlement in the corresponding income statement category based on commodity type
Undesignated	Mark-to-market	Net basis in the related income statement category for interest rate, currency and commodity derivative.

Disclosures

For derivative instruments and hedging activities, the following items are required to be reported at each quarterly or annual reporting period:

- Disclose the objectives for holding derivative instruments and hedging instruments, and the risk management strategy for achieving those objectives (annual disclosure requirement only).
    - Distinguish between cash flow hedges, fair value hedges, foreign currency exposure hedges.
    - Describe the Company's risk management policy for each type of hedge and those risks hedged.
- Derivative instruments designated and qualified as fair value hedges:
    - the net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges' ineffectiveness and (b) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the Consolidated Statement of Operations.
    - the amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.
- Derivative instruments designated and qualified as cash flow hedges:
    - the net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges' ineffectiveness and (b) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance
    - a description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in AOCI, and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months.
    - the maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments.
    - the amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur by the end of the originally specified time period or within the additional period of time.
- Derivative instruments designated and qualified as hedges of the foreign currency exposure of a net investment in a foreign operation:
    - the net amount of gains or losses included in the cumulative translation adjustment during the reporting period
- The fair value of trading contracts outstanding at the end of the period.
- The components representing the change in fair value from prior period.
- Provide quantitative information about market risk as of the end of the latest fiscal year,

  - categorize market risk sensitive instruments into instruments entered into for trading purposes and instruments entered into for purposes other than trading purposes
  - Within both the trading and other than trading portfolios, separate quantitative information shall be presented, to the extent material, for each market risk exposure category (i.e., interest rate risk, foreign currency exchange rate risk, commodity price risk, and other relevant market risks, such as equity price risk).
- The methodology utilized to determined fair value (e.g. external sources: quoted market prices, current market transactions; internal valuation models).
- For energy trading activities, *all* of the following shall be disclosed, in accordance with EITF Issue No. 02-3:

a. The applicability of Issue 98-10

b. The types of contracts that are accounted for as energy trading contracts

c. The fair values of its energy trading contracts, aggregated by source or method of estimating fair value and by maturity dates of the contracts

d. A description of the methods and significant assumptions used to estimate the fair value of its various classes of energy trading contracts

e. A reconciliation of the beginning and ending carrying values of its energy trading contracts, aggregated by source or method of estimating fair value, showing separately the changes attributable to (1) unrealized gains and losses recognized at inception of a contract, (2) unrealized gains and losses recognized as a result of changes in valuation techniques and assumptions, (3) other unrealized gains and losses recognized during the period, and (4) realized gains and losses recognized during the period

f. The sensitivity of its estimates to changes in the near term[1]

[1]Paragraph 14 of SOP 94-6 provides that "the disclosure should indicate the nature of the uncertainty and *include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term*" (footnote references omitted).

Key Terms

Capacity Contract[4]

An agreement by an owner of capacity to sell the right to that capacity to another party so that it can satisfy its obligations. For example, in the electric industry, capacity (sometimes referred to as installed capacity) is the capability to deliver electric power to the electric transmission system of an operating control area. A control area is a portion of the electric grid that schedules, dispatches, and controls generating resources to serve area load (ultimate users of electricity) and coordinates scheduling of the flow of electric power over the transmission system to neighboring control areas. A control area requires entities that serve load within the control area to demonstrate ownership or contractual rights to capacity sufficient to serve that load at time of peak demand and to provide a reserve margin to protect the integrity of the system against potential generating unit outages in the control area.

Clearly and Closely Related

"The phrase *not clearly and closely related* in paragraph 10(b) with respect to the normal purchases and normal sales scope exception is used to convey a different meaning than in paragraphs 12(a) and 60 of SFAS No. 133 with respect to the relationship between an embedded derivative and the host contract in which it is embedded. For purposes of determining whether a contract qualifies for the normal purchases and normal sales scope exception, the application of the phrase *not clearly and closely related to the asset being sold or purchased* should involve an analysis of both qualitative and quantitative considerations. The analysis is specific to the contract being considered for the normal purchases and normal sales scope exception and may include identification of the components of the asset being sold or purchased. The underlying in a price adjustment incorporated into a contract that otherwise satisfies the requirements for the normal purchases and normal sales exception would be considered to be *not clearly and closely related to the asset being sold or purchased* in any of the following three circumstances:

1. The underlying is extraneous (that is, irrelevant and not pertinent) to both the changes in the cost and the changes in the fair value of the asset being sold or purchased, including being extraneous to an ingredient or direct factor in the customary or specific production of that asset.
2. If the underlying is not extraneous as discussed in (1) above, the magnitude and direction of the impact of the price adjustment is not consistent with the relevancy of the underlying. That is, the magnitude of the price adjustment based on the underlying is significantly disproportionate to the impact of the underlying on the fair value or cost of the asset being purchased or sold (or of an ingredient or direct factor, as appropriate).
3. The underlying is a currency exchange rate involving a foreign currency that meets none of the criteria in paragraphs 15(a)-15(d) of Statement 133 (as amended) for that reporting entity. (The inclusion of this circumstance is consistent with the portion of paragraph 10(b) that states, "contracts that...are denominated in a foreign currency that meets none of the criteria in paragraphs 15(a)-15(d) shall not be considered normal purchases and normal sales.")" [DIG Issue C20]

"The test mandated by Question C20 for determining whether changes in the underlying are not irrelevant to changes in the fair value of the asset being purchased or sold under the contract is that there be an expectation that the price adjustment feature will impact the final sales price in line with market changes. Accordingly, a price adjustment feature based on a broad market index would be clearly and closely related to the item being sold under the contract assuming the impact of the price adjustment would be comparable to the actual market value changes of that item (or components of the item being sold or purchased)." [From ARM Interpretation 10b-4)

For embedded derivatives, paragraph 12 of SFAS No. 133 focuses on whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. If the host contract encompasses a residual interest in an entity, then its economic characteristics and risks should be considered that of an equity instrument and an embedded derivative would need to possess principally equity characteristics (related to the same entity) to be considered clearly and closely related to the host contract. However, most commonly, a financial instrument host contract will not embody a claim to the residual interest in an entity and, thus, the economic characteristics and risks of the host contract should be considered that of a debt instrument.

Fair value[5]

The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using discount rates commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets and liabilities should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring forward contracts, such as foreign currency forward contracts, at fair value by discounting estimated future cash flows, an entity should base the estimate of future cash flows on the changes in the forward rate (rather than the spot rate). In measuring financial liabilities and nonfinancial derivatives that are liabilities at fair value by discounting estimated future cash flows (or equivalent outflows of other assets), an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

Note: The above definition of fair value applies to measurements on or before December 31, 2007. Effective January 1, 2008, the definition of fair value is amended under the guidance of SFAS No. 157, "Fair Value Measurements." Effective January 1, 2008, refer to the accounting policy entitled "Fair Value Measurements," for relevant guidance.

Financial instrument

Cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation* (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity

* *Contractual obligations* encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of *liability* set forth in Concepts Statement 6, although some may not be recognized as liabilities in financial statements - may be "off-balance-sheet" - because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

b. Conveys to that second entity a contractual right‡ (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

‡ *Contractual rights* encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of *asset* set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements - may be "off-balance-sheet" - because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

Firm commitment

An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.
b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

Forecasted transaction

A transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

APPENDIX A

Application and Practice: Conclusions Reached Around Accounting for Risk Management Activities

Determination of Whether a Contract Contains a Notional

The determination as to whether a contract contains a notional under the provisions of SFAS No. 133 often requires significant judgment and interpretation of the accounting standards and is often based upon the facts and circumstances in each individual contract. However, the Company has developed certain interpretations related to the determination of a notional, which are discussed below.

1. "System Firm" Provisions – Many electricity contracts have "system firm" provisions whereby the seller's obligations to sell under the contract are subject to the availability of the system. "System firm" indicates that if electricity does not flow when called upon under a contract due to the fact that the transmission system is down, there are no damage or other payments as a result of such failure to perform. Therefore, the quantities deliverable under the contract could potentially be reduced to zero during the contractual term without the selling party incurring any penalties for nonperformance. This is an indicator that a notional does not exist, even though there may be a very low probability that such event would occur. However, partly due to the low probability of such failure to perform, it is the Company's policy to not solely base the notional conclusion on whether the contract contains "system firm" provisions.
2. Force Majeure Provisions – Most contracts have standard force majeure provisions, which are somewhat similar to the "system firm" provisions discussed above in that the seller's obligations under the contract are excused under unusual circumstances, such as fire, flood, and earthquakes, which prohibit the seller from being able to meet its obligations under the contract. Under these provisions, the seller does not owe any damages to the buyer due to failure to perform if such failure to perform is due to force majeure. Therefore, the quantities deliverable under the contract could potentially be reduced to zero during the contractual term without the selling party incurring any penalties for nonperformance. This is an indicator that a notional does not exist, even though there may be a very low probability that such event would occur. However, similar to the conclusion

noted above for "system firm" provisions, it is the Company's policy to not solely base the notional conclusion on whether the contract contains force majeure provisions.

3. Ability to "Economically Exercise" – Economic exercise is the ability to buy or take delivery of amounts under the contract solely based upon the contract being "in the money". This concept is in contrast to contracts which are only utilized to satisfy a buyer's own actual needs and excess amounts cannot be purchased in order to take advantage of an "in the money" situation whereby the contractual price is lower than the current market price. The ability to economically exercise a contract usually results in a determinable notional. However, if a contract is only available to meet an entity's own actual needs, whether or not there is a notional will depend upon other contractual provisions (such as liquidating damage and termination provisions, as discussed below).
4. Contract Liquidating Damages Provisions and Termination Provisions – Under the guidance given in DIG Issue A6 (requirements contracts or contracts that cannot be economically exercised), the existence of liquidating damage and/or termination provisions under a contract may result in the contract having a notional. Normally, any liquidating damage or termination provision which requires the payment of a penalty based upon a determinable amount tied to the estimated volumes to be delivered under the contract will result in a determinable notional. Such liquidating damage or termination amounts paid can be either fixed or based upon a market-based formula. Additionally, contracts with a determinable minimum volume to be delivered have a notional equal to that minimum and contracts with a determinable maximum but no stated minimum volume to be delivered do not have a notional. If quantities deliverable under the contract can be reduced to zero without the seller or buyer incurring penalties for non-performance, there is not a determinable notional.

Determination of Whether a Contract Contains an Initial Net Investment

The determination as to whether a contract involves an initial net investment involves a level of judgment as there is no specific threshold specified in the accounting standards for when there is considered to be an initial net investment. If a contract is not fully prepaid by more than a minor amount (after adjustment for the time value of money), the contract is considered to have this characteristic of a derivative.

Determination of Whether a Contract Contains Net Settlement

The determination as to whether a contract contains net settlement under the provisions of SFAS No. 133 often requires significant judgment and interpretation of the accounting standards and is often based upon facts and circumstances related to the commodity or asset being purchased. However, the Company has developed certain interpretations related to the determination of net settlement, which are discussed below.

1. Explicit or implicit net cash settlement (paragraph 9(a) of SFAS No. 133) – As discussed in DIG Issue No. A8, *Definition of a Derivative: Asymmetrical Default Provisions*, asymmetrical default provisions in a contract do not result in net cash settlement under paragraph 9(a) of SFAS No. 133. An asymmetrical default provision is one in which the defaulting party has an obligation to compensate the counterparty's loss but the defaulting party does not have the right to demand any gain from the counterparty. Symmetrical default provisions may also not result in a conclusion that the contract is a derivative if the provision does not grant a party the unilateral right to net settle. For a contract to be net settled under paragraph 9(a), the defaulting counterparty must have the ability to default and as a result compel the other counterparty to make payment to the defaulting counterparty of the fair value of the contract. If the non-defaulting counterparty can chose whether or not to enforce the net payment provision, the contract does not have net settlement under paragraph 9(a).
2. Market mechanisms facilitate net settlement (paragraph 9(b) of SFAS No. 133) – In order to be considered net settlement under paragraph 9(b), there must be the ability for either

party to the contract to be fully relieved of all of its rights and obligations under the contract (including credit risk under the contract). An exchange, such as the NYMEX exchange, often gives the ability for a party to be fully relieved of all its rights and obligations under the contract. If a market mechanism exists, the assignment provisions of the contract must be examined pursuant to the guidance given in DIG Issue No. A7, *Definition of a Derivative: Effect of Contractual Provisions on the Existence of a Market Mechanism That Facilitates Net Settlement*. If a contract is assignable only if approval of the counterparty is obtained, the probability of obtaining such consent from the counterparty must be assessed when determining whether there truly is net settlement under paragraph 9(b) of SFAS No. 133.

3. Readily convertible to cash (paragraph 9(c) of SFAS No. 133) – the asset deliverable under the contract (such as a commodity) must be readily convertible to cash in order to obtain net settlement under SFAS No. 133. The asset deliverable under the contract must be evaluated as to whether it is readily convertible to cash at the contractual delivery point (e.g. plant location, grid location, Hub location, etc). If the asset is not readily convertible to cash at the contractual delivery point, the Company must evaluate which location is the most cost effective to transport the commodity from the contractual delivery point to where the asset would be considered readily convertible to cash. DIG Issue No. A10, *Definition of a Derivative: Assets That Are Readily Convertible to Cash*, clarifies that the cost to transport the asset from the contractual delivery point to the point of delivery where the asset is readily convertible to cash must be less than 10% of the sales price of the asset (at the readily convertible to cash delivery point) in order to consider the asset readily convertible to cash. Likewise, if the cost to transport the asset is equal to or greater than 10% of the sales price of the asset, the asset is not considered readily convertible to cash. For the seller, whether or not an asset deliverable under a contract is considered readily convertible to cash is not impacted by the buyer's ability to resell the underlying asset or commodity. The significance of the conversion costs should be performed only at inception of the contract or when a contract subsequently meets the definition of a derivative for reasons other than the level of transaction costs.

Electricity, both off-peak and on-peak, is typically considered readily convertible cash (RCC). Also, as an example, electricity delivered inside the Duke Energy Carolina's border may be considered not RCC depending on the relationship between transmission costs and the price of electricity. Depending on the size of the contract (number of mWs), electricity delivered at the Duke Energy Carolinas' border may not be considered RCC. Electricity delivered to or within a Regional Transmission Organization ("RTO") or Independent System Operator ("ISO") is typically considered readily convertible to cash.

APPENDIX B

CONTRACT TYPE ANALYSIS: DERIVATIVE VS. NON-DERIVATIVE

The following is a brief summary of certain transactions encountered by the Company in the normal course of business and discussion of the assessments that have been made regarding whether or not these transactions are usually considered derivatives pursuant to SFAS No. 133. Note that the discussion below is meant to be a guide and should not be used as a substitute for performing a detailed SFAS No. 133 analysis on a contract-by-contract basis (as contracts can contain unique provisions which may result in a different conclusion than as discussed below):

<u>Tolling Agreement</u>

"Tolling" contracts provide the holder the right, but not the obligation, to call on the power generation owner to provide aservice to convert natural gas to electricity at a predefined heat conversion rate. An energy trader or risk manager may enter into a power tolling contract with a power generation owner in a geographical area where the energy trader has no power delivery commitments to take advantage of any market opportunity and to provide the power generation owner commodity price risk protection. The owner of the power generation plant owns, operates, and dispatches the facilities under the terms of the agreement. The tolling contract provides the energy trader with the ability to convert natural gas to electricity in exchange for a monthly capacity payment or fixed fee from the energy trader (sometimes referred to as the capacity or demand charge). The terms of the contract require the power generation owner to deliver power to the energy trader at a predefined delivery point and may provide for alternative delivery points with applicable basis adjustments.

Tolling agreements should first be assessed to determine if they represent leases under EITF Issue No. 01-08 and SFAS No. 13. If they are not leases, most tolling agreements generally meet with certain characteristics of a SFAS No. 133 derivative. Specifically, a tolling agreement is likely to have 1) an underlying, which is the price for fuel and/or electricity; 2) no initial net investment as the capacity payment is paid monthly throughout the term of the contract and 3) net settlement since the commodity delivered (i.e. power) is generally considered to have a spot market and thus would be readily convertible to cash in accordance with DIG Issue No. A19, *Definition of a Derivative: Impact of a Multiple Delivery Long-Term Supply Contract on Assessment of Whether an Asset Is Readily Convertible to Cash*. It is the buyer's ability to turn the power into cash that constitutes de facto net settlement for SFAS No. 133 purposes. However, the remaining characteristic of a derivative - a notional or fixed payment provision - may not be present in all tolling agreements. Whether or not a toll contains a notional will be based partially upon whether or not the parties to the transaction can "economically exercise" (refer to definition in Appendix A) their rights under the contract and what the liquidating damages (LD) and/or termination provisions are under the guidance given in DIG Issue A6.

Tolling agreements should also be considered for analysis under FIN 46 (revised December 2003), *Consolidation of Variable Interest Entities*.

Tolling Agreements – Firm Liquidated Damages (LD) Products

Certain tolling agreements are firm products whereby the buyer of the toll is protected from any and all risks associated with physical operations of a plant. The seller of the toll has effectively guaranteed 100% availability of the contracted power along with a fixed, guaranteed heat rate. For example, if the plant experiences an unplanned outage when the buyer has called upon the power, the seller must buy power in the market to cover the buyer's call order or pay market-based replacement value for any losses incurred by the buyer to keep the buyer whole for their short position created by the seller's default. These tolls behave very similar to financial options because the buyer assumes no unit contingent/operational plant risk. For these types of tolling agreements, a notional exists since the liquidating damages provision calls for a variable payment that is expected to reimburse the harmed party for market price movements (see DIG A6 discussion). In other words, the contract provides for the delivery of either power or market-based liquidating damages that are not substantially different. Thus, this type of toll would most likely be classified as a derivative.

Tolling Agreements – Unit Contingent Products

Other tolling agreements require the buyer to take on some level of plant-specific risk. These tolling agreements are viewed commonly in the industry as "unit contingent" products. They are structured similarly to the firm LD products mentioned above, with the exception that the buyer is assuming availability risk, heat rate risk, and/or other types of risk that is associated with owning, controlling, or operating a power generation facility. The operational risk assumed by the buyer may or may not ultimately be more than that inherent in firm LD products that are characterized similar to financial options. It is the uniqueness of unit contingent tolling agreements that necessitates a facts-and-circumstances analysis to determine whether such agreement is or is not a derivative.

An example of this type of unit contingent tolling agreement (which, as noted above, would first need to be assessed to determine if it is a lease) includes a contract whereby the seller has guaranteed a heat rate and the plant availability is guaranteed for 90% of the year, except for scheduled maintenance in which the buyer is notified prior that the plant will not be available. This structure is very common for unit contingent tolling agreements. In this example, there may be a 100MW plant whereby a minimum notional of 788,400 MWh (computed based on 90% of 100 MW capacity multiplied by 24 hours times 365 days) may be computed. However, this minimum notional may be challenged and overcome if certain factors regarding the liquidating damages provisions and force majeure provisions are met.

Specifically, tolling agreements address what compensation the buyer is to receive in the event of non-performance. This compensation may be in the form of replacement energy (i.e. market-based liquidating damages), formulaic (non-market based) reduction to the overall capacity payment, no compensation, or some variation thereof. Generally, if a unit contingent toll contains a provision for replacement cost (market based) liquidating damages, the contract is deemed to be a derivative because the contract would be analogous to the firm liquidated damages toll described above. However, if the liquidating damages are non-existent or not market-based and are not deemed to be significant, the existence of the minimum notional may be successfully challenged and the contract deemed not a derivative. Consideration may also need to be given to the buyer's ability to "economically exercise" (refer to definition in Appendix A) their rights under the contract.

In addition to the liquidating damages provisions, broad force majeure provisions evident in the tolling agreements may indicate that no notional exists. Force majeure clauses generally bear certain characteristics such as acts of God, war, etc. However, if the force majeure provision contained in the tolling agreement is overly broad to the extent that it includes operational provisions, such as labor or material shortages, and either liquidating damages are not required during the force majeure period or the liquidating damages are not significant, the contract may be deemed to not have a notional and hence not be a derivative.

The determination as to whether a tolling agreement is a derivative is inherently based partially on the subjective judgment of the evaluator. While the determination of "significant" liquidating damages and "broad" force majeure clauses may vary from individual to individual, Duke Energy will maintain documentation at the appropriate business unit on the analysis of all tolls to ensure that consistent application of these definitions are applied, especially within a business unit. While we have segregated certain general types of tolling agreements in this document to help facilitate the definition of a derivative, we will continue to evaluate whether any tolling agreement is a derivative on a contract-by-contract basis.

Transportation Contracts

Transportation or pipeline capacity contracts provide the holders of the capacity the opportunity, but not the obligation, to transport physical quantities of gas from one location to another on a daily basis. The holder of the capacity has the choice as to whether to ship and use the capacity, or not, based upon various factors relevant to its operations, including gas usage estimates for its operations or its customers, as well as the difference between the price of gas at the pipeline receipt and delivery points. The payment or settlement with the pipeline company by the capacity holder has a fixed and a variable component. The fixed payments, known as demand charges, are made to the pipeline company each month, whether or not the holder uses the capacity. The variable component is paid to the pipeline owner for capacity actually used by the holder during the month.

In 1992, FERC Order 636 implemented restructuring of interstate pipeline operations, and the 2000 FERC Order 637 further deregulated the natural gas industry by refining the remaining pipeline regulations to address inefficiencies in the capacity release market. The effects of the order allowed the development of natural gas commodities. Order 636 required pipeline companies to unbundle, or separate, natural gas sales operations from pipeline transportation activities and set up separate transportation and trading affiliates. This supported the development of natural gas marketing, which was deregulated and opened to competition. This order led to the development of the secondary transportation market, where shippers can purchase pipeline capacity from other shippers that temporarily or permanently spare capacity. The secondary market, known as the capacity release market, required each pipeline to set up an electronic bulletin board and institute rules by which holders of unwanted transport capacity may take bids from others who wish to lease or buy it. Order 636 was followed by a series of measures by the FERC that were designed to promote competition in the natural gas market and increase flexibility in pipeline transportation. In Order No. 637, issued February 9, 2000, the Commission (a) suspended until September 30, 2002 the operation of the price caps on capacity release sales of less than one year, and (b) authorized certain other policy changes in the pipeline ratemaking area.

As of January 1, 2003, a transportation contract does not meet the definition of a derivative because there is no provision for net settlement (all other defining characteristics are met). For the period Order No. 637 was effective, certain industry experts have indicated that there existed a market mechanism for natural gas transportation contracts because the lifting of the price cap and the posting and bidding process required by the bulletin boards facilitated a free market that was evidenced by the Electronic Bulletin Board. However, these same industry experts now believe that since the effective period for Order No. 637 expired on September 30, 2002, such market mechanism has been eliminated, as a party does not have the ability to relieve itself of all rights and obligations through a "market".
While we would agree that there is no market mechanism to facilitate net settlement, Duke Energy also believes that transportation contracts do not require delivery of an asset that is readily

convertible to cash. The readily-convertible-to-cash criterion is not satisfied, as there are no quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price. Because the underlying on which contract settlement is based (the price or value of the right to receive transportation) is a non-financial asset (see definition of "financial asset" under "Key Terms" above) that is not readily convertible to cash, paragraph 10(e) of SFAS No. 133 provides that the contract is not subject to the requirements of SFAS No.133. Further, in the discussions and deliberations of EITF Issue 02-3, the Task Force discussed that transportation contracts may not meet the definition of a derivative due to the significant service element included in the contract as well as the contract not being readily convertible to cash. Although the pricing of these contracts may be very similar to the pricing of a basis swap, the service element is pervasive and, therefore, transportation contracts are considered to be executory contracts.

Freight Contracts

Due to the significant service element involved, railroad contracts (usually used for coal deliveries) are not considered to be derivatives. Likewise, trucking contracts are not considered to be derivatives.

Full or Supplemental Requirements Contracts and Load-following arrangements

Full requirements contracts are contracts whereby the seller agrees to provide all of the commodity needs of a buyer. For example, Company A enters into a forward contract with Company B to provide as much electricity at a contract price (as opposed to a current market price) that is required by Company B to satisfy their needs during the next twelve-month period. Similar to a full requirements contract, a supplemental requirements contract provides for the seller to supply the excess requirements over the available resources of the buyer. Certain contracts for Duke Energy's wholesale electric customers are supplemental requirements contracts. A load-following contract is a type of requirements contract in which the company agrees to follow the load shape of the counterparty with predefined limits to enable one counterparty to buy or sell power in order to instantaneously match supply and demand.

Commodity contracts generally specify a fixed number of units of a commodity to be purchased or sold under a contract. However, some contracts, such as requirements contracts, do not specify a fixed number of units to be exchanged and, instead, specify either a maximum number of units, minimum number of units, or range of units to be purchased or sold during a specified period. DIG Issue No. A6, *Definition of a Derivative: Notional Amounts of Commodity Contracts,* provides that a requirements contract has a notional amount only if a reliable means to determine such a quantity exists.

DIG Issue A6 further states that in many contracts, even though the notional amount is not specified, it can be reliably determined based on other provisions within the contract or within agreements contemporaneous to the contract. One technique to quantify and validate the notional amount in a requirements contract is to base the estimated volumes on the contract's settlement and default provisions. Often the default provisions of requirements contracts will specifically refer to anticipated quantities to utilize in the calculation of penalty amounts in the event of nonperformance. Other default provisions stipulate penalty amounts in the event of nonperformance based on average historical usage quantities of the buyer. If those amounts are determinable, they should be considered the notional amount of the contract.

The identification of a requirements contract's notional amount may require consideration of volumes or formulas contained in attachments or appendices to the contract or other legally binding side agreements. The determination of a requirements contract's notional amount must be performed over the life of the contract and could result in the fluctuation of the notional amount if, for instance, the default provisions reference a rolling cumulative average of historical usage.

In circumstances where the notional amount is not determinable, making the quantification of such an amount highly subjective and relatively unreliable (for example, if a contract does not contain settlement and default provisions that explicitly reference quantities or provide a formula based on historical usage), such contracts are considered not to contain a notional amount as that term is used in SFAS No. 133.

The determination as to whether a full or supplemental requirements or load-following agreement has a notional will be made on a contract-by-contract basis. Certain requirements contracts and load-following contracts at the Company do not provide the buyer the ability to take quantities in excess of its need and resale these excess quantities and do not contain a stated minimum, default or other provisions in them that indicate the presence of a notional amount and thus are not SFAS No. 133 derivatives.

Electricity Capacity Contracts

Capacity contracts, (for electric power), typically allow the buyer to take as much power as needed, up to the contract maximum. Unless the contract is a lease, whereby the seller allows the buyer to control a specific generation facility, the contract may require SFAS No. 133 derivative treatment. Capacity contracts are generally considered to be derivatives, due to the existence of a notional. , The buyer is not normally restricted from selling their excess capacity on the open market if the price is right. Accordingly, such contracts are deemed to have a notional since they are economically exercisable. However, if the buyer is restricted from selling excess capacity on the open market (can only purchase power to meet its own needs), the termination and liquidating damage provisions of the contract need to be examined to determine whether a notional exists, under the guidance given in DIG Issue A6. Seller capacity or demand charges as well as energy charges are normally not prepaid at the inception of the contract; therefore, these contracts normally have no initial net investment. Since electricity is generally considered to be readily convertible to cash, these contracts have net settlement, assuming transmissions costs from the delivery point to an active market are less than 10%.

Derivative capacity contracts customarily qualify for the normal purchase normal sale exemption under paragraph 10(b)(4) of SFAS No. 133. The rules in paragraph 58(b) of SFAS No. 133 and DIG Issue No. C15, *Scope Exceptions: Normal Purchases and Normal Sales Exception for Option-Type Contracts and Forward Contracts in Electricity*, allow power producers selling from a specific plant to end users to qualify for the exemption.

Electric Transmission and Ancillary Services

Electric transmission and ancillary services are services necessary to deliver power from the generation source to the end user as well as the other services necessary to maintain the operational security and the integrity of the electric grid. These are generally negotiated between principals and carry significant operational risk. These contracts are non-standard and are not traded actively. These contracts are not SFAS 133 derivatives, as they do not meet any of the requirements for net settlement. These contracts are considered "service contracts" and are, therefore, excluded from the scope of SFAS No. 133 under paragraph 10(e)(2).

The development and participation in RTOs or ISOs may change the conclusion on whether or not a contract is a derivative for certain types of ancillary services contracts such as Financial Transmission Rights ("FTRs") and capacity swaps.

Other Energy Related Contracts

From time to time, the Company may enter into other energy related contracts not described above. While these contracts generally do not meet the definition of a derivative due to the lack of net settlement, any energy related contract executed that is not specifically provided for herein will be reviewed individually to determine if such contract meets the definition of a derivative.

DERIVATIVE ONLY CONTRACT TYPES

Forward-Based Derivatives

Forward contracts. The simplest derivative is the forward contract. A forward contract obligates one counterparty to buy, and the other to sell, a specific underlying at a specific price, amounts (i.e. notional) and date in the future. The change in the value of a forward contract is roughly proportional to the change in the value of its underlying. Typically, no net investment is required. Forward contracts are customized with terms and conditions tailored to fit the particular business, financial, or risk management objectives of the counterparties. Negotiations often take place with respect to contract size, delivery locations, delivery dates, and credit terms. Forwards, in other words, are not standardized. Some forward contracts for power and gas are traded in the over-the-counter (OTC) market, which is mature enough to facilitate net settlement, as the underlying commodities are readily convertible to cash, especially for short-term contracts. (Other forward contracts are bilateral contracts which are not traded in the OTC market.) Longer term contracts may lack liquidity; however, subject to DIG Issue A19, Duke Energy's forward contracts in the power or gas markets are usually deemed to net settle as there is a current spot market for these commodities and the market is presumed to perpetuate. Forward contracts meet all of the requirements of a SFAS 133 derivative.

Swap Transactions. As the name implies, a swap transaction obligates the two parties to the contract to exchange a series of cash flows or a commodity, such as gas or power, that is readily convertible to cash at specified intervals or a single date. The cash flows of a swap are either fixed, or calculated for each settlement date by multiplying the quantity of the underlying (notional amount) by specified reference rates or prices. The notional amount is only used to calculate the payment stream, but it is not exchanged. Payments are generally netted, with the difference being paid by one party to the other. As described in paragraph 9a, swap contracts have an explicit net settlement provision – e.g. neither party is required to deliver an asset that is associated with the underlying, only net price change differences. Therefore, similar to forward contracts, swap transactions meet the requirements of a SFAS 133 derivative.

Futures contracts. The basic form of a futures contract is similar to that of a forward contract. A futures contract obligates its owner to buy a specified underlying at a specified price on the contract maturity date (or settle the value for cash). Despite the similarity in payoff profiles, important economic differences distinguish futures from forwards and swaps. The contract terms of futures describing the quantity and quality of the underlying, the time and place of delivery, and the method of payment are fully standardized. Price is the only variable left to be determined. This full standardization leads to fungibility-that is, contracts of the same maturity are perfect substitutes. These characteristics are designed to facilitate anonymous trading in an active and liquid exchange market. Futures differ from forwards and swaps in that the contractual obligations under the futures contracts are entered into directly with the exchange clearinghouse and are generally satisfied through offset – the cancellation of an existing futures position though the acquisition of an equal but opposite position. Because of the existence of an actual exchange, as described by paragraph 9b, futures contracts have a market mechanism. Consistent with forwards and swaps, futures contracts meet all of the requirements of a SFAS 133 derivative.

Option-Based Derivatives

Option transactions. In exchange for payment of a premium (a small net investment), an option contract (excluding electricity capacity contracts which are discussed in a separate section of this policy) gives the option holder the right but not the obligation to buy or sell the underlying (or settle the value for cash) at a price, called the strike price, during a period or on a specific date. Thus, the owner of the option can choose not to exercise the option and let it expire. The buyer benefits from favorable movements in the price of the underlying but is not exposed to corresponding losses. Option contracts are another building block of derivatives. Options contain a notional, require a small net investment and are net settled, as the underlying commodities, typically gas or power, are typically readily convertible to cash. Duke Energy holds that generally all options and subcategories of options, such as the following contract types meet the requirements of a SFAS 133 derivative unless specifically exempted. Paragraphs 20(c) and 28(c) of SFAS No. 133 give certain restrictions for obtaining hedge accounting for a written option.

Caps, Floors and Collars. Just as forwards can be bundled to create swaps, options can be bundled to create other option-based contracts called, caps, floors, and collars. The buyer of the cap pays a premium, normally at inception. At each payment date, the seller must pay the buyer an amount based on the difference, if positive, between the reference and strike rate (cap). A cap therefore protects a floating-rate borrower against a rise in prices above the cap. A floor contract is the opposite of a cap in that payment is made only if the difference is negative. A floor therefore protects an index price investor against a decline in prices below the floor. Buying a collar is equivalent to buying a cap and selling a floor.

Swaptions. A swaption (or swap option) is an option on a swap. It gives the buyer the right, but not the obligation, to enter into a specified swap contract at a future date. In this case, the asset underlying the option contract is another derivative transactions (i.e., a swap). A swaption is usually considered a written option for the holder of the swap.

Documentation and Consultation for Significant Accounting or Reporting Matters

Applicability:	Applies to Enterprise
Originator:	Finance
Approval:	Corporate Controller
Effective Date:	12/15/2004
Revision Date:	03/31/2008
Reissue Date:	03/31/2008

Statement of Purpose and Philosophy

To ensure ethicality and consistency, this policy was developed to provide guidelines related to (1) the documentation of significant accounting or reporting matters and (2) the consultation protocol for interacting with the Corporate Accounting Research Group ("CARG"), a unit of the Corporate Controller's Department, and the external auditor regarding significant accounting and reporting matters. This policy is applicable to all Business/Corporate Units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company"). The objectives of this policy include describing the appropriate components of a memo for a significant accounting or reporting matter and best practices for documentation; addressing reporting, consultation and review requirements; and developing consistency in the documentation throughout Duke Energy. Duke Energy internal consultation requirements and protocol are further defined in the related policy entitled "Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues, New Accounting Guidance, and Significant Non-recurring Entries", and the Company's Accounting Function roles and responsibilities are also discussed in the "Duke Energy Finance Entity Level Controls Documentation".

Policy Expectations

This policy applies to the documentation of any accounting or reporting matter that is specifically discussed with a member of the CARG or with Duke Energy's external auditors. In addition, this policy is encouraged to apply to any other accounting or reporting matters that may require documentation based on Business/Corporate unit judgment but not consultation with CARG and/or the external auditors.

Accountability: Roles and Responsibilities

Corporate Controller Department:

- Review this policy periodically, identify any areas of improvement and communicate any changes to Business Unit Accounting Personnel.
- Maintain CARG Research Matters Lotus Notes database and file all documentation subject to this policy in the database in a timely manner.

- Either the Corporate Controller or the head of CARG is required to approve, or concur with, conclusions reached on all matters that require CARG involvement as indicated in the policy entitled "Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues, New Accounting Guidance, and Significant Non-recurring Entries."
- Provide feedback to Business Units/Corporate Areas regarding areas of non-compliance with this policy for any particular matter in a timely manner.

Business Unit/Corporate Area Accounting Management:

- Ensure Business Unit/Corporate Area personnel abide by documentation requirements and consultation protocol as stated herein.

Standards/Requirements

Documentation Guidelines

Documentation of an accounting or reporting matter should be comprised in order of the following general sections:

- Purpose
- Background
- Issue(s)
- Accounting Guidance and Discussion
- Conclusion
- Attachments

A description of each of the above sections is as follows:

Purpose - The purpose section describes why the memo has been written. It typically is brief in nature (1-3 sentences) and alerts the reader as to the key subject matter.

Background - The background section describes information leading up to the issue to be discussed. It provides information regarding key personnel, decisions made regarding related business and economic events and why such decisions are important to the matter under evaluation. The Background section provides the context needed to understand and evaluate the accounting or reporting matter to be addressed. Depending on the nature of the matter, this section may range from a few sentences to several paragraphs.

Issue - The issue section describes the specific accounting or reporting matter or matters to be addressed. An issue should be specific in nature and, if appropriate, multiple issues should be separately listed and separately addressed in the memo. Documentation of this section may be accomplished in the form of a question (e.g., how should Duke Energy account for a particular transaction?) or in the form of an assertive position (e.g., Duke Energy should account for a particular transaction in this manner).

Accounting Guidance and Discussion - The accounting guidance and discussion section describes the applicable literature related to the issue and an explanation of the applicability of such guidance to the issue being addressed. Documentation should include specific citations of the accounting references used and excerpts, as applicable. This section should discuss the accounting literature that is in support of any desired accounting treatment as well as any literature that might point to a different conclusion. The purpose of this section is to ensure that all applicable accounting literature has been identified and appropriately considered.

Conclusion - The conclusion section draws on the information provided in the previous section to provide a final resolution on the issue being addressed. It is typically fairly brief in nature and should often be evident based on the discussion above.

Attachments - The attachments section contains information referenced in the body of the memo. Such information includes supporting documentation, calculations, other related memos, examples, etc. Depending on the nature of the memo, this section may or may not exist.

Documentation of all matters prepared in accordance with this policy should contain the following attributes:

- Memo included on related Duke Energy Business/Corporate Unit letterhead
- Memo should include the caption "Draft- for discussion purposes only" until such memo is approved by business/corporate unit management, external auditors, and CARG if appropriate.
- Memo should include a date indicator, version number or some other identifier to indicate the progression of initial and revised documentation.
- Memo should include the name of external auditor personnel to whom the memo was provided as well as the name(s) of CARG and any other Duke Energy personnel (including Business/Corporate Unit management) copied on the memo

In addition, documentation style of internal memos should be consistent among Business/Corporate Units. When preparing documentation in accordance with this policy, the following best practices should be employed:

- Always assume the documentation will be delivered to a third party (e.g., SEC)
- Focus on the facts
- Avoid extraneous comments and discussion
- Use short and complete sentences with action verbs
- Include relevant dates and Duke Energy personnel involved
- Define terms and acronyms
- Use "Duke Energy" or "the Company" instead of "I" or "you"
- Perform a thorough self-review with each draft memo
- For sensitive matters, obtain input from Duke Energy legal department regarding privileged information

Reporting, Consultation and Review Protocol

Assess the need for CARG involvement - the policy entitled "Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues, New Accounting Guidance, and Significant Non-recurring Entries" discusses the involvement of CARG and contains, in part, the following:

"**CARG Involvement:** This denotes whether involvement of CARG is mandatory or optional. All BUs and Corporate Areas should use their judgment when deciding when to use CARG if their involvement is optional. It is highly advisable to use CARG if a matter requires consultation with the external auditor, includes significant assumptions or subjectivity, has little or no accounting guidance, or requires significant interpretation of available accounting guidance. Additionally, if an item does not initially meet the threshold for CARG involvement, but future activity is anticipated that will bring the total amount to the threshold, the BU is required to involve CARG, to avoid restatements and different interpretations in later periods. Regardless of the consultation activity, any and all position papers must be logged into the Corporate database. If a position does not require CARG input or consultation, the final position paper should note that CARG has not reviewed or approved the position. CARG "Involvement" encompasses both (1) consultation with and review by CARG and (2) approval or agreement from CARG. Any matters for which CARG is involved but does not agree with or approve of the position of the B.U. will be elevated to the Corporate Controller for resolution as discussed in "Resolution of issues" section of the policy entitled "Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues, New Accounting Guidance, and Significant Non-recurring Entries."

For items for which CARG involvement is deemed appropriate, the reporting, consultation and review protocol may be summarized into the following general steps:

- Notify CARG of accounting or reporting matter
- Provide documentation of accounting or reporting matter (as discussed above) to CARG
- Submit revisions to documentation as a result of CARG review
- Coordinate external auditor review with CARG
- File documentation within Business/Corporate Unit files
- Provide a copy of final documentation, including any attachments, to CARG in electronic format

For items for which CARG is not involved, the procedures should generally follow these same steps, substituting the references to "CARG" with "external auditor." For matters for which CARG was not involved, a final version of any documentation should be provided to CARG, as discussed in "Provide a copy of final documentation to CARG" below.

An explanation of each of the above steps is as follows:

Notify CARG of accounting or reporting matter - Upon identification of an accounting or reporting matter within the Business/Corporate Unit, a Business/Corporate Unit contact (the "Contact") should be established and such individual should inform a member of CARG regarding the matter to be addressed.

Provide documentation of accounting or reporting matter to CARG - Upon discussion of the matter with CARG, the Contact and CARG will jointly determine the nature and timing of the documentation to be provided and any assistance that the Business/Corporate Unit may require from CARG. While assistance may be provided from CARG, responsibility of all documentation will reside with the Business/Corporate Unit unless expressly agreed with CARG. All documentation submitted by the Contact should receive local management approval prior to being sent to CARG for review. CARG members will consult internally and with others as they deem appropriate based upon the facts and circumstances surrounding each matter (e.g., materiality, level of judgment required, any potential impact on prior periods, etc.).

The author of each memo is responsible to ensure that any other policies have been complied with, including the policy on "Preparing & Reviewing Financial Schedules, Statements, or Reports." While each issues memo is not required to undergo a formal "prepare/review" process, any financial information in an issues memo, or in any corresponding attachment to a memo, authored by anyone outside of CARG should be subjected to the procedures in the "Preparing & Reviewing Financial Schedules, Statements, or Reports" policy, including the documentation requirements of this policy. For any memos authored by members of CARG, since any financial information used by CARG usually comes from a corporate or business unit, any financial information in an issues memo, or in any attachments, should be verified to CARG's source of the information by another member of CARG. The performance of these procedures by CARG should be documented when "final" versions of memos are placed in the CARG Research Matters Lotus Notes database (including the name of the person who verified any financial or other quantitative information).

<u>Submit revisions to documentation as a result of CARG review</u> - As mentioned above, upon Business/Corporate Unit approval, an initial draft memo will be presented to CARG. Depending on the nature of the matter, documentation may be reviewed by one or more members of CARG. A version of the memo containing comments or proposed revisions will be provided to the Contact within the established time frame. The Contact should process proposed revisions or indicate why such revisions should not be processed and address all questions posed by CARG. Upon completion of review, the Contact should submit a revised version of the documentation to CARG. This process may repeat, as necessary, until approval is received from CARG. CARG will also coordinate any other review deemed appropriate (e.g., Corporate Controller).

<u>Coordinate external auditor review with CARG</u> - Upon notification of the accounting or reporting matter to CARG, CARG will coordinate with the Business/Corporate Unit regarding responsibility for communications with the external auditor for both the corporate and local teams. The standard procedure on matters requiring documentation will be for the Business/Corporate unit (or CARG if requested by the Business/Corporate unit) to initially inform the external audit team in the respective location. The Business/Corporate Unit and CARG will also coordinate the timing for communications with the external auditor, with concurrent communications permitted for matters of a time sensitive nature.

<u>File documentation within Business/Corporate Unit files</u> - If CARG involvement is determined to be appropriate by the Business/Corporate unit, no documentation subject to this policy will be considered final until indicated, or signed-off, by CARG. Either the Corporate Controller or the head of CARG is required to approve, or concur with, conclusions reached on all matters that require CARG involvement as indicated in the policy entitled "<u>Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues, New Accounting Guidance, and Significant Non-recurring Entries</u>."

Upon finalization of the documentation of a significant accounting or reporting matter, the Contact should remove the draft stamp, ensure the date of documentation is appropriate, and modify electronic file name, as appropriate. All previous drafts should be disposed in accordance with Duke Energy's documentation retention policies. An electronic copy of the final documentation should reside in a designated folder on the local Business/Corporate Unit's server. Discretion may be applied to storage of hard copy documentation by local management.

Provide a copy of final documentation to CARG - Upon finalization of the documentation of a significant accounting or reporting matter, provide an electronic copy of the final documentation, including any attachments, in electronic format to the CARG representative for filing in the CARG Research Matters Lotus Notes database. When indicating a matter as "final" in the CARG Research Matters Lotus Notes database, the CARG member should indicate whether the Corporate Controller or the head of CARG, or both, approved, or concurred with, the documented conclusion. Also, as discussed above, when filing a memo in the database, the CARG member should also indicate the name of the person who verified any financial or other quantitative information included in the memo, or in any attachments to the memo, that was prepared by a member of CARG.

Copies of all documentation of significant accounting or reporting matters subject to this policy should be submitted to CARG. The procedures for matters in which CARG is involved are outlined above. For matters for which CARG was not involved, a final version of the documentation should be provided to a member of CARG for filing in the CARG Research Matters Lotus Notes database. If a position does not require CARG input or consultation, the final position paper should note that CARG has not reviewed or approved the position. CARG members may choose to read such documentation submitted to them for filing purposes and any CARG questions or comments should be resolved prior to filing the documentation as final.

Financial Statement Disclosure of Related Party Transactions

Applicability:	Applies to Enterprise
Originator:	Corporate Controller
Approval:	Corporate Controller
Effective Date:	12/15/2004
Revision Date:	03/31/2008
Reissue Date:	03/31/2008

Statement of Purpose and Philosophy

Transactions between related parties commonly occur in the normal course of business. These transactions include, but are not limited to, sales, purchases, loans, transfers, leasing arrangements, guarantees, and other commercial transactions. To assist investors in understanding the impact of these transactions on the financial statements ,U.S. generally accepted accounting principles (GAAP), specifically Statement of Financial Accounting Standards ("SFAS") No. 57, *Related Party Disclosures*, and Securities and Exchange Commission (SEC) Regulation S-X Rule 4-08(k)(1), require the disclosure of certain control relationships and related party transactions. This policy provides guidance for identifying, appropriately accounting for, and reporting related party transactions.

Policy Expectations

This policy is designed to help ensure consistent application of the accounting rules and disclosure provisions for related party transactions across the consolidated Duke Energy group. All Business Units and Corporate Areas must follow U.S. GAAP with respect to accounting for and reporting related party transactions and maintain adequate internal processes to ensure compliance.

Accountability: Roles and Responsibilities

Business Units/Corporate Areas ("Units")

- Ensure appropriate unit personnel understand the definitions and requirements of the accounting for and reporting of related party transactions, as evidenced through unit communications, training of personnel, etc.
- Appropriately account for, based upon the economic substance, any known related party transactions in accordance with GAAP
- Report related party transactions in each quarter accordance with the instructions provided by the Corporate Controller's Department
- Review and update, as needed, enterprise list of related parties for Duke Energy Corporation (DEC) distributed by the Corporate Controller's Department each quarter
- Maintain enterprise list of related parties for any registrant that reports to the unit. Consult World Records database to find consolidated subsidiaries of DEC

Corporate Controller's Department

- Provide interpretation of accounting guidance as to whether or not a person is considered a related party (Corporate Accounting Research) and whether or not a transaction is considered material (Internal/External Reporting)
- On a quarterly basis, obtain information about related parties and related party transactions from the DEC Business Units/Corporate areas through the distribution of the list of related parties to the Business Units/Corporate Areas and review of related party transaction summaries provided byt he Business Units/Corporate Areas
- On an annual basis, obtain summary of Directors and Officers (D&O) questionnaire responses from Corporate Legal Department to determine if any disclosures are required (Internal/External Reporting)
- Report material related party transactions as appropriate in the periodic SEC filings (Internal/External Reporting)

Standards/Requirements

Background and Related Accounting & Reporting Guidance

SFAS No. 57, *Related Party Disclosures*, and SEC Regulation S-X Rule 4-08(k)(1) require disclosure in the consolidated financial statements and periodic (e.g., quarterly) filings of certain relationships and transactions between an entity (or registrant) and its related parties, as appropriately defined, so that users of an entity's financial statements have a full and clear picture of the financial position and results of operations of that entity when making an investment and/or lending decision.

Based on the guidance in SFAS No. 57 and S-X Rule 1-02, related parties are generally understood to be one of the following (refer to Key Terms below for Duke Energy Corporation's guidance regarding these definitions):

1. Affiliates - an affiliate is a person that controls, is controlled by, or is under common control with another person. Control may be direct or indirect and may be exercised through one or more intermediaries
2. Management- any person with responsibility for achieving objectives of the organization and requisite authority to make decisions that pursue those objectives. Management normally includes members of the board of directors, chief executive officers, chief operating officer, any vice president in charge of a principal business function (such as sales, administration, or finance), and any other individual who performs a similar policy making function
3. Principal owners - a person who owns more than 10% of any class of equity securities of an entity. Such ownership may be direct or indirect and includes beneficial ownership as well as ownership through one or more affiliates. Principal owners include owners, each of whose individual holdings is 10% or less of the voting interest but whose combined holdings are more than 10%, if such owners are acting in concert with respect to a transaction or transactions with the reporting entity
4. Promoter - a person who receives 10% or more of the stock of an entity in connection with its founding or organization
5. Immediate family members - family members whom a principal owner or member of management might control or influence or by whom they might be controlled or influenced because of the family relationship

The above items do not necessarily represent an all inclusive listing. The determination of whether a person or an entity is a related party to a reporting entity is generally a determination of fact. Such determination does, in certain cases, require the exercise of professional judgment. When certain persons (or person) have the ability to exert significant influence over the terms of a transaction between two parties, those parties could be considered related. For example, if Entity A's Chief Executive Officer's (CEO) immediate family member is the owner of Entity B and those two entities enter into transactions with each other, those entities could be considered related parties, as significant influence is presumed to exist between the CEO and his/her immediate family member as to the price and other terms that would not be present between unrelated parties. In contrast, if the CEO's immediate family member is an employee of Entity B with no ability to exert any influence over the terms of the transaction(s), those parties would generally not be considered related. An additional example would be a situation in which a member of the board of directors of Entity A is the CEO of Entity B, transactions between Entity A and Entity B would be considered related party transactions to both entities, as that director/CEO is presumed to have the ability to exercise significant influence over the terms to those transactions.

Related party transactions are any direct or indirect transactions between the reporting entity and a related party, as defined above. Related party transactions generally include transactions between:

- A parent company and its subsidiaries (transactions eliminated in consolidation are not required to be disclosed under SFAS No. 57 as they are not included in the consolidated financial statements, but they remain related party transactions nonetheless)
- Subsidiaries of a common parent (e.g., Cinergy Corp. and Duke Energy Carolinas, LLC are under the common control of Duke Energy)

The reporting entity and:

- Other affiliated businesses
- Management (including directors and members of their immediate families), excluding compensation arrangements
- Principal owners (including members of their immediate families), excluding compensation arrangements
- Pension and profit-sharing trusts managed by or under the trusteeship of management
- Investees accounted for on the equity method of accounting (see below for guidance regarding equity method investees of a reporting entity's equity method investee)
- Promoters
- Other interests having the ability to exert significant influence (see above for examples)

As discussed above, the determination of whether a person or an entity is a related party to a reporting entity requires significant judgment. From the accounting guidance discussed above, it is clear that an equity method investee of a reporting entity is considered a related party. However, it is less clear as to whether an equity method investee of a reporting entity's equity method investee (referred to as a "second tier" equity investee) should be considered a related party. Such determination will depend upon the level of involvement the reporting entity has with the second tier equity investee. For example, the reporting entity may have a 50% owned equity investee (investee A) which has a 50% owned equity investee (investee B). Therefore, the reporting entity has an indirect ownership of 25% in investee B. Normally, direct ownership in an entity of 20% or greater results in a presumption that the investee should be accounted for under the equity method and, therefore, would be considered a related party. The determination as to whether or not the second tier equity investee is considered a related party to the reporting entity will depend upon such factors such as the level of influence over operating and financial decisions of investee B held by investee A and, indirectly, the reporting entity (such as board representation, contractual arrangements, etc).

Established accounting principles ordinarily do not require transactions with related parties to be accounted for on a different basis from that which would be appropriate if the parties were not related. Related party transactions should be considered satisfactorily accounted for when:

- The substance of the transaction is accounted for in conformity with existing authoritative accounting literature and the accounting principles selected are appropriate in the circumstances, and
- When the requisite disclosures (material transactions and relationships) are made in accordance with the requirements of SFAS No. 57 and S-X Rule 4-08

Disclosures required by paragraphs 2-4 of SFAS No. 57 include the following:

2. Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures shall include:

a. The nature of the relationship(s) involved

b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements

c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period

d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

e. The information required by paragraph 49 of SFAS No. 109, *Accounting for Income Taxes* (see below)

3. Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated.

4. If the reporting enterprise and one or more other enterprises are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting enterprise significantly different from those that would have been obtained if the enterprises were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the enterprises.

Paragraph 49 of SFAS No. 109, *Accounting for Income Taxes*, states the following:

49. An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented

b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in (a) above are presented.

Regulation S-X Rule 4-08(k) requires the following:

(1) Related party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows.

(2) In cases where separate financial statements are presented for the registrant, certain investees, or subsidiaries, separate disclosure shall be made in such statements of the amounts in the related consolidated financial statements that are (i) eliminated and (ii) not eliminated. Also, any intercompany profits or losses resulting from transactions with related parties and not eliminated and the effects thereof shall be disclosed.

For purposes of applying the provisions of SFAS No. 57 and Regulation S-X Rule 4-08, only those transactions that are material need be disclosed. See Staff Accounting Bulletin ("SAB") No. 99 for guidance in determining materiality. Also, for stand-alone financial statements of Duke Energy subsidiaries (e.g., Duke Energy Carolinas, LLC, Duke Energy Ohio, Inc. and Duke Energy Indiana, Inc.), the guidance found in SAB, Topic 1B, should be followed with respect to the allocation of expenses from a parent to a subsidiary and the related required disclosures.

<u>Procedure for Reporting Related Party Transactions</u>

In order to appropriately account for and disclose related party transactions at the Duke Energy Corporation level, the following policy/procedure is to be followed at the Corporate/Business unit level

- Corporate Controller's Department will distribute DEC enterprise list of related parties to appropriate personnel within the Corporate/Business units quarterly
- Business Units/Corporate Areas will provide updates to the DEC enterprise list of related parties to the Corporate Controller's Department quarterly or when there are significant changes
- Business Units/Corporate Areas will report related party transactions in accordance with this policy and the instructions contained in the quarterly data request distributed by the Corporate Controller's Department. Related party transactions with one entity that are less than $1 million in aggregate need not be reported to the Corporate Controller's

Department. The units should consult with the Corporate Controller's Department (Internal/External Reporting) on questions of materiality.

- When developing the enterprise list of related parties for DEC's subsidiary registrants (such as Duke Energy Carolinas, LLC), the unit will need to consult the World Records database to *identify consolidated entities of DEC which are not included in the subsidiary registrant's* consolidated financial statements as these entities will not be on the DEC enterprise list of related parties. The "ownership" tab in the World Records database will indicate the parent entity. The consolidated subsidiaries are eliminated in the DEC consolidation, but may not be eliminated in the consolidation of the subsidiary registrant.

Key Terms

Compensation Arrangements - salary, bonus, deferred compensation, pension, profit sharing, stock options and awards, expense allowances, director fees, and other similar items that are paid or incurred in the ordinary course of business. Compensation arrangements also may include other items pursuant to company policy, such as providing low-cost financing for shares acquired through a stock option plan.

Control - the power to direct or cause the direction of the management and policies of a specified person. Control may be exercised directly or indirectly through ownership, contract, or by other means.

Enterprise - registrant

Immediate Family - a person's spouse; parent; child; sibling; parent-, child-, sibling-in-law; and anyone who shares a person's home in a non-employee capacity

Ordinary Course of Business - Paragraph 1 of SFAS No. 57 gives the following examples of items that are considered in the ordinary course of business:

Some examples of common types of transactions with related parties are: sales, purchases, and transfers of realty and personal property; services received or furnished, for example, accounting, management, engineering, and legal services; use of property and equipment by lease or otherwise; borrowings and lendings; guarantees; maintenance of bank balances as compensating balances for the benefit of another; intercompany billings based on allocations of common costs; and filings of consolidated tax returns.

Management - refers to management of the registrant (i.e., the board of directors and executive officers of the registrant)

Person - an individual, corporation (excluding 501(c)(3) tax-exempt organizations), partnership, association, joint-stock company, business trust, or unincorporated organization.

Form 8-K Requirements and Filing Procedure

Applicability:	Appllies to Enterprise
Originator:	Chief Legal Officer
Approval:	Chief Legal Officer
Effective Date:	08/23/2004
Revision Date:	01/01/2008
Reissue Date:	01/01/2008

Statement of Purpose and Philosophy

The Securities and Exchange Commission ("SEC") requires certain U.S. companies to disclose certain specified corporate events on a current basis on SEC Form 8-K, generally four business days after the event has occurred. Currently, these requirements apply to the following Duke Energy entities: Duke Energy Corporation ("DEC"); Duke Energy Carolinas LLC; Duke Energy Ohio, Inc. and Duke Energy Indiana, Inc. The events requiring disclosure are shown on Attachment A. This policy outlines the Company's expectations regarding compliance with Form 8-K reporting requirements.

Policy Expectations

All Business Units/Corporate areas should understand the Form 8-K reporting requirements and ensure that Legal and/or the Controller are appropriately informed when a Form 8-K reportable event may occur or has occurred at the unit.

Accountability: Roles and Responsibilities

Business Units/Corporate Areas:

- Ensure appropriate staff are familiar with Form 8-K reporting requirements
- Identify events and transactions that could be deemed reportable for Form 8-K purposes before the event/transaction occurs
- Communicate on a timely basis to the Corporate Controller's Department or Legal Department (the "Corporate Department") when a Form 8-K reportable event may occur or has occurred at the unit. Refer to Attachment A to determine which Corporate Department to contact and designated contact individuals, based on the type of event/transaction. This communication should be made for any event that could potentially be reportable at any registrant level
- Upon confirmation that a Form 8-K filing is required, prepare initial draft of disclosure language, including any documents required or appropriate to be filed as an exhibit to the Form 8-K, and provide to the appropriate Corporate Department for review, edit, approval and filing in a timely manner

Corporate Controller and Legal Departments:

- Based on the type of event/transaction, either the Corporate Controller's Department or the Legal Department will lead the decision process (refer to Attachment A) as to whether or not it is necessary to file a Form 8-K and will review the decision and coordinate with the other Corporate Department

- Corporate Department communicates decision as to whether Form 8-K will be filed back to originating Business Unit or Corporate area
- When a decision has been made to file a Form 8-K, the Corporate Department will immediately notify Corporate Communications and Investor Relations, to the extent necessary, to ensure coordinated external message
- Corporate Department establishes filing deadline and schedules any meetings required for Review and Approval stage
- Obtain draft of Form 8-K, circulate for review and approval and coordinate filing with the other Legal Department
- The Corporate Controller's Department will convene Disclosure Committee (or subcommittee as approved by the Disclosure Committee charter) and other meetings, as necessary, for review and approval
- Lead Corporate Department will file/submit Form 8-K to SEC by deadline
- Contact/consult with appropriate internal and external parties, as necessary
- Ensure that Form 10-Q/K incorporates any information that was required to be reported, but was not previously reported, on Form 8-K

Standards/Requirements

- Refer to Attachment A for a list of items that must be disclosed on Form 8-K. For further information, consult the SEC release http://www.sec.gov/rules/final/33-8400.htm

- Before a Form 10-Q/K is filed, the Company must specifically assess whether required Form 8-K filings were made on a timely basis and whether those filings contained appropriate disclosures. If needed, the Company will include disclosures in the current Form 10-Q/K and/or file a late Form 8-K

Key Terms

Designated Contact Individuals in Corporate Departments

Corporate Controller's Department: General Manager, Research and Reporting

Legal Department: Vice President, Legal – Corporate, Securities and Finance

Journal Entry Creation and Approval Requirements for Non-System Generated Journals

Applicability:	Applies to Enterprise
Originator:	Corporate Controller
Approval:	Corporate Controller
Effective Date:	09/30/2003
Revision Date:	03/01/2008
Reissue Date:	03/01/2008

Purpose

The intent of this Policy is to provide minimum standards to be used in the preparation and approval of "non-system generated journal entries" (journal entries). Properly documenting and approving journal entries mitigates the risk of material misstatement to our financial statements and provides Duke Energy Corporation and subsidiaries with internal and external auditable documents supporting financial statements and other reporting requirements.

Terms

Create - To initiate a journal entry.
Valid - The stage in the journal entry process when a journal has been initiated and accounting has been validated (i.e., no chartfield errors and application of Generally Accepted Accounting Principles (GAAP) is accurate).
Approve - A journal is marked for approval to post to the general ledger.
Post - The action of reflecting the journal entry in the general ledger.
Pencils Down - Date specified when that all Business Units and Corporate Areas have made all necessary journal entries. After this time, the Close and Consolidations group updates the consolidated financial statements.
Un-post - The action of reversing a journal which has been posted to the general ledger.

Expectations

All Business Units and Corporate Areas which create journal entries must comply with the requirements of this Policy.

Roles Associated with Journal Entry Creating and Reviewing

There are two distinct roles associated with processing a journal entry: Creating and Reviewing. Transactions recorded in the company's general ledger must be consistent with the direction and decisions of management. Each individual associated with the journal entry process is expected to have an understanding, appropriate to his or her role, as to whether the entry is reasonable, relevant, complete, complies with GAAP and properly referenced. The performance of the Reviewer responsibilities must not be a perfunctory exercise. An independent party should be able to conclude that the performance of these responsibilities is meaningful and appropriate.

The following section designates specific accountabilities of the roles associated with each journal:

Creator

- Prepares the journal entry, attaches the appropriate supporting documentation and references it to the journal entry, or if supporting documentation is filed separately, indicates the location. See *Attachment A – Recommended Guidelines for Documenting a Journal Entry* for journal entry referencing guidelines.
- Ensures information received from others is appropriate or is derived from someone with appropriate authority (see related Policy, "Preparing and Reviewing Schedules, Statements, or Reports").
- Completes the journal line description field.
- Prepares a written summary of the purpose of the journal on the face of the journal entry or separate page, referencing any applicable accounting literature or pronouncement (e.g., a FASB pronouncement, APB Opinion, FERC Code of Federal Regulations section, etc.).
- Ensures the journal is Valid.
- Loads the journal in the financial application via the appropriate mechanism.
- Acts as the steward during the journal entry process flow to ensure the timeliness and completion of journal entry responsibilities.

Reviewer

- Cannot organizationally report to the Creator of the journal entry.
- Ensures proper accounting for the journal entry.
- Verifies journal entry is being recorded to the appropriate accounting period.
- Checks or confirms calculations (e.g., foot/cross-foot, multiplication, division, etc.).
- Has the appropriate technical or functional expertise to perform the review responsibilities.
- Verifies adequate documentation is attached to the journal to substantiate the entry.
- Performs final verification that the journal does not require further review or approval by management - see "Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues, and Significant Non-recurring Entries" Policy.
- Approves the journal for posting.

Electronic date, time and signature stamps are the evidence of creation and review. Financial applications used to process journal entries are required to have a system-enforced segregation of duties which requires action from two individuals - journal entry Creator and Approver (to post). The Approver (to post) is required to be the Reviewer.

Assembling the Journal

The journal entry and supporting documents should be organized in a reasonable and appropriate manner and include the following:

- Journal Entry reports
- Written summary of the purpose of the journal entry
- Supporting documentation, appropriately referenced

Recurring Journal Entries

"Recurring" journal entries are designated as such as part of the initial setup of these journal entries in the financial application. After initial set-up, the financial application automatically creates these journal entries each month. An appropriate individual must approve the journal entry to post.

Because recurring journal entries are created by the financial application and their review is maintained within the financial application, it is not required to maintain hard copy documentation of the Create and Approve process. Two steps are required to initially set up these journal entries, but only one step, posting, is required in subsequent months.

A journal entry which is manually initiated each month, while it may be regarded by the Business Unit/Corporate Area as recurring, is not considered a "Recurring" journal entry for purposes of this Policy since such designation is not maintained in the financial application. Accordingly, such manual journal entries are subject to this Policy.

Statistical Journal
Statistical journals impacting the general ledger, or journals which impact rates used for allocations, loading factors for overheads, etc., must have two individuals perform the initial setup or change, but do not require monthly manual approval until a change is initiated.

Reporting Overrides
An override represents any failure to comply with the requirements of this Policy. Overrides must be reported to Internal Controls, Corporate Controller's Department no later than 4 business days after "pencils down" of the close cycle. See *Attachment B - Journal Entry Create/Review Override Report* for the form to use to report overrides. If there are no overrides to report, indicate such positive affirmation to Internal Controls in the Corporate Controller's department no later than 4 business days after "pencils down."

Requesting an Exception to this Policy
An exception to any aspect of this Policy is requested using the form shown in *Attachment C - Request for Ongoing Exception to Policy*. No exceptions to this Policy are authorized until approval from the Corporate Controller's Department is received. Any failure to comply with this Policy prior to receipt of an approved exception constitutes an override which must be reported.

Accountability: Roles and Responsibilities
Creator and Reviewer:

- Process journal entry in compliance with this policy.
- Have appropriate expertise and understanding of the journal entry and supporting documentation.

Business Unit and Corporate Area Management:

- Ensure that the appropriate individuals in their respective Business Unit/Corporate Area are aware of and comply with the requirements of this Policy.
- Report Policy overrides to Internal Controls, Corporate Controller's Department.
- Send requests for an exception to this Policy to Internal Controls, Corporate Controller's Department.

Corporate Controller's Department:

- Internal Controls reviews overrides to this Policy for reasonableness and, if appropriate, reports to Corporate Controller.

Corporate Controller reviews and approves, if appropriate, requests for an exception to this Policy.