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Final Report

Compliance Audit

Of

Duke Energy Ohio

On Behalf Of

Public Utility Commission of Ohio

March 29, 2010

SILVERPOINT CONSULTING

And

Vantage Consulting, Inc.

Compliance Audit of Duke Energy - Ohio

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I. EXECUTIVE SUMMARY

A. BACKGROUND

Duke Energy Ohio, Inc., (DE-Ohio) has as its primary businesses: generation; transmission; distribution of electricity; the sale of/transportation of natural gas; and energy marketing. DE-Ohio is a wholly-owned subsidiary of Cinergy Corp., (Cinergy). In 2006, Cinergy merged with, and became a wholly-owned subsidiary of, Duke Energy Corporation (Duke Energy).

DE-Ohio consists of both regulated and non-regulated operations. In 1999, Ohio passed restructuring legislation that enabled retail customers to choose their energy suppliers beginning in January 2001. As part of its restructuring plan, Cincinnati Gas & Electric (later renamed DE-Ohio) agreed to, among other things, corporate separation of regulated and unregulated operations. DE-Ohio functionally separated the operation and maintenance of its "legacy Cinergy" generating portfolio from its regulated distribution service. The regulated business segment, Duke Energy Ohio Franchised Electric and Gas (DE-Ohio FE&G), provides service in the southwest portion of Ohio, and through its wholly-owned subsidiary, Duke Energy Kentucky, Inc., in nearby areas of Kentucky. DE-Ohio's unregulated Commercial Power business segment owns and manages power plants and engages in the wholesale marketing and procurement of electric power, fuel, and emission allowances.

In 2008, the Ohio General Assembly enacted Amended Senate Substitute Bill No. 221, restructuring Ohio's competitive retail electric service markets and establishing advanced energy resource standards. This new legislation requires DE-Ohio to establish a standard service offer of competitive retail electric service by applying to the Public Utilities Commission of Ohio (PUCO or Commission) for approval of an Electric Security Plan (ESP) or a market rate offer.

On July 31, 2008, the Company filed its Electric Security Plan and Amended Corporate Separation Plan (CSP) in Case Nos. 08-920-EL-SSO et al. In its Order of December 17, 2008, the Commission approved a stipulated agreement regarding the DE-Ohio Electric Security Plan, including the Amended CSP.[1] DE-Ohio designed its Amended CSP to comply with Chapter 4901:1-20-16 Ohio Administrative Code (O.A.C.) regarding corporate separation. Under the stipulation, DE-Ohio agreed to submit to an annual audit review of its CSP, including its Cost Allocation Manual (CAM).

In a March 2009 stipulated agreement in the latest DE-Ohio electric distribution rate case, Case Nos. 08-709-EL-AIR et al., the parties agreed to, and the PUCO adopted, Staff's recommendation that the scope of the CSP audit be expanded to include the documentation,

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1/ DE-Ohio's original CSP, approved in Case No. 99-1658, remained in effect until the Commission approved the amended plan on December 17, 2008.

examination, and testing of all allocation methods and factors that are used to assign costs to DE-Ohio FE&G.

In December 2008, the Commission adopted Chapter 4901:1:37, O.A.C., which implemented the corporate separation laws set forth in Amended Senate Substitute Bill No. 221 and effectively replaced Chapter 4901:1-20-16. The Commission requested that utilities submit an amended CSP within 60 days of the April 2, 2009 effective date of the new regulations. On June 11, 2009, the Company filed, in Case No. 09-495-EL-UNC, its application for approval of the Second Amended Corporate Separation Plan, which describes the processes and controls that DE-Ohio implemented consistent with Chapter 4901:1-37 et seq. and Ohio Revised Code 4928.17.[2] The Plan governs the corporate separation of non-competitive retail electric service from competitive retail electric service as well as products and services offered by other DE-Ohio affiliates.

B. PROJECT SCOPE AND METHODOLOGY

To assist it with the evaluation of the new CSP, the Commission issued a Request for Proposal (RFP) soliciting proposals from qualified firms to audit and attest to the accuracy of DE-Ohio's compliance with its Commission-approved CSP (*i.e.*, the Amended CSP) and to conduct testing of allocation methods and factors that are used to assign costs to PUCO-regulated operations. On September 30, 2009, the Commission selected the team of Silverpoint Consulting LL and Vantage Consulting, Inc. (Silverpoint-Vantage) to conduct the audit.

The audit covers an 18-month period from January 1, 2008 through June 30, 2009. According to the RFP, the requirements of the audit are as follows.

- Review relevant orders, testimony, Staff reports, etc., in Cases 08-920-EL-SSO, 08-709-EL-AIR, and 05-732-EL-MER.
- Review all documentation relating to the Company's compliance with its PUCO-approved CSP.
- Review all documentation relating to the Company's allocation policies, practices, and procedures.
- Document the methods and allocation factors used to assign costs to Ohio regulated operations.
- Review and test affiliate costs assigned to DE-Ohio.
- Develop an opinion on the appropriateness of charges assigned to DE-Ohio.
- Determine the impact of the transition from Cinergy Corporation to Duke Energy Corporation on the allocation methods and the amount of Administrative and General (A&G) cost assigned to PUCO-regulated operations.

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[2]/ Section 4928.17 of the Ohio Revised Code (O.R.C.) dictates that a regulated electric utility engaging in any business other than the supply of regulated retail electric service, whether directly or through an affiliate, must implement and operate under a corporate separation plan approved by the Commission.

- Review, test, and offer an opinion on DE-Ohio's compliance with Chapter 4901:1-37, O.A.C.

The scope of the audit also includes offering an opinion as to whether DE-Ohio has successfully implemented its Commission-approved CSP.

Silverpoint-Vantage conducted this audit using Generally Accepted Government Auditing Standards (GAGAS). The auditors conducted sampling in accordance with Section 350 of the Generally Accepted Auditing Standards (GAAS). The audit work plan is provided in our Proposal which is part of the contract to conduct this project.

In conducting this Compliance Audit, 125 Data requests were requested and 41 interviews were held. In addition, numerous phone calls and e-mails were used to clear up details. A verification meeting was held to review key factual issues. Both the PUCO Staff and DE-Ohio representatives reviewed the Draft Report. Silverpoint-Vantage reflected their comments in the Final Report as appropriate.

C. REPORT ORGANIZATION

This report is organized into eight chapters. In Chapter I, Silverpoint-Vantage describes the background and scope of this audit and provides an executive-level summary of its findings. In Chapter II, Silverpoint-Vantage offers its opinion on (1) the sufficiency of DE-Ohio's compliance with Chapter 4901:1-37, O.A.C., and (2) the Company's success in implementing its approved CSP. Chapter II also contains Silverpoint-Vantage's detailed discussion, findings, and conclusions regarding the Company's compliance with five of the six auditable provisions of Chapter 4901:1-37, O.A.C., specifically, (i) the content of the CSP application, (ii) structural safeguards, (iii) accounting separation, (iv) access to books and records, and (v) Code of Conduct.[3] Chapter IV contains the detailed findings regarding the sixth and final relevant provision, financial separation.

The balance of the report focuses on Silverpoint-Vantage's analysis of affiliate transactions involving DE-Ohio FE&G, in part to determine whether these transactions present an opportunity for cross-subsidization, which structural safeguard rules expressly prohibit. In this section of the report, Silverpoint-Vantage documents, analyzes, and tests the methods used by affiliates to assign costs to DE-Ohio FE&G, and offers its opinion on the appropriateness of charges to DE-Ohio FE&G. The auditors also present a comparison of A&G-related costs charged to DE-Ohio regulated operations before and after the merger between Cinergy and Duke Energy.

In Chapter III, Silverpoint-Vantage identifies all categories of affiliate transactions involving DE-Ohio, and discusses accounting issues related to those transactions. Chapter V presents Silverpoint-Vantage's detailed discussion, findings and conclusions regarding non-Service

3/ Section 4901:1-37-09, which relates to the sale or transfer of generating assets, is not relevant during the audit period.

Company affiliate transactions, *i.e.*, those between DE-Ohio and its utility and non-utility affiliates. Due to the complexity of the subject, Silverpoint-Vantage presents its analysis of Service Company transactions in two chapters. Chapter VI discusses the functions provided by the Service Company, and the cost assignment and cost allocation methods used to distribute the costs for those functions. Chapter VII contains an analysis of charges assigned by the Service Company to its client companies, including DE-Ohio. Finally, Chapter VIII contains Silverpoint-Vantage's analysis of the effect of the merger on Service Company allocation methods and A&G costs.

D. OVERALL CONCLUSIONS

On this assignment, the auditor was asked to offer an opinion on DE-Ohio's compliance with Chapter 4901:1-37, O.A.C. The overall opinion of the Silverpoint-Vantage team is that DE-Ohio is in compliance with all areas. Chapter II of this report summarizes our conclusions regarding Structural Safeguard, Separate Accounting, Financial Arrangements, and Code of Conduct, Emergency. In each case we Find DE-Ohio in compliance.

Our analysis of the 4901:1-37-05 Application provided details of the Corporate Separation Plan. Our consultants concluded that the Corporate Separation Plan that DE-Ohio submitted in Case No. 09-495-EL-UNC on June 11, 2009 conforms to the requirements of Chapter 4901:1-37-05. With regard to 4901:1-37-07 Access to Books and Records, our consultants concluded that DE-Ohio is in compliance with this provision of the regulation.

Our analysis of section 4901:1-37-08 Cost Allocation Manual (CAM), indicated that DE-Ohio's CAM complies with the provisions listed in this section of the regulation with the possible exception of an agreement that should have been included per (D)(3). A recommendation is made to address this issue.

The analysis of section 4901:1-37-09 Sale or Transfer of Generating Assets reviewed only the process since no activities under this provision occurred during the audit period. The process is clearly spelled out in the CAM.

Our final conclusion regarding overall compliance was that DE-Ohio provides appropriate training on relevant policies and procedures as well as the regulations on corporate separation.

Technical analysis concluded that all affiliate transactions were subject to written agreements, that affiliate transaction accounting system and methods are sufficient to ensure the accuracy and reliability of affiliate transaction data, and that there was no evidence of widespread problems that would call into question the overall integrity and reliability of the affiliate transaction data used in this audit. Technical issues of the merger are being addressed appropriately. One recommendation made to insure transparency was that a formal corporate-wide affiliate transaction accounting manual be developed and maintained.

In general, separation of financial instrument is being handled appropriately. The only issue raised, and discussed at length, is the impending end of the Electric Security Plan at the end of 2011. The question of separation through "ring fencing" or other means is discussed. A recommendation to address this issue is detailed.

The Silverpoint-Vantage review of operational agreements addressed a broad range of technical issues and found them to be reasonable. One recommendation to clarify the treatment of transactions between the regulated and non-regulated portions of DE-Ohio. Similarly the analysis of cost distribution methods did not uncover any major problems. A recommendation is made to keep PUCO Staff informed of future changes to Service Company cost distribution methods.

In its analysis of Service Company charging practices, Silverpoint-Vantage did not identify any serious problems.

Finally, Silverpoint-Vantage conducted a comparison of pre- and post-merger charges. The auditors have presented a significant amount of information but reached no specific conclusions.

E. SUMMARY OF RECOMMENDATIONS

Silverpoint-Vantage offers the following recommendations.

II-R1 Future CAMs submitted by DE-Ohio should include all agreements that describe the allocation of costs among its affiliates. (Refer to Finding II-F7)

The Commission's regulation specifically refers to all documentation and agreements that describe cost allocations among its affiliates. During the discovery process of this audit, an agreement with an affiliate was provided that was not also included in the CAM. DE-Ohio needs to be more diligent and thorough in its determination as to which documents and

III-R1 Develop and maintain a formal affiliate transaction accounting manual. (Refer to finding III-F3)

Silverpoint-Vantage believes it is appropriate for any utility with a service company, or with service agreements among utility and non-utility affiliates, to maintain a formal affiliate transaction accounting manual. The fact that DE-Ohio is not required by the PUCO to maintain an affiliate transaction accounting manual is not a sufficient reason for not doing

I-R2 Develop a plan, as part of the next Energy Security Plan discussions, to determine if further insulation from Duke Ohio ratepayers or complete separation of risks associated with DE- Ohio owned generation assets is appropriate. Refer to finding IV-F8)

The need for a revised ESP in 2011, provides the opportunity to address this issue in greater detail. Some initial steps that DE-Ohio should be required to perform include:

- conduct a risk assessment of the DE-Ohio-owned generation system given current industry issues;

- identify means to either, further insulate ratepayers, or to separate ownership in a manner that does not impair ratepayers;

- develop proposed solutions and provide to the PUCO by mid-2011 in order to complete any necessary hearings and transactions before the termination of the ESP.

I-R3 Duke Energy should clarify with Staff its position regarding the appropriate treatment of transactions between the regulated and non-regulated portions of DE-Ohio. (Refer to Finding V-F5.)

While the commercial power segment of DE-Ohio is not technically an affiliate of DE-Ohio FE&G because it is part of the same legal entity, the utility had until recently treated it as such for the purposes of pricing transactions. The company continues to issue formal Service Requests for services between the two segments, consistent with the Non-utility Agreement, but no longer follows the transfer pricing requirements of that agreement.

DE-Ohio FE&G charged over $100,000 in labor to the commercial power segment in the first six months of 2009, which previously would have triggered an associated overhead charge of approximately $200,000. Labor charges from the commercial power segment to DE-Ohio were more significant, totaling several million dollars in the first half of 2009. The financial impact on DE-Ohio FE&G of the change in policy could be significant.

I-R4 DE-Ohio should keep PUCO Staff informed of future changes to Service Company cost distribution methods. (Refer to Finding *VI-F2*.)

Prior audit reports on Duke Energy affiliate transactions and cost distribution methods presented three recommendations related to the methods by which the Service Company distributes its costs, specifically:[4]

- narrow the use of the three-part formula general allocator;
- eliminate the effect of spreading overhead costs from the calculation of allocation percentages;
- develop a method to fairly assign Service Company overhead costs.

The prior audit reports further recommended that if the Service Company decided to maintain its approach of spreading overhead charges in a way that is not linked to usage of services or cost causation in any discernible way, it be required to make a showing that its approach yields equitable results, and that those results are comparable to more direct, less simplified approaches. Similarly, the reports recommended that the Service Company be required to make a showing that it's charging method results in fully allocated costs for each function that it provides.

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[4]/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36.

Silverpoint-Vantage believes that these recommendations remain appropriate. Clearly, cost distribution methods should be adequately designed to prevent cross-subsidization and yield equitable results. In its Order of the affiliate transaction audit of DE-Carolinas, the North Carolina Utilities Commission concluded the following.[5]

- DE-Carolinas should implement procedures to reduce the use of the three-factor allocator, both by increasing the amount of costs directly charged and assigned, and by developing better methods to directly charge for functions that are demand driven.
- The current approach for distributing Service Company costs does not clearly demonstrate that it results in fully distributed costs by individual functions, which is necessary for complying with the Code of Conduct and for preventing cross-subsidization.
- DE-Carolinas has the burden of proving that it pays no more than fully distributed costs on a service-by-service basis. Accordingly, DE-Carolinas should eliminate the effect of spreading overhead costs from the calculation of allocation percentages.
- The Service Company should develop a new method to track and assign overhead costs in a way that results in a better correlation between a business unit's use of a service function and the cost that it pays for that function. DE-Carolinas has the burden of proof in this regard.

The Company has implemented changes to address these concerns beginning in 2010. The methods by which the Service Company distributes costs to client companies have a direct bearing on DE-Ohio FE&G's cost of providing regulated service. It is therefore important that the Company keep the Commission and Staff apprised of interim changes until the next audit in Ohio. Silverpoint-Vantage recommends that DE-Ohio FE&G, upon request, make available to Commission Staff and future auditors the final reports from any third-party audits of Duke Energy affiliates that address these issues.

I-R5 **DE-Ohio should keep PUCO Staff informed of future improvements to Service Company charging practices.** (Refer to Finding VII-F2.)

Prior audit reports on Duke Energy affiliate transactions and cost distribution methods presented two recommendations related to the Service Company's charging practices, specifically:[6]

- increase the percentage of labor that the Service Company directly charges to business units;
- encourage employees to do more positive time reporting.

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[5]/ Order Ruling on Audit Recommendations, Docket No. E-7, Sub 795B, issued July 3, 2008.

[6]/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36.

Silverpoint-Vantage believes that these recommendations remain appropriate. In its Order on the affiliate transaction audit of DE-Carolinas, the North Carolina Utilities Commission concluded the following.[7]

- The Service Company should identify and implement methods to increase the percentage of direct labor charged to business units.
- It is appropriate for DE-Carolinas to encourage employees to do more positive time reporting, which should result in more appropriate cost assignment.

The lack of a common time reporting tool is not a satisfactory reason for the Company to delay needed training in this regard.

The Company has implemented changes to address these concerns beginning in 2010. The Service Company's charging practices have a direct bearing on DE-Ohio FE&G's cost of providing regulated service. It is therefore important that the Company keep the Commission and Staff apprised of interim changes until the next audit in Ohio. Silverpoint-Vantage recommends that DE-Ohio FE&G, upon request, make available to Commission Staff and future auditors the final reports from any third-party audits of Duke Energy affiliates that address these issues.

7/ Order Ruling on Audit Recommendations, Docket No. E-7, Sub 795B, issued July 3, 2008.

II COMPLIANCE

A. INTRODUCTION

DE-Ohio's initial Corporate Separation Plan (CSP) was approved in Case No. 99- 1658-EL-ETP. DE-Ohio filed its Amended Corporate Separation Plan as part of its Application to establish an ESP in Case No. 08-920-EL- SSO. The Commission approved DE- Ohio's ESP and Amended Corporate Separation Plan by order dated December 17, 2008. Consistent with Ohio Administrative Code 4901:1-37 and Ohio Revised Code 4928.17, DE-Ohio submitted its Second Amended Corporate Separation Plan. The Plan describes the processes and controls DE-Ohio, Inc., has implemented to comply with the recently enacted regulations. This Plan governs the corporate separation of noncompetitive retail electric service from competitive retail electric service as well as the products and services offered by certain affiliates of DE-Ohio. DE-Ohio's Cost Allocation Manual (CAM) contains agreements that generally describe how costs are allocated between, and among, DE-Ohio and its affiliates.

In this chapter, Silverpoint-Vantage will review each of the regulatory requirements of revised Chapter 4901:1-37 O.A.C. (Code) and DE-Ohio's compliance with each of those requirements. Some of the requirements will be addressed in more detail in other chapters of this report, however, the conclusions of those chapters will be summarized in this one.

B. COMPLIANCE REQUIREMENTS OF CHAPTER 4901:1-37 O.A.C.

This section of the Code lists the structural safeguards that the utility must have in place to comply. The Code states specifically:

> *(A) Structural Safeguards.*
>
> ***(1) Each electric utility and its affiliates that provide services to customers within the electric utility's service territory shall function independently of each other.***
>
> ***(2) Each electric utility and its affiliates that provide services to customers within the electric utility's service territory shall not share facilities and services if such sharing in any way violates paragraph (D) of this rule.***
>
> ***(3) Cross-subsidies between an electric utility and its affiliates are prohibited. An electric utility's operating employees and those of its affiliates shall function independently of each other.***
>
> ***(4) An electric utility may not share employees and/or facilities with any affiliate, if the sharing, in any way, violates paragraph (D) of this rule.***
>
> ***(5) An electric utility shall ensure that all shared employees appropriately record and charge their time based on fully allocated costs.***

(6) Transactions made in accordance with rules, regulations, or service agreements approved by the Federal Energy Regulatory Commission, Securities and Exchange Commission, and the Commission, which rules the electric utility, shall maintain in its cost allocation manual (CAM), and file with the Commission, shall provide a rebuttable presumption of compliance with the costing principles contained in this chapter.

II-F1 DE-Ohio has implemented effective structural safeguards.

As discussed in more detail in the appropriate sections below, DE-Ohio has implemented the structural safeguards as required by this section of the Code. As discussed later in this chapter, DE-Ohio has developed and implemented policies that prohibit DE-Ohio, or any of its affiliates, to mutually provide services to customers within its service territory. Each functions independently. Similarly, DE-Ohio does not share facilities or services with any affiliates that provide services to customers in its service territory. Accordingly, DE-Ohio complies with sections (1), (2), (4) and (5) above.[8]

Although there may be some imprecision in Service Company costs allocated to DE-Ohio-FE&G, it is important to note that there was no evidence that the Service Company intentionally allocated costs so as to provide an advantage to any Duke Energy affiliates. As discussed in Chapter VI and VII, there is some concern that the Service Company could do a better job of both directly assigning costs and allocating some of its common costs. However, it is generally true that most utilities could do better at assigning costs. There is a trade-off between the precision of tracking costs and the additional cost incurred to track costs to that level of detail.

(B) Separate Accounting

Each electric utility and its affiliates shall maintain, in accordance with generally accepted accounting principles and an applicable uniform system of accounts, books, records, and accounts that are separate from the books, records, and accounts of its affiliates.

II-F2 DE-Ohio complies with the regulatory requirement for it and its affiliates to maintain separate books, records and accounts.

DE-Ohio and its affiliates maintain, in accordance with generally accepted accounting principles and an applicable uniform system of accounts, separate books, records and accounts. Thus, DE-Ohio complies with section (B) above.

(C) Financial Arrangements

Unless otherwise approved by the Commission, the financial arrangements of an electric utility are subject to the following restrictions.

8/ In addition to the discussion later in this chapter, see also DRs 3, 4, 11, 12, 25 and 26.

(1) Any indebtedness incurred by an affiliate shall be without recourse to the electric utility.

(2) An electric utility shall not enter into any agreement with terms under which the electric utility is obligated to commit funds to maintain the financial viability of an affiliate.

(3) An electric utility shall not make any investment in an affiliate, under any circumstances, in which the electric utility would be liable for the debts and/or liabilities of the affiliate incurred as a result of actions or omissions of an affiliate.

(4) An electric utility shall not issue any security for the purpose of financing the acquisition, ownership, or operation of an affiliate.

(5) An electric utility shall not assume any obligation or liability as a guarantor, endorser, surety, or otherwise with respect to any security of an affiliate.

(6) An electric utility shall not pledge, mortgage, or use as collateral any assets of the electric utility for the benefit of an affiliate.

II-F3 DE-Ohio complies with the regulatory requirements specified in section (C) of the Code. DE-Ohio's compliance with this section of the Code is discussed in more detail in Chapter IV of this report.

This finding is explained in more detail in Chapter IV of this report.

(D) Code of Conduct

(1) The electric utility shall not release any proprietary customer information (e.g., individual customer load profiles or billing histories) to an affiliate, or otherwise, without the prior authorization of the customer, except as required by a regulatory agency or court of law.

(2) On or after the effective date of this chapter, the electric utility shall make customer lists, which include name, address, and telephone number, available on a nondiscriminatory basis to all nonaffiliated and affiliated certified retail electric service providers transacting business in its service territory, unless otherwise directed by the customer. This provision does not apply to customer-specific information, obtained with proper authorization, necessary to fulfill the terms of a contract, or information relating to the provision of general and administrative support services. This information shall not be used by the certified retail electric service providers for any other purpose than the marketing of electric service to the customer.

(3) Employees of the electric utility's affiliates shall not have access to any information about the electric utility's transmission or distribution systems (e.g., system operations, capability, price, curtailments, and ancillary services) that is not contemporaneously available, readily accessible, and in the same form and manner available to a nonaffiliated competitors providing retail electric service.

(4) An electric utility shall treat as confidential all information obtained from a competitive retail electric service provider, both affiliated and nonaffiliated, and shall not release such information, unless a competitive retail electric service provider provides authorization to do so or unless the information was or thereafter becomes available to the public other than as a result of disclosure by the electric utility.

(5) The electric utility shall not tie (or allow an affiliate to tie), as defined by state and federal antitrust laws, or otherwise condition the provision of the electric utility's regulated services, discounts, rebates, fee waivers, or any other waivers of the electric utility's ordinary terms and conditions of service, including but not limited to tariff provisions, to the taking of any goods and/or services from the electric utility's affiliates.

(6) The electric utility shall ensure effective competition in the provision of retail electric service by avoiding anticompetitive subsidies flowing from a noncompetitive retail electric service to a competitive retail electric service or to a product or service other than retail electric service, and vice versa.

(7) The electric utility, upon request from a customer, shall provide a complete list of all competitive retail electric service providers operating on the system, but shall not endorse any competitive retail electric service providers, indicate that an electric services company is an affiliate, or indicate that any competitive retail electric service provider will receive preference because of an affiliate relationship.

(8) The electric utility shall use reasonable efforts to ensure retail electric service consumers protection against unreasonable sales practices, market deficiencies, and market power and the electric utility's compliance officer shall promptly report any such unreasonable sales practices, market deficiencies, and market power to the director of the utilities department (or their designee).

(9) Employees of the electric utility or persons representing the electric utility shall not indicate a preference for an affiliated electric services company.

(10) The electric utility shall provide comparable access to products and services related to tariffed products and services and specifically comply with the following:

(a) An electric utility shall be prohibited from unduly discriminating in the offering of its products and/or services.

(b) The electric utility shall apply all tariff provisions in the same manner to the same or similarly situated entities, regardless of any affiliation or non-affiliation.

(c) The electric utility shall not, through a tariff provision, a contract, or otherwise, gives its affiliates or customers of affiliates preferential treatment or advantages over nonaffiliated competitors of retail electric service or their customers in matters relating to any product and/or service.

(d) The electric utility shall strictly follow all tariff provisions.

(e) Except to the extent allowed by any applicable law, regulation, or commission order, the electric utility shall not be permitted to provide discounts, rebates, or fee waivers for any retail electric service.

(11) Shared representatives or shared employees of the electric utility and affiliated electric services company shall clearly disclose upon whose behalf their public representations are being made when such representations concern the entity's provision of electric services.

II-F4 <u>DE-Ohio complies with section (D) of the Code as stated above. DE-Ohio's compliance with each of the specific eleven requirements is discussed below.</u>

In many ways, one can think of a utility's Code of Conduct as an umbrella compliance document that covers all of the important aspects of a utility's relationships with its affiliates. For the Company's Code of Conduct to comply, it must encompass all of the eleven requirements listed in the Code. DE-Ohio's Code of Conduct is included in its Corporate Separation Plan. DE-Ohio's Code of Conduct conforms to the regulation and addresses each of the provisions. However, to understand how DE-Ohio complies. Silverpoint-Vantage requested information from DE-Ohio that supports how DE-Ohio complies and verified, through interviews, that DE-Ohio actually follows established policies, procedures and practices.

With regard to section (1) above, DE-Ohio meets this requirement through procedures that virtually make it impossible for the customer confidential information to be provided to an affiliate without customer permission. The Customer Service Center will only provide customer information to the Commission, or other parties working on behalf of the customer, if it has the customer's account number or permission from the customer to release the information.[9] The key to complying with this provision is to make certain that the employees that have access to this information are keenly aware of the importance of keeping the customer-specific information confidential. At DE-Ohio this is accomplished not only through the Code of Conduct training, but also by providing the affected employees with detailed information about the need to keep the information confidential as well as explaining the consequences of inadvertently leaking this information. Employees are provided written procedures on how to maintain the confidentiality of the customer information, why it is important to keep the information confidential, as well as procedures and forms to be used in the event the customer information in leaked.[10]

With regard to compliance with section (2) above, DE-Ohio makes customer lists available to retail suppliers so they can actively market their services. The information to be provided under this provision is referred to as pre-enrollment data. It provides the name, address and telephone number of the customer, unless the customer directs otherwise. This

[9]/ See DR 28.

[10]/ See DR 28 attachment.

information is provided in accordance with DE-Ohio's tariff Section VII, End Use Customer Enrollment Process.[11]

With regard to compliance with section (3) above, DE-Ohio does not allow access to any information about transmission or distribution systems that would convey a competitive advantage to any affiliate that it does not contemporaneously provide to any non-affiliated competitor of retail electric service. A portion of this compliance is governed by Federal Energy Regulatory (FERC) regulations which re-enforces DE-Ohio's compliance with the PUCO Code.[12] In addition, DE-Ohio's includes in its Code of Conduct training, the need to protect this operational information.

With regard to compliance with section (4) above, DE-Ohio must provide confidential treatment for all information obtained from both affiliated and non-affiliated competitors for retail electric service. The protocols to facilitate the transfer of the information and maintaining its confidentiality is accomplished by adherence to guidelines provided in Electronic Data Interchange Guidelines, developed jointly by the utilities in Ohio and the competitive retail electric suppliers.[13]

Section (5) above prohibits DE-Ohio from providing discounts, rebates, fee waivers, or any other waivers from tariff provisions. That is, DE-Ohio is not allowed to tie the provision of any affiliate so as to provide it a competitive advantage. Based on interviews and a review of responses to data requests, DE-Ohio provides regulated services to its affiliates in strict conformance with its tariffs.[14] Thus, DE-Ohio is in compliance with section (5).

With regard to section (6) above, DE-Ohio is prohibited from providing any anticompetitive subsidies to its affiliates that provide retail electric services. DE-Ohio accomplishes this by prohibiting the endorsement of any competitive retail electric service provider. Further, DE-Ohio's affiliate transaction policies and procedures ensure that all employee sharing and affiliate transactions are at fully embedded cost pursuant to PUCO-approved service agreements and in accordance with FERC affiliate pricing rules and regulations. A comprehensive review of DE-Ohio's service agreements and compliance with the costing provisions contained therein is provided in Chapters III, V and VI of this report. Although some exceptions are noted in those chapters, the conclusion is that affiliate transaction accounting system and methods are sufficient to ensure the accuracy and reliability of affiliate transaction data.

With regard to section (7) above, DE-Ohio must, upon request from a customer, provide a list of all competitive retail electric service providers. DE-Ohio accomplishes compliance with this section of the regulation by referring all customer requests to either, the PUCO

11/ See DR 27 attachment.

12/ Interview #2

13/ See DRs 27 and 30 attachment.

14/ See DR 49 and Interview #2

which maintains a list of all approved retail electric service providers, or, DE-Ohio's web site (www.Duke_energy.com) which also provides the list of all approved retail electric service providers.[15] This procedure ensures compliance with the regulation.

With regard to DE-Ohio's compliance with sections (8) and (9) above, the Code of Conduct training alerts employees to identify and report to the Compliance Department any unreasonable sales practices, market deficiencies or market power exercised by any retail electric service supplier. Likewise, a DE-Ohio employee cannot indicate a preference for an affiliated electric service company. Both of these concerns are reviewed in the employee training regarding Ohio's Rules on Corporate Separation.[16] The training provides phone numbers and contact information to report any abuses.

The specific provisions of section (10) above are intended to make certain that a level playing field with regard to the provision of retail products and services. No participant in these markets should be provided an advantage relative to another participant regardless of whether the entity is an affiliate of DE-Ohio or not. The maintenance of the level playing field is accomplished by complying with the first 9 sections of this regulation. As DE-Ohio complies with sections (1) through (9) it also complies with (10) and, by inference, supports a level playing field for the provision of retail electric products and services.

With regard to DE-Ohio's compliance with section (11) above, the Code of Conduct training makes clear that "shared service employees must clearly disclose who they represent (the entity) where representations concern the provision of electric service".[17] Once again, the compliance is accomplished through the employee training on these issues and making employees aware of the issue, the need to comply and the potential consequences of not complying. Based on the discussion above, Silverpoint-Vantage finds that DE-Ohio is in compliance with section (D), Code of Conduct, of the PUCO regulation.

(E) Emergency

(1) Notwithstanding the foregoing, in a declared emergency situation, an electric utility may take actions necessary to ensure public safety and system reliability.

(2) The electric utility shall maintain a log of all such actions that do not comply with this chapter, and such log shall be subject to review by the commission and its staff.

This emergency provision was not applicable during the audit period. Accordingly, DE-Ohio was in compliance.

2. <u>4901:1-37-05 Application</u>

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[15]/ Interview #2.

[16]/ See DR 22 attachment and Interview #2

[17]/ See DR 22 at page 14 of 21.

This section of the regulation provides the details to be included in the utility's Corporate Separation Plan. The Plan must be approved by the Commission. Specifically, the Code states:

(B) The proposed corporate separation plan shall be a stand alone document that, at a minimum, includes the following:

(1) Provisions that maintain structural safeguards.

(2) Provisions that maintain separate accounting.

(3) A list of all current affiliates identifying each affiliate's product(s) and/or service(s) that it provides.

(4) A list identifying and describing the financial arrangements between the electric utility and all affiliates.

(5) A code of conduct policy that complies with this chapter and that employees of the electric utility and affiliates must follow.

(6) A description of any joint advertising and/or joint marketing activities between the electric utility and an affiliate that the electric utility intends to utilize, including when and where the name and logo of the electric utility will be utilized, and explain how such activities will comply with this chapter.

(7) Provisions related to maintaining a cost allocation manual (CAM).

(8) A description and timeline of all planned education and training, throughout the holding company structure, to ensure that electric utility and affiliate employees know and can implement the policies and procedures of this rule. The information shall be maintained on the electric utilities' public web site.

(9) A copy of a policy statement to be signed by electric utility and affiliate employees who have access to any nonpublic electric utility information, which indicates that they are aware of, have read, and will follow all policies and procedures regarding limitation on the use of nonpublic electric utility information. The statement will include a provision stating that failure to observe these limitations will result in appropriate disciplinary action.

(10) A description of the internal compliance monitoring procedures and the methods for corrective action for compliance with this chapter.

(11) A designation of the electric utility's compliance officer who will be the contact for the commission and staff on corporate separation matters. The compliance officer shall certify that the approved corporation separation plan is up to date and in compliance with the commission's rules and orders. The electric utility shall notify the commission and the director of the utilities department (or their designee) of changes in the compliance officer.

(12) A detailed description outlining how the electric utility and its affiliates will comply with this chapter. The format shall identify the provision and then provide the description.

(13) A detailed listing of the electric utility's electric services and the electric utility's transmission and distribution affiliates' electric services.

(14) A complaint procedure to address issues concerning compliance with this chapter, which, at a minimum, shall include the following:

(a) All complaints, whether written or verbal, shall be referred to the compliance officer designated by the electric utility to handle corporate separation matters or the compliance officer's designee.

(b) The complaint shall be acknowledged within five working days of its receipt.

(c) A written statement of the complaint shall be prepared and include the name of the complainant, a detailed factual report of the complaint, all relevant dates, the entities involved, the employees involved, and the specific claim.

(d) The results of the preliminary investigation shall be provided to the complainant in writing within thirty days after the complaint was received, including a description of any course of action that was taken.

(e) The written statements of the complaints and resulting investigations required by paragraphs (B)(14)(c) and (B)(14)(d) of this rule shall be kept in the CAM, in accordance with rule 4901:1-37-08 of the Administrative Code for a period of not less than three years.

(f) This complaint procedure shall not in any way limit the rights of any person to file a formal complaint with the commission.

II-F5 The Corporate Separation Plan that DE-Ohio submitted in Case No. 09-495-EL-UNC on June 11, 2009 conforms to the requirements of Chapter 4901:1-37-05.

On June 11, 2009, DE-Ohio filed its Second Amended Corporate Separation Plan. The filing was necessary for DE-Ohio to comply with the revised regulations. The revised regulation details, with specificity, the information that must be included in the corporate separation plan. In response to a data request, DE-Ohio provided a copy of its Amended Corporate Separation Plan and Second Amended Corporate Separation Plan. Silverpoint-Vantage's focus was on the Second Amended Corporate Separation Plan as that is the plan before the PUCO for its immediate consideration.

DE-Ohio's Second Amended Corporate Separation Plan speaks to every provision of the regulation. The information submitted with the CSP is generally consistent with the responses Silverpoint-Vantage received to data requests and in interviews with DE-Ohio employees. During our discovery process, two agreements involving DE-Ohio and affiliates were provided but not included in the Corporate Separation Plan or the CAM. These agreements are the Facilities Operation Agreement[18] and the Receivables Loan Agreement. The Facilities Operation Agreement is a 102-page document that describes the agreement between Cincinnati Gas & Electric Company (CG&E) and Union Light, Heat and Power Company (ULH&P) where CG&E allows ULH&P to use its step-up transformer banks at the East Bend, Miami Fort, and Woodsdale stations. The agreement includes the cost of owning, operating, and maintaining these transmission facilities which were not included in CG&E's open access transmission tariff which ULH&P has agreed to pay. However, based on subsequent discussions with Duke Energy personnel the auditors concluded that this agreement is subject to FERC regulation and as such did not need to be included in the Cost Separation Plan. The Receivables Loan Agreement is between CG&E, Cinergy Receivables Company, a special purpose entity, and two non-affiliated commercial banks. The arrangement outlined in the agreement allows CG&E to finance its accounts receivables. The auditors believe that this agreement should be identified in the Corporate Separation Plan.

3. <u>4901:1-37-07 Access to Books and Records</u>

Compliance with the revised Code requires the utility to provide appropriate access to books and records. The Code states specifically:

(A) The electric utility shall maintain records sufficient to demonstrate compliance with this chapter, and shall produce, upon the request of staff, all books, accounts, and/or other pertinent records kept by an electric utility or its affiliates as they may relate to the businesses for which corporate separation is required under section <u>4928.17</u> of the Revised Code, including those required under section <u>4928.145</u> of the Revised Code.

(B) The staff may investigate such electric utility and/or affiliate operations and the interrelationship of those operations at the staff's discretion. In addition, the employees and officers of the electric utility and its affiliates shall be made available for informational interviews, at a mutually agreed time and place, as required by the staff to ensure proper separations are being followed.

(C) If such employees, officers, books, and records cannot be reasonably made available to the staff in the state of Ohio, then upon request of the staff, the appropriate electric utility or affiliate shall reimburse the commission for reasonable travel expenses incurred.

II-F6 <u>Based on DE-Ohio's responses during this investigation, one must conclude that DE-Ohio is in compliance with this provision of the regulation.</u>

With few exceptions, Silverpoint-Vantage was provided complete cooperation from DE-Ohio with the provision of requested information and access to personnel for interviews. The few exceptions usually related to delays in responding, lack of clarity in the request, or incomplete responses. However, these problems were generally resolved through follow-

[18]/ See DR 70 and attachment.

up requests or interviews. Most importantly, Silverpoint-Vantage does not believe at this point that any information was not provided that would change its findings and recommendations.

4. <u>4901:1-37-08 Cost Allocation Manual (CAM)</u>

The regulatory requirements related to the CAM and its contents are provided in this section of the revised regulation. The requirements state as follows.

(A) Each electric utility that receives products and/or services from an affiliate and/or that provides products and/or services to an affiliate shall maintain information in the CAM, documenting how costs are allocated between the electric utility and affiliates and the regulated and non-regulated operations.

(B) The CAM will be maintained by the electric utility.

(C) The CAM is intended to ensure the commission that no cross-subsidization is occurring between the electric utility and its affiliates.

(D) The CAM will include:

(1) An organization chart of the holding company, depicting all affiliates, as well as a description of activities in which the affiliates are involved.

(2) A description of all assets, services, and products provided to and from the electric utility and its affiliates.

(3) All documentation including written agreements, accounting bulletins, procedures, work order manuals, or related documents, which govern how costs are allocated between affiliates.

(4) A copy of the job description of each shared employee.

(5) A list of names and job summaries for shared consultants and shared independent contractors.

(6) A copy of all transferred employees' (from the electric utility to an affiliate or vice versa) previous and new job descriptions.

(7) A log detailing each instance in which the electric utility exercised discretion in the application of its tariff provisions.

(8) A log of all complaints brought to the electric utility regarding this chapter.

(9) A copy of the minutes of each board of directors meeting, where it shall be maintained for a minimum of three years.

(E) The method for charging costs and transferring assets shall be based on fully allocated costs.

(F) The costs should be traceable to the books of the applicable corporate entity.

(G) The electric utility and affiliates shall maintain all underlying affiliate transaction information for a minimum of three years.

(H) Following approval of a corporate separation plan, an electric utility shall provide the director of the utilities department (or their designee) with a summary of any changes in the CAM at least every twelve months.

(I) The compliance officer designated by the electric utility will act as the contact for the staff when staff seeks data regarding affiliate transactions, personnel transfers, and the sharing of employees.

(J) The staff may perform an audit of the CAM in order to ensure compliance with this rule.

II-F7 DE-Ohio's CAM complies with the provisions listed in this section of the regulation with the possible exception of an agreement that should have been included per (D)(3).

DE-Ohio provided the auditors with a copy of its current CAM and a copy of its 2008 CAM.[19] The current CAM is a 401-page document that addresses, point by point, each of the regulatory requirements listed above. The only exceptions noted were the lack of inclusion of the Facilities Operation Agreement and Receivables Loan Agreement. These documents were described earlier in the section on the 4901:1-37-05 Application. Based on subsequent discovery, the auditors concluded that the Facilities Operation Agreement is FERC jurisdictional and does not have to be included in the CAM.

II-R1 Future CAMs submitted by DE-Ohio should include all agreements that describe the allocation of costs among its affiliates. (Refer to Finding II-F7)

The Commission's regulation specifically refers to all documentation and agreements that describe cost allocations among its affiliates. During the discovery process of this audit, an agreement with an affiliate was provided that was not also included in the CAM. DE-Ohio needs to be more diligent and thorough in its determination as to which documents and agreements to include in its CAM.

5. 4901:1-37-09 Sale or Transfer of Generating Assets

In the event that DE-Ohio decides to sell of transfer any of its generating assets, it must comply with the following requirements.

(A) Consistent with division (E) of section 4928.17 of the Revised Code, an electric utility shall not sell or transfer any generating asset it wholly or partly owns without prior commission approval.

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[19]/ Response to DR 5.

(B) An electric utility may apply for commission approval to sell or transfer its generating assets by filing an application to sell or transfer.

(C) An application to sell or transfer generating assets shall, at a minimum:

(1) Clearly set forth the object and purpose of the sale or transfer, and the terms and conditions of the same.

(2) Demonstrate how the sale or transfer will affect the current and future standard service offer established pursuant to section 4928.141 of the Revised Code.

(3) Demonstrate how the proposed sale or transfer will affect the public interest.

(4) State the fair market value and book value of all property to be transferred from the electric utility, and state how the fair market value was determined.

(D) Upon the filing of such application, the commission may fix a time and place for a hearing if the application appears to be unjust, unreasonable, or not in the public interest. The commission shall fix a time and place for a hearing with respect to any application that proposes to alter the jurisdiction of the commission over a generation asset.

(E) If, after such hearing or in the case that no hearing is required, the commission is satisfied that the sale or transfer is just, reasonable, and in the public interest, it shall issue an order approving the application to sell or transfer.

(F) Staff shall have access to all books, accounts, and/or other pertinent records maintained by the transferor and transferee as related to the application to sell or transfer generating assets and in accordance with rule 4901:1-37-07 of the Administrative Code.

To date, DE-Ohio has not requested the sale or transfer of any of its generating assets and at this time these provisions of the regulation are not applicable.

C. OVERALL CONCLUSION AT DE-OHIO

As anyone familiar with the utility industry knows, compliance has become a growing initiative in recent years. Utilities must comply with Sarbanes-Oxley requirements, FERC requirements, NERC requirements for Critical Infrastructure Protection, as well as state regulations. Unfortunately, demonstrating compliance is much like trying to prove a negative. Thus, for a utility to be confident that it is in fact in compliance depends heavily on well-communicated policies and procedures to prevent violations and effective training of employees.

II-F8 DE-Ohio provides appropriate training on relevant policies and procedures as well as the regulations on corporate separation.

An effective compliance program depends on employees knowing the rules they must follow, knowing who is responsible for maintaining compliance and understanding what to do. The relevant training at DE-Ohio consists of three courses. One course is the Code of

Business Ethics that all employees must successfully complete.[20] The second course is FERC Standards of Conduct and Affiliate Restrictions training that transmission function, merchant function and identified shared support employees take annually. The third is a course on Ohio's Rules on Corporate Separation that employees who deal specifically with these matters must take.[21] The Compliance Department works with Human Resources (HR) and other relevant departments to identify the employees that need to take the course on Corporate Separation. The training audience is identified, the training is deployed to the audience, the Compliance Department reviews to identify non-compliance and reminders are sent to those not in compliance to ensure all identified employees take the required course.

The Compliance Department utilizes compliance software OpenPages (OP) to monitor, track and document compliance with regulatory requirements, processes and procedures. Once the information is inputted to OP, the program will track to make certain the responsible employee completes the course by sending email reminders. Past due notices are sent to the employee, his superior and the Compliance Department. The Compliance Department also uses an interface with the HR database to identify any employment changes for employees assigned responsibility in OP to ensure each requirement is always assigned to a current active employee.

Silverpoint-Vantage has reviewed the material presented in both of the classes mentioned above and finds it provides the necessary material to assist DE-Ohio in maintaining an effective compliance program. In other sections of this report, the auditors have discussed the policies and procedures that DE-Ohio has implemented to assure its compliance with PUCO corporate separation requirement. Although there always seems to be room for improvement, Silverpoint-Vantage concluded that DE-Ohio's policies and procedures are sufficient to maintain compliance.

20/ See DR 82 and attachment.

21/ See DR 22 and attachment.

III. AFFILIATE TRANSACTION CATEGORIES AND ACCOUNTING

A. INTRODUCTION

DE-Ohio engages in many kinds of transactions with its Service Company, with its sister utilities, and with other non-utility affiliates. Each type is subject to certain terms, conditions, and pricing methods. In this chapter, Silverpoint-Vantage identifies all possible ways in which transactions can occur between DE-Ohio and its affiliates. It also provides its assessment of the accuracy and reliability of Duke Energy's affiliate transaction accounting methods. In that regard, Silverpoint-Vantage provides an overview of the accounting systems the Company used to record affiliate transactions during the audit period, and discusses the Company's transition to one common system in July 2008. In addition, the auditors discuss the Company's time reporting and payroll processes, and the method it uses to calculate hourly labor charges. The team also provides an assessment of the Company's accounting documentation and controls, and evaluates billing and settlement practices.

B. CATEGORIES OF AFFILIATE TRANSACTIONS

There are thirteen agreements in place that govern specific types of transactions between DE-Ohio and its affiliates. These agreements are:

- Service Company Utility Service Agreement;
- Operating Companies Service Agreement;
- Operating Company/Non-utility Companies Service Agreement;
- Utility Money Pool Agreement;
- Agreement for Filing Consolidated Income Tax Returns and for Allocation of Consolidated Income Tax Liabilities and Benefits;
- Inter-company Asset Transfer Agreement;
- Utility-Non-utility Asset Transfer Agreement;
- Agreement for Gypsum and FGD Waste Material Disposal Services;
- Joint Transmission System Planning and Operating Agreement;
- Miami Fort Unit 6 Operation Agreement;
- Gas and Propane Services Agreement;
- Facilities Operation Agreement;
- Receivables Loan Agreement.

The Commission approved the first five of these agreements in connection with the merger between Cinergy and Duke Energy. The last five agreements in this list were executed before the merger and were not subsequently modified to reflect naming changes. Specifically, after the merger, Cincinnati Gas & Electric Company (CG&E) was renamed Duke Energy Ohio, PSI Energy, Inc. (PSI) was renamed Duke Energy Indiana (DE-Indiana), Union Light, Heat and Power Company (ULH&P) was renamed Duke Energy Kentucky (DE-Kentucky), and Duke Power Company, LLC was renamed Duke Energy Carolinas (DE-

Carolinas). The terms "Duke Energy Ohio" and "CG&E" as used in these agreements refer to the legal entity, and as such include both regulated and non-regulated segments.[22]

Silverpoint-Vantage discussed these agreements with Duke Energy personnel, and found that the Miami Fort Agreement and the Gypsum and FGD Agreement involve only the non-regulated portion of DE-Ohio.[23] Eleven of the thirteen agreements described above are therefore within the scope of this audit, which focuses on transactions involving DE-Ohio's regulated operations. The following discussion provides a brief summary of the purpose, participants, and pricing terms of the agreements.[24]

AFFILIATE AGREEMENTS

III-F1 All affiliate transactions involving DE-Ohio FE&G take place subject to formal written agreements.

The nature of affiliate transactions should be well defined, and formal agreements are the best method for doing so. All stakeholders should clearly understand the relevant terms and conditions, including pricing methods, for a given type of affiliate transaction in order to help minimize the potential for cross-subsidization. DE-Ohio participates in fourteen different types of affiliate transactions, all but two of which involve DE-Ohio FE&G regulated operations. All of these transactions are covered by either a formal written agreement or, in the case of transactions involving DE-Ohio's non-regulated insurance affiliate, formal declaration pages.

Service Company Utility Service Agreement

Two versions of the Service Company Utility Service Agreement (Service Company Agreement) were in effect during the audit period. In the earlier version, dated January 2, 2007, the client companies receiving services are DE-Ohio, DE-Indiana, DE-Kentucky, DE-Carolinas, and Miami Power Corporation (Miami Power).[25] The parties providing services are Duke Energy Business Services (DEBS) and Duke Energy Shared Services (DESS), collectively the Service Company. In the later version, effective September 1, 2008, DEBS is identified as the successor in interest to DESS. The two versions of the agreement are very similar.[26]

22/ Response to DR4.

23/ Interviews of November 10-11, 2009.

24/ Agreements provided in response to DRs 3, 5, 52, and 70.

25/ The Service Company has a separate agreement with non-utility affiliates that has essentially the same terms. (Response to DR79)

26/ The September 2008 version of the agreement contains new language that expands the general definition of services to include pass-through payments (*e.g.*, employee benefits) made by the Service Company on behalf of client companies.

Under the Agreement, the Service Company provides to its client companies the 23 business functions listed in the following Exhibit.

Compliance Audit of Duke Energy Ohio

Exhibit III-1
Service Company Functions

Accounting	Human Resources	Information Systems
Finance	Public Affairs	Legal
Internal Auditing	Investor Relations	Planning
Executive	Transportation	Rates
Facilities	Meters	Materials Management
Fuels	Rights of Way	Marketing/Customer Relations
Power Engineering/Construction	Power and Gas Planning/Operations	Environmental, Health and Safety
System Maintenance	T&D Engineering/Construction	

Appendix A to the Service Company Agreement briefly describes each function and specifies the cost allocation method applicable to each. Pricing is based on fully distributed costs, which the agreement defines as the sum of direct costs, indirect costs, and costs of capital. Charges for salaries should be based on time records, and calculated on the basis of employee labor costs plus fringe benefits, indirect labor costs, and payroll taxes. Indirect costs for each functional group should be directly assigned when identifiable to a particular activity, project, work order, process, or responsibility center. Under the agreement, the indirect costs of a functional group, when not identified specifically, should be distributed "in relationship to the directly assigned costs of the Function."

When work applies to two or more companies, the Service Company may allocate the cost of that work among benefiting companies, using the allocation ratios specified in the agreement; these ratios are listed in the following Exhibit.[27]

[27]/ The Company added two new ratios, the number of meters and O&M expenditures ratios, to the September 2008 version of the agreement, but they are not currently used. The new version makes slight changes in the definitions of certain ratios to reflect the distinction between electric and natural gas distribution.

Compliance Audit of Duke Energy Ohio

Exhibit III-2
Service Company Allocation Ratios

Sales	Electric peak load	Number of customers
Number of employees	Construction expenditures	Number of CPU seconds
Revenues	Inventory	Procurement spending
Square footage	Gross margin	Labor dollars
Transmission circuit miles	Distribution line miles	Number of IS servers
Number of PC workstations	Net plant, property, and equipment	Generating unit MW capability
Number of meters	O&M Expenditures	"Three-factor"

Operating Companies Service Agreement

Two versions of the Operating Companies Service Agreement (Operating Company Agreement) were in effect during the audit period; the primary difference is in pricing language. The parties to both the January 2, 2007 and September 1, 2008 versions of the agreement are Duke Energy's operating public utilities DE-Ohio, DE-Indiana, DE-Kentucky, DE-Carolinas, and Miami Power. The Operating Company Agreement authorizes the utility parties to perform services for one another in accordance with formal Service Requests. These services may include, but are not limited to, areas such as engineering and construction, operation and maintenance, installation services, equipment testing, generation technical support, environmental, health and safety, and procurement. A utility may lend employees to another so long as such loans do not interfere with the providing utility's business operations or utility responsibilities.

The January 2007 version of the Agreement states that utilities must directly charge for all services at fully distributed cost, which includes direct costs, indirect costs, and costs of capital. The September 2008 version explains that different pricing terms are required for wholesale merchant or electric generation-related services. Such services provided by DE-Indiana, DE-Kentucky, or DE-Carolinas to DE-Ohio's non-regulated generation business must be priced at the higher of cost or market, and those services provided to these utilities by DE-Ohio's non-regulated generation business must be priced at no more than market. The Agreement incorporates by reference "DE-Carolinas Conditions," which impose single transaction and aggregate annual limits for pricing at fully distributed cost. Transactions beyond these limits are subject to cost versus market pricing rules set forth in the North Carolina Code of Conduct.

Operating Company/Non-utility Companies Service Agreement

The parties to the Operating Company/Non-utility Companies Service Agreement (Non-utility Agreement) are DE-Ohio and the non-utility affiliates who executed the agreement.[28] The current version of the agreement is dated January 2, 2007. The terms of the Non-utility Agreement are similar to those in the agreement among the operating companies, but with more detailed liability and indemnification language. Under the agreement, services must be performed in accordance with formal Service Requests, and pricing must be based on fully distributed costs. DE-Ohio can provide the same services for a non-utility affiliate that it does for other utilities. Non-utility affiliates may provide services in such areas as meter reading; materials management, vegetation management; information technology (IT) services; monitoring, surveying, inspecting, constructing, locating, and marking of overhead and underground utility facilities; and marketing and customer relations. The parties may lend employees to one another so long as such loans do not interfere with the utility's responsibilities or business operations.

Utility Money Pool Agreement

The parties to the current Utility Money Pool Agreement (Money Pool Agreement), dated November 1, 2008, are Duke Energy, Cinergy, DE-Ohio, DE-Kentucky, DE-Indiana, DE-Carolinas, Miami Power, KO Transmission Company, and DEBS.[29] The purpose of the agreement is to establish a cash management program to coordinate and provide for certain short-term cash and working capital requirements of the parties. Under the agreement, each party (except for Duke Energy and Cinergy) has the right to make short-term borrowings or request loans from the pool subject to defined borrowing limits. The agreement describes interest and repayment terms, as well the as the allocation of income and earnings from the investment of excess funds. The operation of the money pool is handled by the Service Company on an at-cost basis.

Agreement for Filing Consolidated Tax Returns and for Allocation of Consolidated Income Tax Liabilities and Benefits

Duke Energy and its "members" are the parties to the current Agreement for Filing Consolidated Tax Returns and for Allocation of Consolidated Income Tax Liabilities and Benefits (Tax Sharing Agreement); the current version of the agreement is dated October 1, 2008.[30] Members include DE-Ohio, its regulated utility affiliates, and a large number of its unregulated affiliates. Under the agreement, Duke Energy and its members agree to join in the filing of a consolidated annual Federal income tax return and to allocate the Federal tax

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28/ DE-Ohio's utility affiliates have entered into similar agreements.

29/ This version is substantially the same as the January 2, 2007 version, which was amended to reflect the merger of DEBS and DESS.

30/ Two versions of the agreement were in effect during the audit period. The current version is substantially similar to the prior version dated January 2, 2007, which the Company amended to reflect party name changes, revise the list of signatories, and clarify terms.

liabilities and benefits among the members. The Agreement describes the tax allocation procedures using the "corporate taxable income" method. It also indicates that state and local taxes will be allocated where appropriate between members using principles similar to those used to allocate the consolidated Federal income tax liability.

Joint Transmission System Planning and Operating Agreement

CG&E, PSI, and Cinergy Services (the pre-merger entity later renamed DESS) entered into the Joint Transmission System Planning and Operating Agreement (Joint Transmission Agreement) on October 26, 2001. The agreement reflects the parties desire to continue planning and operating their electric transmission systems as an integrated utility system. The operating companies are defined as PSI and CG&E, which, for the purposes of this agreement, includes UHL&P. It designates Cinergy Services as an agent of the operating companies for certain administrative and coordination functions. Costs associated with the planning, construction, and direct operation and maintenance of the combined bulk transmission system are initially assigned to the operating company that incurs the cost. The agreement describes the process for allocating total annual costs between the operating companies, and requires a reconciling net transfer payment each year. The agreement also describes the process for allocating transmission service revenues.

Miami Fort Unit 6 Operation Agreement

The parties to the Miami Fort Unit 6 Operation Agreement (Miami Fort Agreement) are CG&E and ULH&P. The agreement was entered into on January 25, 2006 and was effective as of January 1, 2006; the initial term is twenty years, which may be extended upon mutual consent. CG&E agreed to operate and maintain Miami Fort Station Unit 6 along with any facilities, supplies, or equipment also used in connection with other generating units at the station. CG&E agreed to make additions, replacements, and retirements to the common facilities in accordance with good utility practice, which includes the maintenance of reasonable coal and fuel oil reserves. Under the agreement, ULH&P must "make Cincinnati whole" for any and all expenses and costs, including overheads, incurred on its behalf. Expenses not otherwise directly assignable to Unit 6 will be allocated on the basis of cost responsibility as mutually agreed upon by the parties.

Facilities Operation Agreement

The parties to the Facilities Operation Agreement are CG&E and ULH&P. The agreement was entered into on September 27, 2004 and was effective as of January 1, 2006. CG&E agreed to allow ULH&P to use its step-up transformer banks at the East Bend, Miami Fort, and Woodsdale Stations. The cost of owning, operating, and maintaining these transmission facilities was not included in CG&E's open access transmission tariff, and ULH&P agreed to a monthly fee of $161,148 to cover these costs.

Gas and Propane Services Agreement

The parties to the Gas and Propane Services Agreement (Gas and Propane Agreement) are CG&E and ULH&P. The agreement was entered into on January 25, 2006 and was effective as of January 1, 2006. CG&E had been the sole owner of the Woodsdale Generating Station, and transferred its interest and title to UHL&P. Under the agreement, CG&E will provide to ULH&P certain operation and maintenance (O&M) services related to the Woodsdale natural gas and propane facilities. These services include such activities as conducting regular inspections, performing leak and corrosion surveys, and calibration. Each month, ULH&P must pay CG&E the fully allocated costs for performing the services.

Agreement for Gypsum and FGD Waste Material Disposal Services

DE-Ohio and DE-Kentucky entered into the Agreement for Gypsum and FGD Waste Material Disposal Services (Gypsum and FGD Agreement) on April 24, 2007. DE-Kentucky will provide disposal services at its East Bend landfill facility for materials produced by Miami Fort as required, and is responsible for obtaining associated permits. DE-Ohio must pay DE-Kentucky each month at the rate of $21.95 per ton in the first year of the contract; the parties will adjust the fee each year based on prices available in nearby public landfill sites.

Inter-company Asset Transfer Agreement

The parties to the Inter-company Asset Transfer Agreement (Utility Asset Agreement) are DE-Ohio, DE-Kentucky, DE-Indiana, and DE-Carolinas. The agreement was entered into by the operating utilities as of December 22, 2008. Assets as defined in the agreement include inventory, capital spares, equipment, and other goods; coal, natural gas, fuel oil used for generation, emission allowances, electric power, and environmental control reagents are expressly excluded.

Under the agreement, the parties may transfer assets as requested by another operating utility, provided that: (1) it will not jeopardize the transferor's ability to provide electric service consistent with good utility practice; and (2) the cost of any transmission- or generation-related items does not exceed $10 million. In general, parties may transfer assets at costs, and have the option of replacement in kind in lieu of payment. There are separate requirements, however, for transfers involving DE-Ohio's non-regulated generation assets, which are subject to Federal Energy Regulatory Commission (FERC) affiliate transaction pricing requirements. Generation-related assets transferred from DE-Indiana or DE-Kentucky to DE-Ohio must be priced at the higher of cost or market; generation-related assets transferred from DE-Ohio to DE-Indiana or DE-Kentucky must be priced at no more than market. DE-Carolinas is precluded from transacting with DE-Ohio's generation operations.[31]

Utility-Non-utility Asset Transfer Agreement

The parties to the Utility-Non-utility Asset Transfer Agreement (Non-utility Asset Agreement) are DE-Ohio on the one hand, and non-utility affiliates who execute the agreement, on the other hand. The agreement was entered into by the parties as of January

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31/ DE-Carolina's participation in the Asset Transfer Agreement is an exception to its code of conduct rules, and is subject to further conditions detailed in an exhibit to the agreement.

1, 2009. The definition of allowable assets, the requirement for non-interference with utility service, and the per-transaction limitation of $10 million are the same as in the Utility Asset Agreement.

Transfers under this agreement are subject to FERC pricing requirements. Assets transferred from DE-Ohio to a non-utility affiliate must be priced at the higher of cost or market. Assets transferred from a non-utility affiliate to DE-Ohio's generation and wholesale merchant functions must be priced at no more than market, and those transferred to DE-Ohio functions other than generation or wholesale merchant must be priced at the lower of cost or market.

Receivables Loan Agreement

The parties to the Receivables Loan Agreement are CG&E, Cinergy Receivables Company, a special purpose entity, and two non-affiliated commercial banks that perform the roles of committed lender and administrative agent. The agreement was entered into by the parties as of February 14, 2002, and provides a means by which CG&E can finance its accounts receivables.

The Duke Energy corporate family includes two captive insurance subsidiaries, Bison Insurance Company Limited (Bison) and NorthSouth Insurance Company Limited. Bison provides insurance services to DE-Ohio FE&G and all of the Duke Energy companies except DE-Carolinas. The relationship between DE-Ohio and Bison represents a separate type of affiliate transaction that is not covered by any of the other agreements. The arrangement between Bison and DE-Ohio FE&G is documented in coverage declaration pages that outline the level of insurance coverage and associated premiums.[32]

Silverpoint-Vantage examines the three major categories of affiliate transactions in separate chapters in this report. The financial agreements, *i.e.*, the Money Pool Agreement, Tax Sharing Agreement, and Receivables Loan Agreement, are discussed in Chapter IV. The auditors discuss the five in-scope operational agreements, *i.e.*, the Operating Company Agreement, Non-utility Agreement, Gas and Propane Agreement, Utility Asset Agreement, and Non-utility Asset Agreement, along with the Bison Insurance arrangement, in Chapter V.[33] Silverpoint-Vantage discusses transactions under the Service Company Agreement in Chapters VI and VII.

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[32]/ In response to Data Request #38, the Company confirmed that it was not a party to any other affiliate transactions not covered by a formal agreement, adding that its affiliate transaction review procedures involve verifying that a service agreement is in place.

[33]/ In the interview of December 4, 2009, company personnel stated that the Facilities Operating Agreement was a FERC contract not subject to Commission regulation, and the auditors did not examine it further. Similarly, the audit team did not examine Joint Transmission and System Planning Agreement transactions in detail other than to review the yearly true-up journal entries for 2008, which were provided in response to DR116.

C. ACCOUNTING SYSTEMS

III-F2 Duke Energy's affiliate transaction accounting system and methods are sufficient to ensure the accuracy and reliability of affiliate transaction data.

Silverpoint-Vantage saw no evidence of significant weaknesses in the Company's affiliate transaction accounting systems, processes, or procedures. The conversion of the Midwest affiliates to PeopleSoft in July 2008 was smooth, and simplified the Company's recordkeeping process. Duke Energy's processes for time reporting and deriving hourly labor rates are adequately controlled, and the Company appears to have adequate accounting procedures in place.

Duke Energy improved its affiliate transaction reporting process during the audit period by introducing detailed monthly affiliate cross-bill reports that make it easier for business units to monitor that charges are accurate, appropriate, and complete. The Company also implemented improvements to its affiliate transaction accounting review process.

Although Duke Energy is now operating with one accounting system, the former Cinergy and former Duke Power organizations continued, after the merger, to maintain their separate systems. Cinergy's legacy accounting system, the Business Data Management System (BDMS), processed charges to and from DESS, DE-Ohio, and other legacy Cinergy affiliates until the end of June 2008. Before the consolidation, Duke Power's legacy PeopleSoft accounting system, the Financial Management Information System (FMIS), exclusively processed charges to and from DEBS, DE-Carolinas, and other legacy Duke Power affiliates. Because each legacy system has its own general ledger and account numbering approach (each based on FERC account numbering), the Company used account mapping logic to translate data from FMIS to BDMS and from BDMS to FMIS. Before the Company converted the entire company to PeopleSoft, data from the legacy Cinergy BDMS general ledger and the legacy Duke FMIS general ledger flowed to a Finance Information Hub, which Duke Energy uses to generate certain financial reports.

Each legacy system has its own terminology and method of operation, and each uses a code block that consists of a set of elements that describe the "who, what, where, when, and how" of an accounting transaction. In FMIS, the Duke Energy organization is divided into a hierarchy of at least a thousand responsibility centers that represent the work group performing a service, and operating units that represent the group for which the service was performed.[34] An accounting entry in FMIS includes a responsibility center and operating unit code, *i.e.*, the "from" and the "to," as well as an account/process/project number, resource type (*e.g.*, labor, materials, payables), and amount. An accounting entry in BDMS includes comparable elements, including a responsibility center, a line-of-business (LOB) code akin to an operating unit code, an amount, and comparable resource type and account codes.

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[34]/ For direct charges in FMIS, the business unit receiving the charge designates which OU code should be charged. OU codes can be general or specific; for example, a code can designate fossil/hydro plants in general or one plant in particular.

The operating unit codes in FMIS and the LOB codes in BDMS are also used to designate allocation pools. FMIS processes allocation pools at month-end by distributing the total amount in each pool to business entities according to predetermined percentages. Unlike FMIS, BDMS does not capture allocable charges in a pool, but rather allocates them as they are incurred. In BDMS, charges made to an allocable LOB are automatically distributed to business entities using the same percentages that FMIS uses to process its comparable allocation pool.

Duke Energy established a project within the Financial Reengineering Program to implement the migration of the Midwest financial system to PeopleSoft. The Company created specific teams that focused on various aspects of the migration. The general ledger team, for example, had the responsibility for ensuring that BDMS journal entries and allocations were effectively converted to PeopleSoft journal entries and allocations. A code block team was responsible for conversion of the BDMS code block to PeopleSoft. Each team was responsible for the analysis, design, build, test, and deployment phases of the transition.[35]

At the same time, the Company put in place the "Business Area Readiness Network," whose representatives were accountable for successfully implementing transition activities within their organizations. These representatives worked with personnel in their business areas to develop detailed instructions for creating charges in the PeopleSoft system that had previously been made in BDMS. The Company also had a group of personnel in place after the cutover to answer questions about the new system. Company personnel indicated that there were no significant issues after the system cutover, likely due to the extensive amount of testing beforehand.[36]

Silverpoint-Vantage looked for unusual or high numbers of journal entries in accounting data from the second half of 2008, which could indicate that the Company had to make significant corrections after the transition. The auditors did not see any evidence contradicting the Company's statement that the transition was relatively smooth. Similarly, during data review and transaction testing, the auditors did not see any evidence of widespread problems that would call into question the overall integrity and reliability of the affiliate transaction data used in this audit.

D. TIME REPORTING, PAYROLL, AND LABOR RATES

The legacy Duke Power Organization uses Workbrain as its time reporting tool and the legacy Cinergy organization uses the Labor Data Capture System (LDCS). Duke Energy experienced problems trying to move the Midwest to Workbrain after the transition to

[35]/ Response to DR18.

[36]/ Interview of November 10, 2009.

PeopleSoft in July 2008, and has since decided to implement a new common payroll input system by early 2011.[37]

Duke Energy pays exempt employees twice a month. Each exempt employee has a fixed salary distribution that can consist of any combination of accounting code block elements. These employees submit time sheets each pay period if needed to record exceptions to their fixed labor distributions, as well as to record any unproductive time such as vacations or sick days. While most exempt employees use exception reporting, some, such as those in IT and other project-oriented departments, positively report all of their time. Duke Energy pays non-exempt employees every two weeks. In some cases, the Company also sets up non-exempt (or even union) employees with fixed labor distributions, but generally these employees must submit a time sheet in order to get paid. Each Duke Energy employee is responsible for reporting his or her time consistent with corporate policy and business unit requirements. The Company had no specific formal training regarding time reporting during the audit period.[38] It does, however, have extensive Workbrain and LDCS user support documentation in place, and responsibilities for reviewing employee time entries are well defined.[39]

Hewitt Associates (Hewitt) processes payroll for both legacy organizations. After processing the payroll, Hewitt provides detailed labor data back to the Duke Energy accounting system. Duke Energy calculates hourly labor rates for each exempt employee on a semi-monthly basis. These employees do not charge overtime, but rather normalize their hours worked to represent the standard hours per pay period. As such, the average hourly labor rate for an exempt employee does not vary. Duke Energy calculates separate regular time and overtime hourly labor rates for non-exempt Service Company and utility employees. It is common practice to charge overtime rates to the business unit responsible for the overtime, but there is no formal policy to that effect.

As part of charging labor to specific business units or allocation pools, the PeopleSoft system automatically applies the loaders for fringe benefits, payroll taxes, incentives, and unproductive time.[40] Accounting personnel enter the percentage for each labor loader item into PeopleSoft each month. While rates typically remain constant for most of the year, accounting personnel do monitor actual expenses and typically adjust loader rates in the fourth quarter to clear any residuals compared to actual costs. Some departments prefer to

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37/ Interview of November 16, 2009. The company has scheduled the first phase of implementation for the summer of 2010, with full implementation by early 2011.

38/ Response to DR12.

39/ Time reporting manuals provided in response to DR11.

40/ Hewitt supplied information to BDMS for the first six months of the audit period. The BDMS system does not automatically apply a loader for incentives, so accounting personnel recorded them at a departmental level via monthly journal entries. The Midwest tracked the actual costs of its labor loaders but applied year-end true-up corrections at the business entity level. As such, BDMS incentives and labor loader corrections are not traceable to individual affiliate transactions.

use actual unproductive time expense in lieu of a specific fixed rate, in which case the rate applied for unproductive labor from that department will fluctuate.

During transaction testing, Silverpoint-Vantage reviewed a few examples of loaded labor rate calculations. Accounting personnel provided printouts from the time reporting systems showing base salaries, actual hours worked, and default labor distributions. They also demonstrated how the system calculated the loaders for fringe benefits, payroll taxes, unproductive time, and incentives. The auditors were comfortable that the process was working properly.

In the majority of cases, Duke Energy distributes labor costs for salaried personnel according to their default labor distributions rather than via positive time reporting, so the accuracy of those default distributions is important. Previous audit reports that addressed Duke Energy affiliate transactions and cost allocation methods indicated that in some cases Service Company employee default labor distributions were not updated to conform to organization or job duty changes, and the auditors suggested that the Service Company routinely review them for appropriateness.[41] Company personnel stated that the human resources group now sends quarterly reports to managers for review to make sure the default labor distributions are correct.[42] Silverpoint-Vantage believes that this resolves the issue.

E. AFFILIATE TRANSACTION ACCOUNTING DOCUMENTATION AND CONTROLS

III-F3 DE-Ohio does not maintain a formal affiliate transaction accounting manual.

DE-Ohio does not have a formal affiliate transaction accounting manual, and as such has no common set of guidelines to assist employees in implementing accounting requirements. Unlike its sister utility DE-Carolinas, DE-Ohio FE&G has no formal documentation that: (a) specifies Service Company functions, allocation ratios, and allocation percentages applicable to each functional cost allocation pool; (b) describes the method it use to derive Service Company direct charge rates; or (c) describes transfer pricing rules and the methods it uses to derive fully distributed cost rates for charges between utility and non-utility affiliates.

The corporation's documentation of accounting, financial reporting, and related controls and policies are written at a very high level.[43] Silverpoint-Vantage found that Duke Energy's corporate policy regarding accounting for inter-company transactions defines roles and responsibilities in general terms, but provides no real detailed guidance on how to process

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[41]/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to DE 36.

[42]/ Response to DR 50.

[43]/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to DR36.

individual affiliate transactions.[44] Various groups within the Duke Energy organization have developed specific guidelines and procedures for their own purposes, but there is no cohesive set of policies and procedures relevant to a broader audience.[45]

It is commonplace for utilities, particularly those with service companies, to maintain a formal accounting manual or similar documentation that clearly defines the Company's policies and procedures for distributing costs among subsidiaries. In order to be a useful reference for employees, accounting documentation should be reasonably detailed regarding the recording and pricing of transactions. The rules for pricing each type of affiliate transaction, whether by direct charging, direct assignment, or allocation, should be clear and consistent with written agreements and regulatory requirements.

DE-Ohio is not required by the PUCO to have an affiliate transaction accounting manual, and does not have one. DE-Carolinas is the only Duke Energy utility that is required by its commission to maintain and file a formal affiliate transaction cost accounting manual.[46] The DE-Carolinas manual goes into more detail than the Service Company Agreement on the subject of allocation pools. It also contains guidelines for non-Service Company affiliate transactions, including the calculation of overhead and transfer pricing rules for charges to regulated and non-regulated affiliates. Silverpoint-Vantage asked whether Duke Energy planned to develop a corporate-wide affiliate transaction accounting manual or similar documentation, now that the Midwest transition to PeopleSoft is complete. Accounting personnel indicated that there are no current plans to do so.[47]

Silverpoint-Vantage looked for evidence of controls on the affiliate transaction accounting process beyond high-level policy statements. The Company indicated that management's monthly analysis of budget variances and O&M expenses helps to ensure that affiliate transaction charges are valid and that the amounts charged are appropriate.[48] Duke Energy also recently began producing monthly crossbill reports that help business unit management identify the source and nature of charges from the Service Company and other affiliates.[49] As discussed in more detail in Chapter V, Duke Energy took steps during the audit period to improve its accounting review procedures for affiliate transactions under the Operating Company and Non-utility Agreements. The Company conducts annual training

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44/ Duke Energy Accounting Policy Statement, "Accounting for Inter-company Transactions Policy," provided in response to DR13.

45/ The accounting group responsible for Service Company allocations, for example, maintains a document that summarizes functional pools and methods of allocation. See the Service Company Cost Allocation Details, Cost Allocations in Service Agreements, provided in response to Data Request #19.

46/ Silverpoint-Vantage used the DE-Carolinas manual as a reference document during this audit.

47/ Interview of November 16, 2009.

48/ Response to DR19.

49/ Sample report provided in response to DR14.

regarding affiliate rules and code of conduct issues for all of its employees, although it conducted no formal training on specific affiliate cost accounting documentation during the audit period.[50]

III-R1 Develop and maintain a formal affiliate transaction accounting manual. (Refer to finding III-F3)

Silverpoint-Vantage believes it is appropriate for any utility with a service company, or with service agreements among utility and non-utility affiliates, to maintain a formal affiliate transaction accounting manual. The fact that DE-Ohio is not required by the PUCO to maintain an affiliate transaction accounting manual is not a sufficient reason for not doing so.

F. BILLING AND SETTLEMENT PROCESS

III-F4 Duke Energy's procedures for billing and settlement of affiliate transactions are adequate.

Duke Energy recognizes that failing to settle inter-company balances each month could create cross-subsidization issues, since an affiliate's relative cash position direct affects whether it can lend to, or needs to borrow from, the money pool. Since December 2008, Duke Energy settles the inter-company accounts payables and accounts receivable of DE-Ohio and other affiliates in cash each month. These practices are consistent with the requirements of the affiliate transaction agreements.

The Service Company, Operating Company, and Non-utility Agreements explicitly state that the service provider should render to client companies a monthly statement of charges, and that in turn each client company should remit all charges to the provider by the end of the month in which it receives the bill. Although they do not contain similar language, other affiliate agreements involving DE-Ohio FE&G imply the need to settle charges monthly.[51] Previous audit reports of Duke Energy's affiliate transactions stated that the Company did not follow these affiliate transaction billing and settlement protocols, noting that failure to settle inter-company balances in a timely fashion is equivalent to a free loan between affiliates. The audit reports recommended that the Company either make its billing and settlement procedures consistent with the language of the service agreements, or amend the agreements.[52] Silverpoint-Vantage believes that the company's actions since those prior audits have resolved the issue.

50/ Responses to DR 12 and 19.

51/ The exception is the Joint Transmission Agreement, which is settled once a year.

52/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36.

The Company amended the Service Company and Operating Company Agreements during the audit period to state that parties may satisfy the billing and settlement requirement by recording billings and payments in their common accounting systems without rendering paper or electronic monthly statements or remitting cash payments. This change appears to be consistent with Duke Energy's corporate policy on accounting for inter-company transactions, which generally states that: (a) Duke Energy wholly-owned affiliates do not settle in cash unless there is a specific business reason or contractual obligation to do so; and (b) balances not settled in cash are reclassified to inter-company advance accounts.[53]

Duke Energy's actual practices, however, are more proactive. The Company stated that it actually records cross-billing activity throughout the month and that Treasury settles net inter-company receivables in cash by month's end.[54] When asked about the apparent conflict between the Company's written policy and its actual practices, the Company stated that if cash balances were not settled monthly, DE-Ohio might have the need to borrow more or less under the Money Pool Agreement, based on unsettled net payables or receivables. The Company reiterated that DE-Ohio's inter-company positions are settled on a monthly basis.[55]

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[53]/ Duke Energy Accounting Policy Statement, "Accounting for Inter-company Transactions Policy," provided in response to Data Request #13.

[54]/ Response to DR 105, 106, and 107.

[55]/ Response to DR 114. In response to DR 13, the Company indicated that DE-Ohio did not begin settling monthly with all affiliates until December 2008.

IV. FINANCIAL AND LIABILITY SEPARATION

In this chapter, Silverpoint-Vantage discusses its review of the sections of the Ohio Code that address financial liability and separation. The analysis is separated into two sections. Section A addresses assignment of liabilities, tax sharing, money pool agreements, asset transfers, investments in affiliates and asset sales and pricing. Section B provides a broad discussion of "ring fencing" and the DE-Ohio Electric Security Plan.

A. FINANCIAL ISSUES

ASSIGNMENT OF LIABILITIES

IV-F1 With the exception of liabilities associated with DE-Ohio Generation and Service Company activities, there are no liabilities assigned to affiliates.

Liabilities related to DE-Ohio are assigned to DE-Ohio business units in the corporate accounting system. DE-Ohio did not identify any liabilities, with the exception of liabilities related to the Service Company that would impact DE-Ohio FE&G customers. The two main categories of liabilities for the Service Company relate to employee benefits and executive benefits. Employee benefits are charged as a fringe benefit load on Service Company labor. Executive benefits are typically charged through the executive allocation pool on the Service Company. The liabilities for these benefits reside with the Service Company, Cinergy Corp., or Duke Energy. Some of the other Service Company liabilities are related to employee incentive accruals, vacation accruals, taxes and accounts payable liabilities. The costs associated with these liabilities are assigned as part of either Service Company labor loads, cleared through Service Company allocation pools or assigned directly to the business units to which they related(*e.g.*, Accounts Payable).[56]

Silverpoint-Vantage has concluded that these liabilities are reasonable and do not expose DE-Ohio to any undue risk.

DE-Ohio also has liabilities associated with its ownership of generating facilities. These liabilities are addressed through the ESP and have been reviewed as part of the merger and they are addressed in more detail elsewhere in this report.

The measurement and assignment of such liabilities is consistent with Ohio requirements that adequate accounting controls and procedures are in place. The terms of the Duke Energy Corporation Tax Sharing Agreement requires that each member participating in the consolidated income tax returns of the Company be treated as if they had filed separate Company income tax returns.

[56]/ DR 61

TAX SHARING

IV-F2 <u>The calculation of federal income tax for DE-Ohio FE&G is conducted using a corporate policy that complies with the Tax Sharing merger Agreement.</u>

Under the Duke Energy Agreement for Filing Consolidated Tax Returns and for Allocation of Consolidated Income Tax Liabilities and Benefits' as of October 1, 2008, Duke Energy and its members agree to join in the filing of a consolidated annual Federal income tax return and to allocate the Federal tax liabilities and benefits among the members. The Agreement describes the tax allocation procedures using the "corporate taxable income" method. It also indicates that state and local taxes will be allocated where appropriate between members using principles similar to those used to allocate the consolidated Federal income tax liability. DE-Ohio's income tax liability is calculated based on its net book income adjusted as required by income tax laws and regulations.

Since there are no longer state income taxes in Ohio, there is no calculation for this area.

INVESTMENTS IN AFFILIATES

IV-F3 <u>A review of Duke Energy Corporation's Lines of Credit did not identify any instances in which DE-Ohio FE&G made improper investments in another affiliate or pledged or used as collateral any utility assets on behalf of such affiliate.</u>

Silverpoint-Vantage requested a recap of all credit support provided within Duke Energy. This request asked for the form, provider, amount, term, and beneficiary of each credit support. It was to include all credit support including all guaranties, letters of credit, surety bonds, treasury securities, or other credit support provided in support of the obligations of another entity.

There are no guarantees to affiliates. Silverpoint-Vantage analysis of post merger guarantees at Cinergy through September 2009, identified 52 instances of Cinergy shown as the Guarantor totaling $383 million. A review of the Obligator and Beneficiary indicates that many were part of Cinergy's pre-merger business, including many companies associated with Cinergy Solutions.

IV-F4 <u>Analysis did not identify any instance in which DE-Ohio FE&G assumed the obligation or liability of an affiliate or has become obligated to maintain the financial viability of an affiliate.</u>

The Receivables Loan Agreement among Cinergy Receivables Company as SPE with CG&E as Collection Agent, Bank One, NA as Committed Lender and ABN AMRKO Bank, NV as Committed Lender and Administrative Agent was reviewed for overall content and continued applicability. The Receivables Loan Agreement, while dated February 14, 2002, is still functional and provides adequate separation of financial liability between affiliates. In addition we interviewed Service company personnel to ascertain whether any obligations were assumed during the audit period.[57] No obligations were identified.

MONEY POOL AGREEMENT

IV-F5 <u>The policies and procedures associated with the utility Money Pool Agreement and the management of short-term cash and working capital are well documented and comply with all merger conditions.</u>

Duke Energy maintains an "Inter-company Funding Policy" that applies to DE-Ohio FE&G and all other regulated affiliates. This policy was issued on April 1, 2006 and revised on January 1, 2009. The statement and purpose of this document is to provide parameters around the activities that encompass cash consolidation. Corporate Treasury has the responsibility to ensure that in accordance with the "Corporate Cash Management Policy", cash assets are, i) properly safe-guarded, ii) managed to maximize value within approved investment parameters, iii) available to Corporate Treasury on a timely basis to fund general corporate needs, iv) not left idle and under utilized, and v) not unnecessarily exposed to the claims of lenders, other creditors, or unacceptable short-term cash investment risks. Corporate Treasury is also responsible and accountable for funding all expenditures that have been appropriately approved in accordance with the "Approval of Business Transactions Policy". This funding will often require the movement of cash between business entities in the form of Inter-company Cash Advances, Inter-company Loans, Equity Distributions and/or Inter-company Equity Investments.

In particular, Silverpoint-Vantage reviewed the Accountability: Roles and Responsibilities as they apply to the Corporate or Business Unit. These roles and responsibilities required that:

- all Corporate and Business Unit personnel of the Enterprise shall ensure compliance with these guidelines;
- all Inter-company Funding Transactions must be approved in accordance with the Delegation of Authority;
- originator of the transaction must coordinate with Tax, Treasury, Accounting and Legal to determine the nature of funding (dividend or return of capital, equity contribution, cash advance or Inter-company loan);
- each Business Unit Controller, or his or her designee, will be responsible for tracking, servicing and accounting for their respective Inter-company Funding Transactions;
- notice of all Inter-company Funding Transactions, along with copies of any supporting documentation, should be provided upon closing to the associated Business Unit Controller's group and accounted for as appropriate for the type of transaction;

57/ DR 52

- all Inter-company Funding Transactions should be accounted for and periodically reviewed in accordance with the "Accounting for Inter-company Transactions Policy".

ASSET TRANSFERS

IV-F6 Asset transfers to and from DE-Ohio FE&G were limited to distribution equipment stores.

DE-Ohio made transfers with DE-Kentucky and DE-Indiana for Electric Meters and Line Transformers. DE-Ohio made transfers with DE- Kentucky for Gas Meters.

Capital asset transfer information is electronically collected from the PassPort system for this type of equipment transfer. Continuing Property Records are maintained in the Power Plant system. The transferring detail information from Passport is matched to the appropriate continuing property record in Power Plant to determine the average original cost and an allocation of the accumulated reserve is made by Power Plant. A transfer is recorded for original cost and accumulated reserve to complete the transfer transaction.

IV-F7 DE-Ohio FE&G's leases for equipment and facilities from Duke Energy Corporation, has increased from 2008 to the first half of 2009.

An analysis of rent and lease expenses identified seven categories of lease equipment and facilities. In 2008, DEO rented $8.2 mil or 14% of the total for those categories within Duke Energy Corp. During the first six months of 2009, this amount increased to $9.3 million or 22% of the total for those categories.[58]

Compliance Audit of Duke Energy Ohio

Exhibit IV-1
DE-Ohio FE&G Leases For Equipment and Facilities

	Jan. - Dec. 2008				Jan. - Jun. 2009		
	DEO	Duke Total	Percent		DEO	Duke Total	Percent
Copier and Faxes	131,005	2,440,647	5%		194,127	1,216,612	16%
Workstations	711,744	9,419,937	8%		742,560	5,561,504	13%
Network Storage	1,298,616	1,298,616	100%		153	153	100%
Tower Leases	568,923	3,956,839	14%		470,492	3,136,612	15%
Vehicles	2,947,426	18,985,812	16%		4,500,047	19,790,769	23%
Mainframe	604,596	7,414,959	8%		1,193,974	3,735,840	32%
Rent (CRES)	1,912,022	14,469,417	13%		2,217,267	9,475,000	23%
	8,174,332	57,986,227	14%		9,318,620	42,916,490	22%

[58]/ DR 45

ASSET SALES PRICING

Asset Transfer procedures are defined in the FE&G Capitalization Policy Guideline and Book Values which includes a specific section Midwest Guidelines.[59]

The Book Values explains how a group depreciation method is applied. The Midwest Guidelines provides detail on how to determine book value of the original cost of an asset within the Continuing Property Record (CPR). It addresses associated Accumulated Reserve limits and the allocation process to be used. It specifically states that allocation is accomplished through dollar year weighted averaging with consideration to the current salvage and cost removal factors associated with the current depreciation rates. The 1077-E and 1076-E reports are used for determining book value.[60]

Duke Asset Transfer Procedures were also reviewed for content and completeness. Sections of the procedures include: I. Initiation of Transfer Request; II. Compliance with Terms of Asset Transfer Agreement; III. E-Form Completed for Asset Transfers; IV. Pricing Transfers and Accounting; V. Stores, Freight & Handling; VI. Reconciliation; and VII. In-Kind Exchanges. The Procedures are a mechanism to ensure compliance with requirements contained in the Asset transfer Agreements (ATA) and to ensure that FERC and State pricing rules are followed. The ATA allows DEI, DEO, DEC and DEK to transfer assets among each other at cost if certain conditions are met, with exceptions that asset transfers be priced to comply with asymmetrical pricing requirements.

There is also a Policy and Procedures for Generation-Related Inventory Transfers between Duke Energy Ohio, Inc., and Duke Energy Kentucky, Inc., and Duke Energy Indiana, Inc. which specifies, in detail, compliance with FERC Code of Conduct rules (Affiliate Restrictions). Effective January 15, 2008, Transfers of generation related inventory item(s) between Duke's non-regulated Midwest utility affiliate (Duke Energy Ohio, "DEO") and its regulated Midwest utility affiliates (Duke Energy Indiana, "DEI" and Duke Energy Kentucky, "DEK") are to be made in accordance with documented procedures. These procedures provide detail on employee actions, categorization, delegation of authority, and compliance with FERC required separation. The procedures also specify monthly reporting and review by Supply chain and Asset Accounting personnel.

B. RING FENCING

REASON FOR RING FENCING

The issue of "ring fencing" arose during the initial Cinergy/Duke merger hearings as a means of liability separation. There are a number of reasons for addressing this issue in this compliance audit.

59/ DR 41

60/ Page 108 of Duke Energy U.S. Electric & Gas Capitalization Guidelines

- In determining compliance with the merger requirements, the auditors need to verify that no additional risk has been added to existing DE-Ohio ratepayers.
- The current ESP expires at the end of 2011 and therefore this issue will be addressed once more.
- Finally, the current carbon legislation being discussed in Washington DC could have an impact on the value of the non-regulated power plant holdings of DE-Ohio.

For these reasons, Silverpoint-Vantage provides an extensive discussion of the issue, general approaches to addressing ring fencing, and its recommendations as to actions DE-Ohio should take in response to this audit and in preparation for the termination of the existing Electric Security Plan.

The financial separation (*i.e.*, ring fencing) protections in place between DE-Ohio FE&G and the non-regulated generation portion of DE-Ohio were addressed during the merger hearings. In Case No. 05-732-EL-MER the Staff Recommendations addressing ring fencing" noted that the Ohio Revised Code and existing Commission regulations insulated Ohio ratepayers and DE-Ohio from adverse effects of the holding company or affiliates. The Commission conclusions agreed with Staff's recommendation in its Finding and Order dated December 21, 2005. In the order the Commission stated that:

> "It is also important that the Ohio regulated utility be protected, or "ring-fenced": such that it is not adversely impacted by the actions of another affiliate or holding company. This concern is consistent with an earlier-ordered Commission COI and various asset and debt issuance controls. The Ohio Revised Code and existing Commission regulations will work to insulate the CG&E and Ohio ratepayers."

Duke further noted that there were Security and Exchange Commission Public Utility Company Holding Act (SEC PUCHA) reporting requirements (34 and 35 Act) in place for this protection.[61]

RING FENCING BACKGROUND

Ring fencing mechanisms have been discussed by regulatory commissions for a number of years and the excerpts from a March 2003 NARUC Subcommittee on Accounting and Finance shed light on definitions and need for this issue to be addressed.[62] The following is paraphrased from that document.

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[61] DR 34, Copy of Staff Recommendations and the pertinent pages of the Finding and Order.

[62]/ March 2003 NARUC Subcommittee on Accounting and Finance group report that included Joe Buckley of the PUCO. The document is included as a work paper and can be referred to for further reference.

Why Ring Fencing?

Due to recent and new events in the energy industry, including the implosion of Enron in late 2001, investigations into the trading activities of numerous marketers, the general glut of electricity in the marketplace, and ongoing legislation addressing carbon issues and global warming there has been a general trend towards electric utility bond downgrades. These downgrades have been most notable for electric utility companies operating within larger corporate structures and for those operating in states that have, or are in the midst of, restructuring. Although utilities that remain fully bundled may not appear in and of themselves to be riskier, bond rating agencies are more inclined to rate utility bonds at a rating similar to that of its parent company.

Because of the recent trend of rating agencies to consolidate utilities and non-regulated affiliated companies when evaluating risks, there has been increasing concern over the impact of non-regulated ventures upon the utility's access to debt and equity capital and the corresponding cost of such capital as well as the prospect of the utility being pulled into bankruptcy by its parent's insolvency. As a consequence, ring fencing techniques are gaining the regulator's attention.

The current issue of carbon cap legislation may add further risk to coal fired power plants with risk to bond ratings of the company holding debt.

Ring Fencing Mechanism

There are several techniques that can be employed separately, or together, to insulate a utility from the risks of affiliate issues within a holding company system. These include pro-active regulatory oversight, financial restrictions, structural separations, and operational controls. In ring-fencing, a shell is built around the utility by employing techniques to create a "package of enhancements." According to Standard and Poor's (S&P), a properly structured package of enhancements consists of three elements:

- a special "Structure," often including a "special purpose entity," structured in a way that reduces the risk of a subsidiary being pulled into bankruptcy along with its parent;
- a tightly drafted set of covenants, including dividend tests, negative pledges, non-petition covenants, prohibitions from creating new entities, restrictions on asset transfers and inter-company advances, that preserve the financial well-being and autonomy of the ring-fenced subsidiary;
- the third element is collateral. If the debt is fully secured by a pledge of all or substantially all of the assets of the subsidiary, the parent, in principle, has less freedom to deal with the assets of the subsidiary.

According to Fitch, "Financial restrictions imposed solely through internal corporate policies are a weaker method of isolating issuer risks relative to those mandated by law, regulation or contract because the corporation may adjust its policies at will. Nevertheless, corporate policies are helpful indicators of management intent. While there are cases in which a financially stressed parent has extracted dividends, inter-company loans or assets from its regulated utility subsidiaries, there are numerous cases illustrating voluntary restraint by a financially stressed parent holding company.

Structural separations are another way to insulate the utility from the risks of non-regulated affiliates. One such structural separation is multiple ownership. When a utility is controlled by at least two parents or is the subject of a joint venture, the financial problems of any one of the parents is less likely to have consequences for the credit quality of the utility. Generally, the utility will be better insulated if credible owners are on equal footing and are able to prevent each other from harming the credit quality of the utility.

Holding Companies are generally structured in one of two ways. The first, more common structure, involves a non-regulated shell holding company, which owns the equity of both the regulated and non-regulated subsidiaries. In the second structure, the regulated utility operates as the parent holding company owning stock in various subsidiary companies. It may prove to be easier to insulate a utility if it is held as a subsidiary in a holding company structure instead of a structure in which the utility holds the equity (and therefore the equity risk) of various subsidiaries.

In some instances, the utility is held as a division of a parent company, without a separate capital structure. In these instances, the regulator might want to consider requiring utility operations be held as a separate subsidiary instead of being operated as a division so that a clearly separate capital structure can be defined. As Fitch notes, the holding company structure aids in the construction of a strong ring fence. A regulated utility operating as a division of the parent company results in a higher risk profile for the utility than if held as a separate subsidiary.

The final way to achieve insulation is the imposition of restrictions from the outside – from regulation, or even legislation, particularly at the state level. The strongest form of regulatory insulation exist where there are tight, statute-based restrictions on cash and asset transfers coupled with active and pre-emptive oversight by the regulatory body.

State Commissions, such as the PUCO, generally have broad powers to protect utilities from any adverse actions of affiliated companies. Some of these powers are explicitly provided for by statute, including prohibitions on the use of debt for non-utility purposes and encumbering utility assets for non-utility purposes. The regulator might also be proactive in encouraging a properly structured package of ring-fencing enhancements as discussed above. That is to say, the regulatory entity might require the insertion of a special purpose entity between the utility and the holding company, structured in a way that reduces the risk of the utility being pulled into bankruptcy along with its parent or other affiliated company. This could also require a tightly drafted set of covenants subject to commission review.

Additionally, many Commissions have codified Codes of Conduct and Cost Allocation Rules as the energy market has evolved toward a more competitive market. Other tools employed by Commissions to safeguard utility assets have been established through Orders under the Commissions broad power of ensuring that utilities provide safe, adequate, and reliable services at just and reasonable rates (or prices).

S&P states that "insulation brought about by legislative statutes is a great deal more certain than state utility commission rulemaking and will provide for greater ratings separation." S&P also states that, "Notably, most state regulators maintain their state or commission has explicit laws or regulations in place that provide sufficient authority to prevent the financial condition of the utility from being adversely affected by the activities of non-regulated affiliates. However, from a credit perspective, Standard & Poor's believes most of these laws and regulations to be reactive measures; they do not prevent the diversified businesses from weakening the regulated business. These rules typically enable state regulators to take action only after the damage has occurred."

Federal Role

There was a recent set of hearings before the Committee on Energy and Natural Resources of the United States Senate on The Adequacy of State and Federal Regulation of Electric Utility Holding Company Structures on May 1, 2008. Silverpoint-Vantage found the testimony of Mr. Scott Hempling of particular interest and summarized here to add support for the need to re-examine the DE-Ohio separation between it and the non-regulated generation it owns.

The stated purpose of the hearing referenced above was to "examine the adequacy of state and federal regulatory structures for governing electric utility holding company structures in light of the repeal of the Public Utility Holding Company Act" of 1935, and in particular to discuss the concerns raised by the report of the United States Government Accountability Office (GAO), *Recent Changes in the Law Call for Improved Vigilance by FERC*, GAO 08-289 (February 2008). These "recent changes" are the 2005 repeal of the Public Utility Holding Company Act of 1935, and the new FERC authorities established by the Public Utility Holding Company Act of 2005.

Some of the points discussed in this testimony and that need to be considered in future hearings regarding the Repeal of PUHCA 1935, appropriate corporate structure for DE-Ohio and its generation assets, separation of risk associated with liabilities held by DE-Ohio that support generation assets.

The Federal Energy Regulatory Commission has recently undertaken steps to increase its active oversight of utility/holding company relationships for those utilities under its jurisdiction. These steps include an on-going rulemaking initiative into cash management practices and a recent decision to impose new conditions to all future public utility issuances of secured and unsecured debt authorized by the commission. These conditions are:

- public utilities seeking authorization to issue secured debt backed by a utility asset must use the proceeds of the debt for utility purposes only;
- if any utility assets that secure debt issuances are "spun off," the debt must follow the asset and also be "spun off;"
- if any of the proceeds from unsecured debt are used for non-utility purposes, the debt must follow the non-utility assets. If the non-utility assets are "spun off," then a proportionate share of the debt must follow the "spun-off" non-utility asset;

- if utility assets financed by unsecured debt are "spun off" to another entity, then a proportionate share of the debt must also be "spun off."

DE-OHIO POSITION ON RING FENCING

IV-F8 Ring fencing will need to be addressed by the end of 2011 when the current Electric Security Plan ends.

The Silverpoint-Vantage consultants asked the Company about debt associated with the power plants in the ESP that rely on DE-Ohio FE&G utility assets for collateral. DE-Ohio responded that the power plants that are covered by the DE-Ohio ESP are all assets owned by DE-Ohio Pursuant to Chapter 4928 of the Ohio Revised Code, generation is a competitive service. The Commission's approval of DE-Ohio's ESP in Case No. 08-920-EL-SSO specifically provided that the DE-Ohio separation plan then in effect would remain in effect, except that the Company was allowed to transfer to an affiliate or sell to an unaffiliated party five gas-fired generating assets, subject to FERC approval. In addition, DE-Ohio agreed to withdraw its then-pending request to transfer certain previously used and useful assets, provided that it may file a subsequent such request to be effective no earlier than January 1, 2012.

Generation services are unregulated. Thus, while DE-Ohio generating assets have not been spun off to a corporate entity that is separate from the regulated electric and gas operations, the generating assets are treated internally as if they were held by an affiliate. Although this separates the two sides of the DE-Ohio from a functional standpoint, it does not create a separate legal entity for the purpose of financing arrangements.

When asked if any affiliate relied upon DE-Ohio FE&G for credit support, Company personnel responded that it has not provided credit support to any affiliates. Because the regulated portion of DE-Ohio is not a separate legal entity, it has therefore not provided credit support to any affiliate.

The auditors asked about the specific regulations referred to in the order and the referenced SEC 34 and 35 Act and in the Ohio Revised Code. The Company stated that the Finding and Order in Case No. 05-732-EL-MER, approving the merger, did not specify what Ohio laws or regulations were deemed to provide protection against actions by affiliates that might be adverse to the interests of Ohio consumers. The Commission Staff recommendations similarly reference the Ohio Revised Code and existing Commission regulations, without specifying which laws and rules staff found to be relevant. DE-Ohio cannot make assumptions regarding which specific statutes or rules were intended by the Commission or Staff. With regard to reporting requirements under PUHCA, any such requirements appear to be irrelevant at this point, based on the repeal of PUHCA in 2005. Therefore, no reference to PUHCA should have been included in the response.

Silverpoint-Vantage explored threats to the adequacy of monitoring ring fencing within DE-Ohio that could affect risk to DE-Ohio FE&G ratepayers. The Company indicated that DE-Ohio complies with all applicable statutes and Commission rules which, as the Commission correctly recognized in the merger order, will insulate Ohio ratepayers from any threats that might be connected with ring fencing. The Company has internal systems to ensure that it continues to comply with all merger requirements, including this one. However, Silverpoint-Vantage, based on interviews with DE-Ohio and Service Company personnel, was not able to identify any individuals who have studied this issue recently or any studies the Company conducted to address emerging issues.

The auditors asked the Company what structural provisions it considered during the most recent rate case to separate affiliate debt responsibility from DE-Ohio FE&G. The Company assumed that this question was asking whether DE-Ohio has considered proposing any structural changes that would avoid any possibility that ratepayers could be impacted by debt that might be incurred within DE-Ohio for generation-related purposes. DE-Ohio stated that in the ESP proceeding, the Company initially applied for authorization to transfer its generating assets to an affiliated entity. As the distribution rate case would not have been the appropriate vehicle for structural changes, no such suggestions were considered in that case.

IV-R1 Develop a plan, as part of the next Energy Security Plan discussions, to determine if further insulation from Duke Ohio ratepayers or complete separation of risks associated with DE- Ohio owned generation assets is appropriate. Refer to finding IV-F8)

The need for a revised ESP in 2011, provides the opportunity to address this issue in greater detail. Some initial steps that DE-Ohio should be required to perform include:

- conduct a risk assessment of the DE-Ohio-owned generation system given current industry issues;
- identify means to either, further insulate ratepayers, or to separate ownership in a manner that does not impair ratepayers;
- develop proposed solutions and provide to the PUCO by mid-2011 in order to complete any necessary hearings and transactions before the termination of the ESP.

V. OPERATIONAL AGREEMENTS

A. INTRODUCTION

DE-Ohio FE&G is party to several agreements with affiliates other than the Service Company. In this chapter, Silverpoint-Vantage examines the charges between DE-Ohio FE&G and its affiliates under these agreements during the 18-month audit period. The auditors discuss the Company's process for handling requests for service under the Operating Company Agreement and Non-utility Agreement, and revisit the concerns with the process identified in prior audits of Duke Energy's affiliate transactions. Silverpoint-Vantage discusses the methods the Company uses to derive transfer prices under the agreements, including the development of overhead loaders. Finally, the audit team discusses the results of its data analysis and testing to determine if transactions involving DE-Ohio FE&G during the audit period were properly priced and adequately supported, and that they did not result in cross-subsidization.

B. OPERATING COMPANY AGREEMENT AND NON-UTILITY AGREEMENT TRANSACTIONS

SERVICE REQUEST PROCESS

V-F1 Duke Energy improved its affiliate transaction review process during the audit period.

To address concerns identified in prior affiliate transaction audits, the Company put in place improved procedures to ensure the consistent use of Service Request Forms (SRFs), the appropriateness of transfer prices, and adherence to approved cost thresholds. Although it did so after the audit period, the Company took steps towards improving its process for tracking charges related to individual SRFs by incorporating a new affiliate charge report that provides spending information and valid date ranges. Silverpoint-Vantage believes the Company's procedures are adequate and that no recommendation is required in this area, however, in the next audit, the auditor should substantiate that the review process remains adequate and that the company can accurately identify charges under each SRF.

Transactions between DE-Ohio FE&G and its regulated and non-regulated affiliates not otherwise covered by a separate agreement are governed by the Operating Company Agreement or the Non-utility Agreement. Under both agreements, parties must perform services for one another in accordance with formal Service Requests. Duke Energy uses a formal SRF to record the requestor, provider, description of service, approvals, estimated costs, accounting codes, and scheduled start and end dates for specific work performed subject to the agreements. The company uses a Service Request Form database to keep track of the requests.

A few issues with the Service Request process were identified in prior affiliate transaction audit reports; specifically: [63]

- Duke Energy affiliates did not consistently issue formal Service Requests for work under the agreements;
- Duke Energy cannot accurately identify charges associated with each Service Request;
- in some cases, actual charges for work performed subject to SRFs exceeded approved estimates;
- Guidelines regarding the types of charges that can be covered by a Service Request were not consistently followed.

During the audit period, the Financial Planning and Reporting accounting group had responsibility for reviewing FE&G-related transactions, including reviewing reports of inter-company charges and linking charges to specific service requests. During 2008, the group implemented more formal procedures for reviewing SRFs, which included:[64]

- confirming that a SRF is in place, and if not, creating one;
- verifying that accounting information, such as responsibility center, is correct;
- reviewing charges above a given dollar threshold level, and spot checking others;
- confirming that pricing is consistent with the service agreements, affiliate guidelines, codes of conduct, and pricing requirement's
- tracking charges to SRFs and investigating charges not tied to a specific SRF.

The review process was centralized under the Director of Financial Planning in January 2009. Outside the audit period, in July, 2009, the Company incorporated into the process a new affiliate charge report that provides spending information and valid date ranges for SRFs.[65] Silverpoint-Vantage reviewed a copy of the report and believes it will simplify the process of monitoring SRF spending.

The Company's written guidelines on SRFs state that only labor and materials associated with providing the requested service should be charged to an SRF, but often other charges were included. To address the observation that affiliates transferred inventory items as part of service requests, Duke Energy put in place new agreements during the audit period to cover transfers of assets, particularly inventory items (discussed below).

Duke Energy has adopted a proactive approach by setting up SRFs early in the year for work that may ultimately not be needed, such as for storm support from affiliates. Similarly, the charges for actual work performed under an SRF during the year may be well

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[63]/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to DR36.

[64]/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to DR36.

[65]/ Response to DR56.

below the approved maximum amount. Silverpoint-Vantage requested a report of all SRFs in effect during the audit period that had DE-Ohio FE&G as one of the parties. The following Exhibit shows a few examples of the 47 SRFs listed in the report.

Compliance Audit of Duke Energy Ohio

Exhibit V-1
Service Requests Involving DE-Ohio FE&G

Client	SRF#	Description	Est. Cost
DE-FE&G as Provider			
DE-Kentucky	730	Perform all O&M services for 2009	$1,200,000
DEBS	402	Labor for employees that charge DEK/DEBS	440,000
KO Transmission	657	O&M services for 2009	200,000
Duke Energy One	561	T&D construction/maintenance projects 2009	240,000
DE-Indiana	135	Perform repair of oil-filled equipment 2009	743,000
Provider	**SRF#**	**Description**	**Est. Cost**
DE-FE&G as Client			
DE-Kentucky	729	Perform all O&M services in 2009	$1,200,000
DE-Ohio Non-regulated	360	Overhaul work at Woodsdale 2008-09	1,500,000
DE-Carolinas	342	Assist in emergency restoration 2008	996,000
DE-Indiana	574	Auxiliary call center support 2009	50,000

During the audit period, there were 35 SRFs with DE-Ohio FE&G as the service provider; the total estimated cost under the SRFs was $5.7 million. Of these, sixteen involved work for utility affiliate DE-Kentucky and nine involved work for non-regulated affiliate Duke Energy One. During the audit period there were twelve SRFs with DE-Ohio FE&G as the service recipient; the total estimated cost under these SRFs was $4.3 million.[66] Of these, seven involved DE-Carolinas, and one involved the non-regulated portion of DE-Ohio.

[66]/ Response to DR55. DE-Ohio FE&G's clients under the 35 SRFs are: DE-Kentucky–16; Duke Energy One–9; DE–Carolinas-3; DE-Indiana–3; DEBS–2; Duke Energy Generation Services–1; KO Transmission–1. The providers to DE-Ohio FE&G under the twelve SRFs are: DE-Kentucky–2; DE-Carolinas-7; DE-Indiana–2; DE-Ohio Non-regulated–1.

TRANSFER PRICING

The Operating Company Agreement and Non-utility Agreement state that charges for utility-related work (other than that involving DE-Ohio non-regulated generation), must be priced at fully distributed costs, which means that a utility must apply some amount for overhead to its fully loaded labor charges to meet this standard. The Rates and Regulatory Accounting Group develops a standard overhead labor cost multiplier rate to be used when billing work outside the utility. The components of the FE&G overhead cost multipliers in use during the audit period are summarized in the following Exhibit.[67]

Compliance Audit of Duke Energy Ohio

Exhibit V-2
FE&G Labor Cost Multipliers

	July 2007-June 2008	July 2008-June 2009
Overhead Component	Standard	Standard
Administrative Cost	.1118	.1137
Corporate Governance Cost	.1003	.0964
Employee Training Cost	.0188	.0300
Service Company Services Cost	.7258	.7033
Facilities Cost	.1286	.1305
Supervisory Cost	.2010	.1908
Total Overhead Multiplier	1.2864	1.2647
DE-Ohio FE&G Labor Multiplier	1.5770	1.8561
Total Ohio FE&G Cost Multiplier	2.8634	3.1028

Silverpoint-Vantage reviewed with accounting personnel the derivation of the overhead loaders,[68] and found the approach reasonable.

To calculate a fully distributed cost labor rate for work charged to an affiliate, a utility applies both the overhead multiplier and the labor multiplier, (which reflects fringe benefits, payroll taxes, unproductive time, and incentives) to a base wage rate. As an example, the standard fully distributed hourly rate in June 2008 for a DE-Ohio FE&G non-exempt employee with an hourly labor rate of $30 per hour would be $85.90 per hour, *i.e.*, $30

67/ Response to DR58.

68/ Interview of December 14, 2009.

multiplied by the sum of 1.2864 and 1.5770, or 2.8634. Silverpoint-Vantage believes that this approach for deriving fully distributed costs for utility labor is reasonable.

When non-utility affiliates charge labor to DE-Ohio FE&G or any other utility affiliate, however, they apply standard labor loaders but no overhead. The Company decided that it was not cost-effective to derive separate overhead loaders for non-regulated affiliates, given the relative infrequency of such charges. During the first six months of 2009, for example, there was less than $300 of labor charges from non-regulated affiliates to DE-Ohio FE&G.[69]

While affiliate transactions priced at fully distributed cost are the norm, there are situations under the Operating Company Agreement that require different standards for transfer pricing. The first relates to transactions between the non-regulated generation portion of DE-Ohio and other utilities, which are governed by new agreement language regarding FERC asymmetrical pricing requirements.[70] Specifically, services from the DE-Ohio non-regulated generation business segment must be priced at no higher than market, and services from Duke Energy utilities to the DE-Ohio non-regulated generation segment must be priced at the higher of cost or market. The asymmetrical rules do not apply to charges between the regulated and non-regulated portions of DE-Ohio, as they are both part of the same legal entity.[71]

The other situation pertains to transactions involving DE-Carolinas. The Operating Company Agreement incorporates the "DE-Carolinas Conditions," which state that services provided to or by DE-Carolinas must be priced in accordance with the Code of Conduct approved by the North Carolina Utilities Commission. The Code of Conduct states that non-power, non-generation, or non-fuel goods and services provided by DE-Carolinas to its utility affiliates or by utility affiliates to DE-Carolinas, with a single item or transaction amount of $100,000 or less, can be transferred at the fully distributed cost. However, transfers above either the single item/transaction limit of $100,000, or an aggregate annual limit of $7.5 million, are subject to the cost versus market pricing rules set forth in the code. Specifically, DE-Carolinas in such cases must pay the lower of fully distributed cost or market price for goods and services it receives, and must be paid the higher of fully distributed cost or market price for goods and services it provides.

DE-Ohio provided emergency storm support totaling approximately $250,000 to DE-Carolinas in March 2009.[72] As the total transaction was greater than $100,000, under the Carolinas Conditions, DE-Carolinas was required to pay market price for these services. DE-Ohio FE&G calculated its hourly rate at $126.71 per hour, which was $45 per hour above

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69/ Response to DR117. Non-regulated affiliates have chosen to use the FE&G loader in lieu of developing separate rates.

70/ In response to DR112, the Company clarified that FERC pricing rules were in effect for the entire audit period, although it did not file an amended agreement until September, 2008.

71/ Response to DR113.

72/ Responses to DR 77 and 117.

market.[73] DE-Ohio received its fully distributed cost for the services, but to satisfy the regulatory condition, DE-Carolinas recorded the above-market portion of those costs below the line.

V-F2 Duke Energy's method for calculating transfer prices under the Operating Company Agreement and Non-utility Agreement is reasonable.

To ensure that neither party cross-subsidizes the other, the Operating Company Agreement and Non-utility Agreement require that charges for utility-related work must be priced at fully distributed costs. DE-Ohio FE&G and the other regulated Duke Energy utilities calculate labor transfer prices by applying to base wages an overhead labor cost multiplier and a labor loading multiplier. Silverpoint-Vantage believes that the Company's approach for deriving fully distributed cost for utility labor is reasonable. This conclusion also applies to transactions involving DE-Ohio FE&G under the Gas and Propane Agreement, which has similar pricing terms.

Non-utility affiliates that charge labor to DE-Ohio FE&G or its sister regulated utilities apply to base wages standard labor loaders but no overhead. Given the relative infrequency of such charges, Silverpoint-Vantage believes it is reasonable for the Company not to devote the resources needed to calculate overhead loaders given the low frequency and value of labor charges from non-utility affiliates.

C. OTHER AFFILIATE TRANSACTIONS

1. Gas and Propane Agreement

A portion of the work performed by DE-Ohio for DE-Kentucky under the Gas and Propane Agreement was performed by FE&G personnel; total charges during the audit period for this work are summarized on the following Exhibit.[74]

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[73]/ Response to DR77.

[74]/ Response to DR108.

Compliance Audit of Duke Energy Ohio

Exhibit V-3
Charges from DE-Ohio FE&G to DE-Kentucky
Woodsdale Generation Plant Work

DE-Ohio FE&G Dept	2008	6 mo 2009	Total
Gas operations	$128	$14,183	$14,311
Substation maintenance	$16,350	$39,887	$56,237
Total	$18,485	$54,070	$70, 548

Pricing terms under this agreement are similar to the other operating agreements discussed above, in that DE-Kentucky pays DE-Ohio's fully distributed cost for the work.

BISON INSURANCE

DE-Ohio receives insurance services from Duke Energy's captive insurance subsidiary, Bison Insurance. According to Duke Energy, its insurance program requires that costs be identified and allocated to a business unit or subsidiary based on its contribution to the risk of the entire Company. The program was designed to encourage risk control, early claims reporting, and efficient claims management, and for cost-based product/service pricing.[75] Duke Energy developed specific premium calculation methods for each line of coverage (*i.e.* general liability, property, etc.), which is similar to how commercial insurance underwrites risk. The Company generally allocates costs, *i.e.*, insurance premiums, on the basis of a blend of exposure and historical loss experience.

V-F3 Duke Energy's method for calculating the cost of premiums from Bison Insurance is reasonable.

DE-Ohio FE&G receives insurance services from its affiliate, Bison Insurance. The Company generally allocates insurance premiums on the basis of a blend of exposure and historical loss experience. Silverpoint-Vantage believes this approach is consistent with the concept of fully distributed cost.

D. ASSET TRANSFERS

In a recent audit report on DE-Indiana's compliance with affiliate standards, the auditors were concerned that the Company did not have formal policies and processes in place for

[75]/ Response to DR48.

asset transfers.[76] Silverpoint-Vantage believes that the Company's actions during the audit period have addressed those concerns. Duke Energy put in place two new agreements, the Utility Asset Agreement and Non-utility Asset Agreement, which govern asset transfers between affiliates. Under these agreements: (a) transfers between regulated utilities are made at cost, based on average unit price; (b) transfers from regulated utilities to non-regulated affiliates are priced at the higher of cost or market; and (c) transfers from non-regulated affiliates to regulated utilities are priced at the lower of cost or market. The terms of the agreements are consistent with FERC asymmetrical pricing rules. Duke Energy also developed written policies and procedures to ensure that Company personnel apply appropriate asset transfer pricing rules.[77] Silverpoint-Vantage reviewed the documentation and found it to be adequate.

There were no asset transfers between the regulated and non-regulated portions of DE-Ohio during the audit period, or between DE-Ohio FE&G and other non-regulated affiliates.[78] The majority of DE-Ohio FE&G asset transfers involved inventory items, which totaled approximately $16 million during the 18-month audit period.[79] The Company uses the Passport system to track the movement of inventory items, which it charges out at the average unit price of the issuing location, consistent with the Utility Asset Agreement.

In addition to inventory, DE-Ohio FE&G transferred capital assets with DE-Kentucky and DE-Indiana. The following Exhibit summarizes the asset transfers reflected in plant property records during the audit period.[80]

76/ Final report of the DE-Indiana Affiliate Standards compliance audit, provided in response to Data Request #35.

77/ Documents provided in response to DR41.

78/ Interview of November 11, 2009.

79/ Response to DR104.

80/ Responses to DR39 and 90. The capital asset transfers took place between November 2007 and October 2008, but were not reflected in Power Plant property records until the end of 2008.

Compliance Audit of Duke Energy Ohio

Exhibit V-4
Capital Asset Transfers

	Number	Total Value
Electric Meters		
Ohio to Indiana	429	$121,761
Indiana to Ohio	1,544	553,937
Ohio to Kentucky	633	274,516
Kentucky to Ohio	3,518	413,242
Gas Meters		
Ohio to Kentucky	148	132,423
Kentucky to Ohio	1,368	241,928
Line Transformers		
Ohio to Kentucky	256	653,994
Ohio to Indiana	38	237,544
Indiana to Ohio	61	125,477

Duke Energy uses the Power Plant capital-asset accounting system to maintain the fixed asset records of its regulated utilities. The Company collects data on capital asset transfers in its Passport system, and matches them to the appropriate continuing property records in the Power Plant system to determine the average original cost and allocation of accumulated reserve for each asset, which forms the basis for setting transfer prices consistent with the Utility Asset Agreement.

V-F4 Duke Energy implemented adequate asset transfer policies and processes during the audit period.

Duke Energy formalized its asset transfer process and procedures during the audit period. The Company put in place the Utility Asset Agreement and Non-utility Asset Agreement to govern asset transfers under pricing terms that are consistent with FERC asymmetrical pricing rules. It also developed written policies and procedures to ensure that company personnel apply asset transfer pricing rules correctly.

E. DATA REVIEW AND TESTING

The company provided inter-company charge data for transactions during the audit period that involved DE-Ohio FE&G and other business units, excluding the Service Company. [81] Silverpoint-Vantage selected charges (*e.g.*, invoices, labor charges) associated with

[81] Data provided in response to DR117.

transactions between DE-Ohio FE&G and its affiliates for testing in order to determine if the company applied the appropriate pricing terms and that it could provide adequate supporting documentation for the charges.

V-F5 During the audit period, Duke Energy changed its policy regarding the inclusion of overhead in labor costs charged between the regulated and non-regulated portions of DE-Ohio.

Silverpoint-Vantage examined inter-company charge data and found, for example, that DE-Ohio FE&G did not apply the overhead labor cost multiplier to the labor charged to the DE-Ohio commercial power business segment during the first half of 2009. The Company indicated that it had applied overhead to labor charges in such transactions for the first half of 2008. After the conversion to PeopleSoft in mid-2008, the Company decided that it would not apply the affiliate overhead loader in transactions between the regulated and non-regulated portions of DE-Ohio because they occurred within a single legal entity.[82]

V-R1 Duke Energy should clarify with Staff its position regarding the appropriate treatment of transactions between the regulated and non-regulated portions of DE-Ohio. (Refer to Finding V-F5.)

While the commercial power segment of DE-Ohio is not technically an affiliate of DE-Ohio FE&G because it is part of the same legal entity, the utility had until recently treated it as such for the purposes of pricing transactions. The company continues to issue formal Service Requests for services between the two segments, consistent with the Non-utility Agreement, but no longer follows the transfer pricing requirements of that agreement.

DE-Ohio FE&G charged over $100,000 in labor to the commercial power segment in the first six months of 2009, which previously would have triggered an associated overhead charge of approximately $200,000. Labor charges from the commercial power segment to DE-Ohio were more significant, totaling several million dollars in the first half of 2009. The financial impact on DE-Ohio FE&G of the change in policy could be significant.

[82] Email of February 18, 2010.

VI. SERVICE COMPANY COST DISTRIBUTION METHODS

A. BACKGROUND

Duke Energy's Service Company charged $1.7 billion to its client companies during 2008, and nearly $1 billion during the first half of 2009. In this chapter, Silverpoint-Vantage describes and evaluates the methods by which the Service Company distributes its charges. The auditors provide a brief background of the Service Company organization and the functions that it performs; they also describe and evaluate the underlying factors that the Service Company uses to allocate shared service and governance costs, and evaluate whether the methods for calculating allocation percentages based on those factors are reasonable. Silverpoint-Vantage describes the Service Company's direct charging methods and its treatment of overhead costs, and revisits the concerns with Duke Energy's cost distribution methods that were identified in prior audits of affiliate transactions and cost distribution methods. Finally, the audit team discusses the results of its testing to determine if allocation percentages were correctly calculated and applied to charges during the audit period.

B. THE SERVICE COMPANY ORGANIZATION

VI-F1 The number of Service Company personnel significantly increased during the audit period.

The number of Service Company personnel increased by more than 10 percent during the audit period. Most of the transferred employees came from the Midwest utilities, primarily DE-Ohio FE&G, and were those that routinely performed work for more than one utility. Transferring these employees to the Service Company greatly reduced the amount of direct charging between Midwest utility affiliates. DE-Ohio employees that had charged a portion of their time to DE-Ohio FE&G operating units continue to do so, the only difference being that the charges now originate from a Service Company responsibility center rather than from a DE-Ohio responsibility center.

At the beginning of the audit period, the Service Company was still composed of two separate legal entities, DEBS (legacy Duke Power) and DESS (legacy Cinergy). The distinction between DESS and DEBS, however, was somewhat artificial, and was primarily due to the fact that DEBS and DESS used separate accounting systems. The Service Company essentially behaved like one entity for the purposes of providing and pricing services to client companies like DE-Ohio. Duke Energy merged DESS into DEBS as of July 1, 2008, at the same time it converted the entire corporation to the PeopleSoft accounting system.

The following Exhibit shows the number of Service Company employees at three points in time: (a) approximately six months before the merger between Duke Energy and Cinergy; (b) approximately one year after the merger; and (c) at the end of the audit period.[83]

Compliance Audit of Duke Energy Ohio

Exhibit VI-1
Service Company Employees

	DEBS	DESS	Total
September 2005	1,553	3,152	4,705
March 2007	3,449	2,560	6,009
June 2009			6,775

The number of DESS employees fell after the merger as the result of early severance and retirement programs, and the movement of some corporate departments to DEBS. Well before the merger, Cinergy had centralized in its service company utility support functions like fuels, engineering and construction, and rates in order to provide them to its utilities more efficiently. After the merger, Duke Energy decided to adopt a similar approach with DEBS, and so moved to DEBS utility-related functions previously performed in the Duke Power utility organization. Duke Energy also centralized at DEBS some functions like human resources and IT that had been performed on a decentralized basis throughout its legacy Duke Power organization. In all, Duke Energy moved approximately 2,000-2,100 Duke Power utility employees to DEBS as of January 1, 2007. At the same time, approximately 70 employees left DEBS as part of the spin-off of the Duke Energy gas business.

The number of Service Company employees significantly increased during the audit period, such that now roughly one-third of Duke Energy's employees are part of the Service Company. Duke Energy transferred approximately 700 employees to the Service Company from the Midwest utilities; approximately 600 of these employees came from DE-Ohio FE&G.[84] Generally, transferred employees were those that routinely charge their time to more than one Midwest utility (*e.g.*, a DE-Ohio FE&G employee that performs T&D work for both DE-Ohio FE&G and DE-Kentucky). Most of the transfers occurred in late 2008 and early 2009.

Silverpoint-Vantage found that this large influx of employees to the Service Company was primarily an accounting reorganization rather than an operational one, and was in part triggered by the Midwest conversion to PeopleSoft. As a general matter, the operating units

[83]/ Data for 2009 provided in response to Data Request #91. Data for 2005 and 2007 taken from prior affiliate transaction audit reports provided in response to Data Request #36.

[84]/ Response to Data Request #95. The Midwest utilities transferred approximately 760 employees to DEBS, and the Service Company transferred approximately 85 employees to the Midwest utilities.

to which these employees charge their time did not change. The net effect of this restructuring is that DE-Ohio FE&G now receives more direct charges from the Service Company, and fewer direct charges from its own employees. Similarly, Midwest utility-to-utility direct charges decreased.

C. SERVICE COMPANY FUNCTIONS AND ALLOCATION POOLS

The Service Company Agreement defines twenty-three business functions, many of which the Service Company separates further into sub-functions. The IT function, for example, consists of five sub-functions: mainframe support, personal computer (PC) support, communications systems, server support, and management support. The Service Company also more finely categorizes its business functions as governance-level, enterprise-level, and utility-level services. The Service Company recognizes that some of the activities its employees perform are of a governance nature, that is, they relate to higher level activities necessary for an organization to exist as a corporation (*e.g.*, investor relations, corporate development). It also recognizes that the clientele for some of its activities is the entire enterprise, while for others it may be only the regulated utilities. All business units within the Duke Energy organization (except the Service Company) receive governance-level services, and all except the non-domestic portion of the International business unit receive enterprise-level services.[85] The clients for utility-level services are DE-Ohio FE&G and its sister utilities.

The following Exhibit summarizes the service levels at which the Service Company provides each of fourteen business functions.

[85]/ The Service Company does not support the non-U.S. portion of the International business unit, but does provide enterprise-level services to the relatively small domestic portion of that business unit.

Compliance Audit of Duke Energy Ohio

Exhibit VI-2
Service Company Functions

Function	Service Level		
	Governance	Enterprise	Utility
Information systems		X	X
Finance	X	X	X
Internal Auditing	X		X
Executive	X	X	X
Human Resources	X	X	X
Public Affairs	X	X	X
Investor Relations	X		
Accounting	X	X	X
Legal	X		X
Planning	X	X	X
Transportation	X	X	X
Materials Management		X	X
Facilities	X	X	X
Environmental, Health and Safety	X	X	X

The Service Company provides nine additional functions exclusively at the utility level; these are listed in the following Exhibit.[86]

Compliance Audit of Duke Energy Ohio

Exhibit VI-3
Utility-Only Functions

Meters	System Maintenance
Fuels	Rights of Way
Rates	Power and Gas Planning and Operations
Power Engineering and Construction	T&D Engineering and Construction
Marketing/Customer Relations	

[86]/ The Commercial Power business unit is also a client for the power-related services.

The Service Company accumulates costs that it cannot directly charge to its client companies in cost pools for each business function, and allocates them to business units according to defined allocation percentages. In 2008, for example, the Service Company distributed over half of its $1.7 billion of charges through allocation pools. There is a separate Service Company cost allocation pool for each function, sub-function, and service level. In all, the Service Company currently uses over 100 cost allocation pools.

In addition to the governance-level, enterprise-level, and utility-level pools, the Service Company also defines specific Midwest-only allocation pools that are for the most part a carryover from the legacy Cinergy organization. Some of the Midwest-only pools, for example, pertain only to DE-Ohio and its subsidiary DE-Kentucky, and were originally put in place because of the unique organizational and staffing relationship between the two utilities. Others pertain to all three Midwest utilities or exclusively to the Commercial Power business unit. The marketing and customer relations function also has separate pools to distinguish between the natural gas and electric businesses. The following Exhibit identifies the number of Midwest-only allocation pools for specific business functions.

Compliance Audit of Duke Energy Ohio

Exhibit VI-4
Midwest-Only Allocation Pools

Accounting (2)	Finance (2)	Executive (3)
Meters (2)	Transport.-Vehicles (1)	Rates (2)
Facilities (1)	Dist. System Maintenance (1)	Mat. Mgmt. – Storeroom (1)
Power Engineering/Construction (1)	Marketing and Customer Relations (8)	Gas System Engineering/Construction (1)
Transmission Engineering/Construction (1)	Distribution Engineering/Construction (1)	

A group of accounting personnel manages the allocations of the Service Company pools; the group reviews allocations monthly to determine if all cost pools have cleared and examines actual versus budgeted costs. This group also has responsibility for calculating the allocation percentages that are used each year. Accounting personnel finalize the allocation percentage calculations for the next year as part of the Company's annual budgeting process. If there are any major organizational changes after the percentages have been finalized (*e.g.*, merger, acquisition, or divestiture), the Service Company would review the appropriateness of its allocation percentages. Service Company personnel indicated that there were no material transactions that required the Service Company to change allocation percentages for pools in 2008 or 2009.[87] The Service Company did, however, make

[87]/ Response to DR10.

adjustments to the allocation percentages for certain IT pools for the second half of 2008 as part of the conversion to PeopleSoft.[88]

D. SERVICE COMPANY ALLOCATION RATIOS

The Service Company Agreement identifies the specific allocation ratio that the Service Company will use to distribute costs for each business function. The most frequently used ratio is the three-factor formula ratio, which the Service Company uses to allocate all governance-level pools except human resources, and to allocate many enterprise- and utility-level functional cost pools. The three-factor formula allocation percentages used for each business unit during the audit period are summarized on the following Exhibit.[89]

Compliance Audit of Duke Energy Ohio

Exhibit VI-5
Three-Factor Formula Percentages by Business Unit

	DEO FE&G	DEK	DEI	DEC	Comm. Power	Inter'l	Other
Governance 2008	10.02%	3.03%	16.7%	52.62%	10.94%	6.05%	0.64%
Governance 2009	10.04%	2.78%	17.33%	51.07%	12.53%	5.73%	0.52%
Enterprise 2008	10.63%	3.21%	17.76%	55.87%	11.65%	0.19%	0.69%
Enterprise 2009	10.61%	2.95%	18.35%	54.00%	13.32%	0.20%	0.57%
Utility 2008	12.12%	3.68%	20.37%	63.83%			
Utility 2009	11.18%	3.41%	21.69%	63.72%			

DE-Ohio FE&G's three-factor formula percentages were relatively constant in the audit period, although the utility-level percentage decreased by a small amount, reflecting the decrease in DE-Ohio FE&G employee levels.

The following Exhibit summarizes the allocation ratios for each Service Company governance-, enterprise-, and utility-level general business function pool, and provides the

[88]/ Unlike BDMS, the PeopleSoft system further assigns business unit percentages down to the operational unit level (*e.g.*, distribution, fossil/hydro). Accounting personnel made adjustments in certain IT percentages for the regulated and non-regulated portions of DE-Ohio as part of the conversion to PeopleSoft, so that costs could be assigned down to the operational level at DE-Ohio. (Phone interview of January 8, 2010).

[89]/ Response to DR8.

allocation percentages for the DE-Ohio FE&G business unit for 2008 and 2009.[90] DE-Ohio FE&G's allocation percentages for these functions were relatively constant over the audit period. With the exception of the three-factor formula, the allocation factors listed above are relatively specific and correlate with the cause and beneficiaries of cost for each function.

90/ The Service Company made slight changes to the IT pool percentages for DE-Ohio FE&G and Commercial Power for the second half of 2008. These values are not reflected in the Exhibit.

Compliance Audit of Duke Energy Ohio

Exhibit VI-6
Allocation Ratios for General Business Functions 2008-2009

Allocation Ratio (DE-Ohio FE&G Gov/Ent/Util %)	Allocation Pool	Governance Level	Enterprise Level	Utility Level
	IT Mgmt/Support		X	X
	Finance	X	X	X
	Internal Auditing	X		X
	Executive	X	X	X
	Public Affairs	X	X	
Three-factor formula	Transp.- Aviation	X	X	
2008 – 10.02/10.63/12.12	Accounting	X	X	X
2009 – 10.04/10.61/11.18	Legal	X		X
	Planning	X	X	X
	Corporate Develop.	X		
	Facilities Services		X	
	Environ. H&S	X	X	
	Investor Relations	X		
# of Employees	Human Resources	X	X	X
2008 – 13.11/13.86/15.16	Transportation			X
2009 – 12.20/13.00/14.16	IT Communications		X	X
CPU Seconds *2008 – 13.32/14.02* *2009 – 13.35/14.59*	IT Mainframe		X	X
# of PCs *2008 – 9.96/10.58* *2009 – 11.79/12.51*	PC Support		X	X
# of Servers *2008 – 13.29/16.03* *2009 – 11.16/15.68*	Server Support		X	X
Square Footage (Varies by location)	Facilities Locations		X	X
Sales *2008 - 25.96* *2009 – 25.80*	Environ. H&S			X
Procurement Spending *2008 – 8.19/9.22* *2009 – 6.64/6.68*	Procurement *		X	X
Wt. avg. # of Customers and # of Employees *2008 – 20.29* *2009 - 19.42*	Public Affairs			X

* Utility-level service also provided to Commercial Power

The Service Company provides certain functions, such as T&D system maintenance and inventory management, only at the utility level. It provides some of the power-related utility functions, such as generation planning, to the Commercial Power business unit. The following Exhibit summarizes the allocation ratios used for each Service Company "utility-only" allocation pool, and provides the allocation percentages for the DE-Ohio FE&G business unit for 2008 and 2009.

Compliance Audit of Duke Energy Ohio

Exhibit VI-7
Allocation Ratios for Utility-Only Service Functions 2008-2009

Allocation Factor	Allocation Pool	DE-Ohio FE&G 2008/2009 %
# of Customers	Meters	25.96/24.68
	Mtr. Rdg./Bill Pymt./Cust. Service	25.96/24.68
Sales[91]	Rates	25.40/25.80
	Sales/DSM	25.40/25.80
	Fuels	n/a
	Wholesale Power Operations *	n/a
	Generation Dispatch	n/a
Inventory	Materials Mgmt. - Inventory	20.39/15.82
Circuit miles	Tran. System Maint./ROW	7.88/8.60
	Dist. System Maintenance	11.41/11.34
Electric peak load	Generation Planning *	n/a
	Transmission Planning	12.21/12.58
Wt. average of electric peak load and circuit miles	Transmission Operations	10.05/10.59
	Distribution Operations	11.81/11.96
	Distribution Planning	11.81/11.96
Generating unit MW capability	Power Operations *	n/a
Plant construction expenditures (G, T, or D)	Transmission Engr./Construction	15.54/12.44
	Distribution Engr./Construction	15.71/16.15
	Power Engr./Construction	n/a

* Service also provided to Commercial Power

The factors that the Service Company uses to distribute the allocation pools for these functions, such as the number of customers for meter reading or circuit miles for T&D system maintenance, bear a reasonably strong relationship to the cause or beneficiary of these costs.

91/ The sales ratio for sales/DSM and rates is based on FERC Form 1 data for megawatt hour sales; Midwest gas sales are converted to equivalent kilowatt hours.

E. CALCULATION OF SERVICE COMPANY COST ALLOCATION RATIOS

The Service Company's method for calculating allocation percentages for its "utility-only" service functions such as T&D operations or inventory management is fairly straightforward. A utility would receive 10 percent of Service Company costs charged to the distribution system maintenance pool in 2008, for example, if it owned 10 percent of the combined distribution circuit miles of DE-Ohio, DE-Indiana, DE-Kentucky, and DE-Carolinas. Each utility's allocation percentages for the utility-only service functions are the same as its share of the underlying factors, which are, specifically, number of customers, sales, inventory dollars, circuit miles, peak load, generating capability, and plant construction expenditures. The allocation percentages for the Midwest-only pools for these utility functions are calculated in the same way, but with a more limited subset of utilities.

The calculation of the Service Company's general allocator, the three-factor formula ratio, is also relatively straightforward. The three-factor formula ratio is the weighted average of three other defined ratios: gross margin; labor dollar; and net PP&E. The underlying factors for these ratios are defined as follows.

- Gross margin equals total operating revenues as defined by Generally Accepted Accounting Principles (GAAP), less cost of sales including purchased gas, purchased power, fuel used in generation, and other costs of goods sold.
- Total labor dollars are those that have been charged to a given business unit, which includes charges made to it by the Service Company or other affiliates; it includes labor, unproductive time, and incentives.
- Net PP&E is the book value of assets less accumulated depreciation.[92]

The Service Company calculates separate three-factor formula ratios for each client company for governance, enterprise, and utility-level service costs. The only difference in the calculation is the list of companies included. The Service Company also uses the same approach to calculate three-factor formula percentages for specific Midwest-only pools.

The method by which the Service Company calculates the number-of-employees ratio, which it uses to allocate the governance-level human resources cost pool and several enterprise- and utility-level functional cost pools, is less straightforward. The Service Company uses a "spreading" approach for determining the enterprise and governance number-of-employees ratios. It adds a prorated share of its employees to each business unit's employee headcount figures, in order to spread to other business units the costs that would otherwise be associated with its own employees, *i.e.*, Service Company overhead. In simplest terms, the Service Company attempts to assign the overhead of each Service Company employee to the business unit(s) he or she supports.

For the purposes of calculating the number-of-employees ratios, the Service Company first separates its employees into two groups, corporate governance or shared services, based on

92/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to DR36.

a general analysis of what types of service it has provided in the aggregate to its client companies.[93] The Service Company then derives for each client business unit two different adjusted employee headcount numbers. It uses one to drive the calculation of the allocation percentages for utility- and enterprise-level cost pools, and the other to drive the allocation percentage for the governance-level human resources cost pool.

For the first adjustment, the Service Company adds to the baseline headcount figure of each client by spreading its shared employees over all other business units, including the corporate group, based on its analysis of where shared service personnel charged their time during the prior period. It then uses these adjusted headcount figures to calculate enterprise- and utility-level number-of-employees percentages, the difference being the subset of companies included in the calculation.

For the second adjustment, the Service Company adds to the previously adjusted headcount figures for each business unit by spreading its corporate governance group over all remaining business units. It then uses these adjusted headcount figures to calculate the governance-level number-of-employees allocation percentages. The result of these calculations for DE-Ohio FE&G is summarized in the following Exhibit. The decrease in these percentages for 2009 is primarily due to the reduction in DE-Ohio FE&G employees in the prior year.

Compliance Audit of Duke Energy Ohio

Exhibit VI-8
DE-Ohio FE&G Number-of-Employees Allocation Percentages

Governance %		Enterprise %		Utility %	
2008	2009	2008	2009	2008	2009
13.11	12.20	13.86	13.00	15.16	14.16

The Service Company has adopted a similar spreading approach for calculating the remaining allocation ratios, which it uses to distribute specific enterprise-level and utility-level service costs for functions such as IT and facilities; these ratios are:

- CPU seconds;
- number of PCs;
- number of servers;
- square footage;
- sales;
- procurement spending;

93/ The Service Company assumed a total of 5,646 employees for its 2008 allocation year calculations and 5,589 employees for its 2009 allocation year calculations. (Response DR9).

- weighted average of number of customers and number of employees.

In each instance, the Service Company grosses up the underlying factor, *e.g.*, number of servers or PCs, for each client business unit, which in effect eliminates the Service Company's share of these overhead costs. Rather than having overhead costs naturally follow labor charges in real time, the Service Company attempts to approximates the outcome a year in advance by analyzing how its over 5,000 employees historically spent their time.[94]

F. SERVICE COMPANY DIRECT CHARGES

A significant portion of the costs charged by the Service Company to its client companies are direct charges. Many of these direct charges are made to client companies in order to reimburse the Service Company for third-party invoices for insurance premiums, employee benefits, outside legal and accounting services, and similar expenses paid on their behalf. The Service Company passes through these charges with no markup. The Service Company can also directly charge a business unit for work performed by its employees on the client's behalf. In such cases, the Service Company derives the direct charges using employee hourly loaded labor rates, which include salary plus labor loaders of fringe benefits, payroll taxes, unproductive time, and incentives, but no additional loaders for overhead.

Because Service Company departments do not precisely correspond to service functions, a client company may not be able to clearly identify the nature of a direct labor charge. Theoretically at least, a Service Company employee can charge his or her time into any functional cost allocation pool or directly to any business unit. The Service Company is composed of hundreds of responsibility centers, any number of which may be involved, either directly or indirectly, in providing a given service function. Some Service Company responsibility centers perform more than one service. A direct charge from an employee in the engineering and technical services staff, for example, could be for T&D planning, T&D operations, or T&D engineering and construction services.

G. SERVICE COMPANY OVERHEAD

While the Service Company Agreement does not explicitly discuss overhead, it does state that charges for services should be based on fully distributed costs. The DE-Carolinas affiliate transaction accounting manual does mention overhead, stating that Service Company charges will be based on fully distributed cost and include:

- labor and non-labor expenses;

[94]/ Prior to the audit period, the Service Company's approach for redistributing the number of PCs, servers, and similar factors resulted in an even more indirect connection between a business unit's use of a shared service and the amount of overhead it absorbed for that function. A business unit's share of the IT overhead for accounting, for example, was based more on its own IT use rather than its use of accounting services.

- payroll taxes, fringe benefits, and incentives associated with labor expenses;
- overhead costs, such as management, administrative, facilities, telecommunications, computers, etc.;
- asset costs attributable to the Service Company, such as property tax, depreciation, property insurance, and cost of capital.

The Service Company uses indirect approaches to account for and allocate these overhead costs. As previously discussed, it spreads many of the overhead costs associated with shared service functions to other business units by the way in which it calculates certain allocation ratio percentages.[95] While the Service Company does assign some overhead costs to governance employees or functions, it typically allocates the cost of those functions indirectly using a general allocator. Similarly, the Service Company does not include overhead costs in direct labor charges to a business unit. Direct charges to a business unit for work performed on its behalf consist only of fully loaded labor, which is not, by definition, fully distributed cost.

H. CONCERNS IDENTIFIED IN PREVIOUS AUDITS

VI-F2 The shortcomings in the Service Company's cost distribution methods identified in previous Duke Energy audits still exist and are relevant to DE-Ohio FE&G.

Previous audit reports of Duke Energy's cost allocation methods and affiliate transactions identified certain issues with the way in which the Service Company distributes its costs.[96] Specifically, the auditors concluded the following.

- While the Service Company uses an effective set of allocation factors, it makes excessive use of general allocators.
- The spreading approach that the Service Company uses to calculate certain allocation percentages can cause charges for specific functions not to reflect fully distributed cost.
- The Service Company's method for distributing overhead costs is simplistic and does not provide a good match between a business unit's use of a service function and the cost that it pays for that function.

While these reports did not affirmatively assert that cross-subsidization existed, they concluded that the Company had not met its burden of proof for demonstrating its methods adequately prevented it. Silverpoint-Vantage found that the Service Company made no

[95]/ There are some relatively small overhead costs such as office supplies or management costs that are generally charged directly into allocation pools and distributed along with other pool costs.

[96]/ See the final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36 (audit period of January to December 2007), and the Final Report on Duke Energy's Affiliate Transactions, filed with the North Carolina Utilities Commission on October 1, 2007 in Docket No. E-7, Sub 795B (audit period of July 2006 through June 2007).

changes during the audit period that significantly affect the validity of these prior findings. However, as stated in Chapter II, no instances of cross-subsidization were identified in the DE-Ohio audit.

Of the $445 million in charges the Service Company allocated to business units in the first six months of 2009, approximately $238 million, or over 50 percent, were allocated using the three-factor formula ratios. Clearly, the Service Company still relies too heavily on the use of general allocators. The Service Company does not identify specific activities within its business functions that could be either directly charged or more accurately allocated by other means. For example, while there may be no allocator clearly preferable to the three-factor formula for accounting services when viewed as a whole, there are clearly better allocators for accounting activities like capital asset accounting that are more closely related to the cause of costs. Oversimplified methods using general allocators do not provide the level of precision necessary for DE-Ohio FE&G to demonstrate that it pays no more than fully distributed costs for each service it receives.

Silverpoint-Vantage believes that the allocation factors that the Company uses to distribute its utility-only services such as T&D engineering and construction and inventory management are reasonable and adequate. While it believes that the factors the Service Company uses to distribute other costs, *e.g.*, the number of employees, servers, or PCs, are reasonable and effective, Silverpoint-Vantage too has concerns with the methods by which the Service Company calculates the associated allocation percentages. Trying to analyze in advance where over 5,000 Service Company employees will charge their time in order to calculate certain allocation percentages involves a considerable degree of judgment and is at best an approximation.

The spreading approach does not adequately tie Service Company employee overhead costs for IT, human resources, floor space, and cost of capital to actual labor charges. The Service Company Agreement states that indirect costs, which include overhead costs, should be directly assigned when identifiable to a particular activity, process, project, responsibility center, or work order. The Service Company's current approach, whereby it (a) spreads many of the overhead costs associated with enterprise-level functions to other business units by the way that it calculates allocation ratio percentages, and (b) fails to include overhead costs in direct labor charges to business units, seems inconsistent with the intent of the agreement.

Under its current approach, the Service Company cannot clearly identify the all-in cost for any of the functions and services it provides. The Service Company both (a) distributes overhead costs in an indirect fashion, and (b) uses general allocators for such a large portion of costs, that it is extremely difficult to determine if the outcome is fair. One cannot clearly correlate what DE-Ohio FE&G or any other business unit pays for a given service with how much it uses that service. Similarly, one cannot clearly determine if DE-Ohio FE&G is cross-subsidizing other business units through the charges that it pays for Service Company functions. The Service Company's methods are not sufficiently transparent and are difficult to verify.

In 2008, Duke Energy was ordered by the North Carolina Public Utilities Commission to address these concerns by the end of 2009.[97] The Company has taken steps to address these issues, which will impact DE-Ohio FE&G costs in the future. Given the sheer size of Service Company costs, Silverpoint-Vantage believes that DE-Ohio FE&G will be affected by changes that improve the link between cost causation and benefits.

VI-R1 DE-Ohio should keep PUCO Staff informed of future changes to Service Company cost distribution methods. (Refer to Finding *VI-F2*.)

Prior audit reports on Duke Energy affiliate transactions and cost distribution methods presented three recommendations related to the methods by which the Service Company distributes its costs, specifically:[98]

- narrow the use of the three-part formula general allocator;
- eliminate the effect of spreading overhead costs from the calculation of allocation percentages;
- develop a method to fairly assign Service Company overhead costs.

The prior audit reports further recommended that if the Service Company decided to maintain its approach of spreading overhead charges in a way that is not linked to usage of services or cost causation in any discernible way, it be required to make a showing that its approach yields equitable results, and that those results are comparable to more direct, less simplified approaches. Similarly, the reports recommended that the Service Company be required to make a showing that it's charging method results in fully allocated costs for each function that it provides.

Silverpoint-Vantage believes that these recommendations remain appropriate. Clearly, cost distribution methods should be adequately designed to prevent cross-subsidization and yield equitable results. In its Order of the affiliate transaction audit of DE-Carolinas, the North Carolina Utilities Commission concluded the following.[99]

- DE-Carolinas should implement procedures to reduce the use of the three-factor allocator, both by increasing the amount of costs directly charged and assigned, and by developing better methods to directly charge for functions that are demand driven.

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[97]/ Order Ruling on Audit Recommendations, Docket No. E-7, Sub 795B, issued July 3, 2008. The North Carolina Utilities Commission issued a November 18, 2008 order granting Duke Energy's request for additional time to demonstrate compliance with the order, extending the due date to November 2, 2009. The next affiliate transaction audit, which includes an evaluation of the company's compliance efforts, must start no later than March 18, 2010.

[98]/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36.

[99]/ Order Ruling on Audit Recommendations, Docket No. E-7, Sub 795B, issued July 3, 2008.

- The current approach for distributing Service Company costs does not clearly demonstrate that it results in fully distributed costs by individual functions, which is necessary for complying with the Code of Conduct and for preventing cross-subsidization.
- DE-Carolinas has the burden of proving that it pays no more than fully distributed costs on a service-by-service basis. Accordingly, DE-Carolinas should eliminate the effect of spreading overhead costs from the calculation of allocation percentages.
- The Service Company should develop a new method to track and assign overhead costs in a way that results in a better correlation between a business unit's use of a service function and the cost that it pays for that function. DE-Carolinas has the burden of proof in this regard.

The Company has implemented changes to address these concerns beginning in 2010. The methods by which the Service Company distributes costs to client companies have a direct bearing on DE-Ohio FE&G's cost of providing regulated service. It is therefore important that the Company keep the Commission and Staff apprised of interim changes until the next audit in Ohio. Silverpoint-Vantage recommends that DE-Ohio FE&G, upon request, make available to Commission Staff and future auditors the final reports from any third-party audits of Duke Energy affiliates that address these issues.

I. DATA REVIEW AND TESTING

VI-F3 Testing identified no significant errors in the Service Company's calculation of allocation percentages or in its application of those percentages to actual charges.

Silverpoint-Vantage confirmed the Service Company's calculations of allocation percentages, and verified that it accuracy applied those percentages to pool charges during the audit period. The auditors found that the accounting personnel responsible for managing the allocations of the Service Company pools have in place a proactive and rigorous review process designed to identify and correct allocation errors.

Silverpoint-Vantage examined the Service Company's supporting documentation to confirm its calculation of the allocation percentages used during the audit period. The auditors also reviewed detailed Service Company charge data for the 18-month audit period and tested whether allocation percentages were consistently and correctly applied. The team found that the Service Company correctly calculated the amounts charged to DE-Ohio FE&G for governance-, enterprise-, and utility-level allocation pools, as well as Midwest-only allocation pools, based on the predefined allocation percentages.

During its review of Service Company data, Silverpoint-Vantage identified several instances in which DE-Ohio FE&G received allocated charges that it should not have received (*e.g.*, from a generation-related pool) or received an incorrect percentage of a pool. In all cases, Service Company accounting personnel reversed or corrected the charges during the same month, so there was no dollar impact. The Company explained that such errors occur because personnel entering manual journal entries can override the operating unit codes that are used by the accounting system to identify the appropriate allocation pools. The Service Company accounting group responsible for managing pool allocations is aware of this issue and routinely checks for such errors as part of its month-end review process.[100] To prevent this type of input error, Duke Energy should consider introducing an automated system check to identify and prevent improper operating unit/allocation pool code combinations.

100/ Interview of February 3, 2010.

VII. SERVICE COMPANY CHARGES

A. INTRODUCTION

In this chapter, Silverpoint-Vantage examines the charges from the Service Company to its client companies, including DE-Ohio FE&G, during the 18-month audit period. The auditors investigate reasons why Service Company charges in general, and those to DE-Ohio FE&G in particular, have significantly increased during the audit period. Silverpoint-Vantage re-examines the primary concern with Service Company charging practices identified in prior audits of Duke Energy affiliate transactions and cost distribution methods, that is, the tendency of the Service Company to rely too heavily on allocations rather than direct charging. Finally, the audit team discusses the results of its testing to determine if charges to DE-Ohio FE&G during the audit period were properly handled and adequately supported.

B. OVERVIEW OF CHARGES

The following table summarizes the total direct and allocated charges from the Service Company to DE-Ohio FE&G and the other client companies during the audit period.[101]

Compliance Audit of Duke Energy Ohio

Exhibit VII-1
Service Company Charges during the Audit Period ($000)

Business Entity	January - December 2008	January - June 2009	Total
DE-Ohio FE&G	$246,213	$188,434	$434,647.00
DE-Indiana	353,966	194,784	548,750
DE-Kentucky	63,124	43,235	106,359
DE-Carolinas	820,235	399,162	1,219,397
Comm. Power	163,549	96,628	260,177
International	27,988	15,335	43,323
Other	18,667	12,008	30,675
Total	$1,693,742	$949,586	$2,643,328

101/ Data provided in response to DR102 and 103. Figures do not include pass-through payments for utility employee benefit-related costs such as employee savings plans, retiree medical, long-term disability, and medical costs for active employees.

DE-Ohio FE&G received a total of $435 million in charges, or approximately 16 percent of the total $2.6 billion in Service Company charges during the audit period. It is difficult to derive much meaning from this aggregate view, however it appears that total Service Company charges for the first half of 2009, if annualized, represent an overall increase of 12 percent compared to the prior year.

The direct charges and allocated amounts for governance and shared services (*i.e.*, enterprise- and utility-level) that the Service Company distributed to business units during 2008 are listed in the following Exhibit.[102]

Compliance Audit of Duke Energy Ohio

Exhibit VII-2
2008 Service Company Charges to Business Units ($000)

Business Entity	Direct	Allocated Governance	Allocated Shared Services	Total	Precent Direct Charge
DE-Ohio FE&G	[redacted]				
DE-Indiana	171,754	42,585	139,627	353,966	49%
DE-Kentucky	29,249	7,756	26,119	63,124	46%
DE-Carolinas	388,231	135,170	296,834	820,235	47%
Comm. Power	74,325	27,256	61,968	163,549	45%
International	10,048	15,338	2,603	27,988	36%
Other	14,764	1,597	2,306	18,667	79%
Total	**$802,778**	**$255,887**	**$635,577**	**$1,693,742**	**47%**

During 2008, the Service Company charged $1.7 billion of costs to its client companies. Of this amount, the Service Company directly charged $803 million, or 47 percent, and allocated to business units $892 million, or 53 percent. Of DE-Ohio FE&G's total charges of $246 million, 46 percent was directly charged.

The direct charges and allocated amounts for governance and shared services that the Service Company distributed to business units during the first six months of 2009 are listed in the following Exhibit.[103]

[102]/ Data provided in response to Data Requests #102 and #103.

[103]/ Data provided in response to DR102.

Exhibit VII-3
Service Company Charges to Business Units ($000)

January to June, 2009

Business Entity	Direct	Allocated Governance	Allocated Shared Services	Total	Precent Direct Charge
DE-Ohio FE&G	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
DE-Indiana	102,800	19,815	72,169	194,784	53%
DE-Kentucky	26,793	3,200	13,241	43,235	62%
DE-Carolinas	182,996	58,910	157,257	399,162	46%
Comm. Power	51,234	14,111	31,283	96,628	53%
International	7,766	6,615	953	15,335	51%
Other	10,318	595	1,095	12,008	86%
Total	$504,888	$114,879	$329,818	$949,586	53%

In the first half of 2009, the Service Company charged $950 million of costs to its client companies. Of this amount, the Service Company directly charged $505 million, or 53 percent, and allocated to business units $445 million, or 47 percent. Of DE-Ohio FE&G's total charges of $188 million, 65 percent was directly charged.

C. ANALYSIS OF CHARGES

The following Exhibit compares charges from the Service Company to DE-Ohio FE&G during the audit period to those from 2007.[104]

[104]/ Data for 2007 from the final reports in the audits of merger-related agreements of DE-Indiana and DE-Kentucky provided in response to DR36. Data for 2008 and 2009 provided in response to DR102 and 103.

Compliance Audit of Duke Energy Ohio

Exhibit VII-4
Service Company Charges to DE-Ohio FE&G
($ Millions)

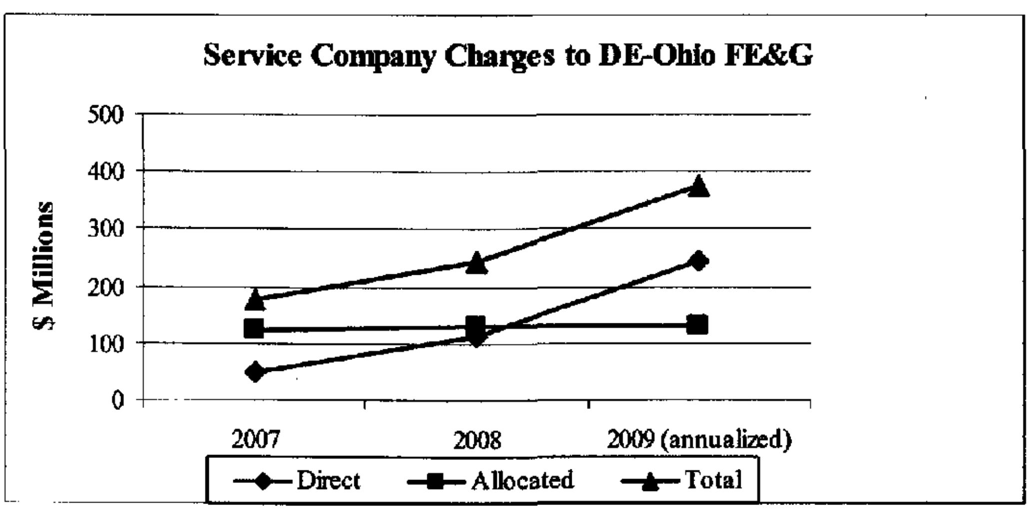
	Direct	Allocated	Total
2007	50.7	125.5	176.2
2008	113.9	132.3	246.2
July-Dec 2008	87.9	68.8	156.6
Jan-June 2009	123.0	65.5	188.4

The $246 million in charges to DE-Ohio FE&G in 2008 represents a 40 percent increase from 2007 levels. If the six-month trend continues for the balance of 2009, total charges to DE-Ohio FE&G will have increased by over 50 percent from 2008 levels (*i.e.*, $377 million versus $246 million) and will be more than twice 2007 levels.

As is evident from the following exhibit, the primary reason for the increase in Service Company charges to DE-Ohio FE&G is the growth in direct charges, rather than allocations.

Compliance Audit of Duke Energy Ohio

Exhibit VII-5
Service Company Charges to DE-Ohio FE&G



VII-F1 <u>While charges to DE-Ohio FE&G from the Service Company doubled by the end of the audit period, most of the increase was due to organizational and accounting treatment changes, rather than actual increases in cost.</u>

Assuming the trend in the first six months of 2009 continues until the end of the year, total charges to DE-Ohio FE&G from the Service Company will have more than doubled from 2007 levels, as illustrated on the following Exhibit.

Compliance Audit of Duke Energy Ohio

Exhibit VII-6
Service Company Charges to DE-Ohio FE&G
($ Millions)

	Direct	Allocated	Total
2007	50.7	125.5	176.2
2008	113.9	132.3	246.2
Jan-June 2009	123.0	65.5	188.4
Est. Total 2009	246.0	131.0	376.8

While allocated charges have remained relatively steady, direct charges by year-end 2009 will be an estimated $200 million higher than two years ago. Silverpoint-Vantage found, however, that most of the increase in direct charges can be linked to changes in Duke Energy accounting treatments and the transfer of a large number of Midwest utility personnel to the Service Company during the second half of 2008. Labor and other expenses that were traditionally recorded as intra-company charges within DE-Ohio FE&G are now treated as inter-company charges to DE-Ohio FE&G from the Service Company, and as such are not new costs. Approximately $53 million of the $70 million increase in direct charges from 2007 to 2008 is due to these factors.

Compared to the second half of 2008, direct charges grew by another $35 million in the first six months of 2009. Much of this increase, however, is due to the change in the accounting treatment for DE-Ohio FE&G's existing $5 million per month regulatory amortization expense. Overall, Silverpoint-Vantage estimates that at least $150 million of the projected $200 million net increase in Service Company charges is due to reasons unrelated to actual cost increases.

The increase in direct charges to DE-Ohio FE&G during the audit period is primarily the result of (a) changes in accounting treatments, and (b) the movement to the Service Company of a considerable number of Midwest utility employees. After the conversion to PeopleSoft and the demise of BDMS in mid-2008, the Service Company began to process certain pass-through costs for DE-Ohio FE&G (as well as other Midwest affiliates) such as employee benefits expense, insurance premiums, and workers' compensation amortization expense. The Service Company also began making more convenience payments on behalf of the Midwest utilities, processing invoices for, as examples, lease/rental expense and purchases of outside services.[105] Until July 2008, these costs had been handled as intra-company charges, *i.e.*, charges that originated from DE-Ohio responsibility centers that were charged by BDMS directly to DE-Ohio FE&G operating units.[106] These costs now originate from Service Company responsibilities centers and are accounted for as inter-company direct charges from the Service Company to DE-Ohio FE&G. The actual cost to DE-Ohio FE&G operating units for these pass-through and convenience payments is not impacted by the change in accounting treatment.

DE-Ohio FE&G transferred to the Service Company approximately 600 of its employees, primarily those that routinely charge their time to more than one Midwest utility. Before the reorganization, labor costs for these employees originated from DE-Ohio responsibility centers. As such, work performed by these employees for DE-Ohio FE&G operating units was billed through BDMS as intra-company charges; work performed for other Midwest utilities was billed as inter-company direct charges. Charges for these employees now originate from Service Company responsibilities centers and are accounted for as inter-company direct charges from the Service Company to DE-Ohio FE&G and its sister utilities.

Direct labor charges from utility responsibility centers reflect a mark-up for overhead costs, but those from the Service Company do not. As previously discussed, the Service Company distributes overhead costs using indirect methods, so that the all-in cost of labor cannot be precisely determined. As such, the cost to DE-Ohio FE&G operating units for work from these employees is not the same as it was before the reorganization; whether it is higher or lower is not clear, but the net effect is likely modest. DE-Ohio FE&G did, however, receive a corollary benefit from the reorganization; some of the utility's allocation percentages decreased in 2009 because it had fewer employees.

Direct charges from the Service Company to DE-Ohio FE&G increased by $63 million from 2007 to 2008, although the majority of that increase occurred in the second half of 2008. Service Company accounting personnel estimated the effect on direct charges from the accounting treatment changes and employee transfers to be $54 million, or over 85 percent of the increase; the estimates are summarized in the following Exhibit.[107]

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[105]/ Response to DR17 and final reports in the audits of merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36. In response to a prior audit recommendation that it clarify its treatment of pass-through costs, the Service Company revised the Service Company Agreement to state that it may "tender payments to third parties as agents for and on behalf of Client Companies, with such charges being passed through to the appropriate Client Companies."

[106]/ As discussed in Chapter III, the responsibility center and operating unit are the "from" and "to," respectively, in Duke Energy general ledger accounting entries.

[107]/ Supplemental response to DR93. The Service Company also charged to DE-Ohio FE&G $9 million for utility employee benefits-related costs in this period, but these costs are not included in the increase being discussed here. Accounting personnel informed Silverpoint-Vantage that all

Compliance Audit of Duke Energy Ohio

Exhibit VII-7
Increases in Direct Charges to DE-Ohio FE&G

July-December 2008

	$ Millions
Sale of accounts receivable	**$ 12**
Increased accounts payable	**28**
Labor moved to Service Co	**10**
Inventory charges	**4**
Total	**$ 54**

Approximately $40 million of the increase in direct charges is due to changes in accounting treatments, and does not represent any actual increase in cost to DE-Ohio FE&G. The $12 million of fees associated with the sale of accounts receivable, which were previously treated as intra-company charges within DE-Ohio FE&G, now originate in a Service Company responsibility center. Similarly, the Service Company processed approximately $28 million in invoices with major vendors on behalf of DE-Ohio FE&G that had previously been paid by the utility itself. The reorganization caused approximately $14 million of the increase. DE-Ohio FE&G was charged $4 million for inventory issued by warehousing responsibility centers that are now part of the Service Company, and the labor costs associated with the employees moved to the Service Company totaled approximately $10 million.[108]

Since the accounting treatment and re-organizational changes are permanent, the higher level of direct charges in the last six months of 2008 constitutes the new baseline for considering direct charges during the last six months of the audit period. As illustrated in the following Exhibit, direct charges from the Service Company to DE-Ohio FE&G continued to grow in the first half of 2009.

benefits-related pass-through payments for DE-Ohio FE&G and other Duke Energy affiliates were excluded from the total Service Company charges provided in response to Data Request #102.

[108]/ All charges from the transferred utility responsibility centers processed in PeopleSoft from July onward are reported as Service Company charges, even though many were not actually transferred until late in the year.

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Exhibit VII-8
Service Company Direct Charges to DE-Ohio FE&G

($ Millions)

	Total
July-Dec 2008	87.9
Jan-June 2009	123.0

To help uncover the reason for the further increase of $35 million, Silverpoint-Vantage compared direct charges to DE-Ohio F&EG by Service Company function for the first six months of 2009 to those for last six months of 2008; the comparison is summarized in the following Exhibit.[109]

[109]/ Data provided in response to DR102. The Overhead/Other category reflects fuels, internal audit, and investor relations; these functions had no or negligible direct charges associated with them.

Exhibit VII-9
Direct Charges to DE-Ohio FE&G
($000)

	July-Dec 2008	Jan-June 2009	Increase
Accounting	(210.4)	245.0	455.4
Environmental	4,288.1	11,183.7	6,895.6
Executive	208.4	217.2	8.8
Facilities	12,157.0	34,948.1	22,791.1
Finance	1,259.4	829.8	(429.6)
Right-of-Way	(428.6)	373.5	802.1
Human Resources	14.8	1.8	(13.0)
IT	4,676.3	2,705.0	(1,971.3)
Legal	1,861.7	973.9	(887.8)
Mkting/Cust Relations	25,939.0	24,163.5	(1,775.5)
Materials Mgmt	1,841.0	669.2	(1,171.8)
Meters	842.1	1,154.5	312.4
Planning	563.8	346.3	(217.5)
Power Engr/Construct	617.2	647.2	30.0
Public Affairs	821.3	552.2	(269.1)
Rates	1,168.4	952.6	(215.8)
System Planning	5,057.6	2,679.1	(2,378.5)
System Maintenance	93.2	17,326.0	17,232.8
T&D Engr/Construct	18,241.0	21,313.6	3,072.6
Transportation	563.4	104.8	(458.6)
Overhead/Other	8,282.6	1,594.2	(6,688.4)
Total	87,857.3	122,981.2	35,123.9

The total $50 million increase in four functional areas was partially offset by $15 million in reductions in other areas. The $7 million difference in overhead and other costs, for example, was the result of a large upward adjustment to construction work-in-progress (CWIP) in 2008 that did not occur in 2009.

Silverpoint-Vantage compared the costs for the environmental health and safety, facilities, and T&D engineering and construction functions during the two time periods, and found the following.

- The $7 million increase in the environmental function is due to an increase in the reserve for environmental damages and claims from $4 million to $11 million.

- The $23 million increase in facilities costs is due to $31 million in charges for regulated retail transition amortization expense (previously treated as an intra-company charge within DE-Ohio FE&G), offset by a drop in CWIP of approximately $8 million.
- The $3 million increase in T&D engineering consists almost entirely of additional loaded labor charges.

The $17 million increase in system maintenance expense is partially due to anomalies in prior year charges. Charges for this function during the second half of 2008 totaling $5.1 million were offset by $5 million in credits, *e.g.*, meter and house regulatory expense (FERC account 878), which exaggerates the effect of the increase in 2009. Of the $17 million in total charges during the first six months of 2009, approximately $14 million was for loaded labor costs.[110]

D. CONCERNS IDENTIFIED IN PREVIOUS AUDITS

VII-F2 <u>The shortcomings in Service Company charging methods identified in prior audits of cost distribution method audits still exist and are relevant to DE-Ohio FE&G.</u>

Prior audit reports of Duke Energy affiliate transactions and cost distribution methods identified certain issues with Service Company charging practices. Specifically, the auditors concluded the following. [111]

- As a general matter, the Service Company does not make sufficient use of direct charging.
- From the perspective of utility-type shared services that it provides, the Service Company has been effective in directly charging those total costs.
- For the traditional, business-type shared services that it provides, the Service Company charges a reasonably sufficient portion of non-labor costs directly, but does not make sufficient use of direct charging for labor costs.
- Service Company employees rely too heavily on the use of default time distributions to allocation pools rather than using positive time reporting.

During this audit, Silverpoint-Vantage found that the Service Company made no significant changes that lessen the validity of these prior findings. Direct charging is preferable to allocation in that it allows a closer link between use and cost, and Silverpoint-Vantage

[110]/ Of the $17.3 million, $5.5 million was charged to CWIP, $5.2 million to T&D O&M accounts, and $3.6 million to customer and A&G accounts.

[111]/ See the final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36 (audit period of January to December 2007), and the Final Report on Duke Energy's Affiliate Transactions, filed with the North Carolina Utilities Commission on October 1, 2007 in Docket No. E-7, Sub 795B (audit period of July 2006 through June 2007).

believes that the Service Company should make reasonable efforts to maximize the use of direct assignment over allocations. The over-use of general allocators as discussed in the prior chapter, for example, is all the more troublesome when the Company charges 90 percent of its costs to a pool rather than, say 10 percent.

In 2008, Duke Energy was ordered to address these concerns by the North Carolina Public Utilities Commission by the end of 2009.[112] The Company has taken steps to address these issues, which will impact DE-Ohio FE&G costs in the future. Given the sheer size of Service Company costs, Silverpoint-Vantage expects that DE-Ohio FE&G will be affected by changes that improve Service Company charging practices.

Silverpoint-Vantage examined the charges to DE-Ohio FE&G during a six-month period by functional area to confirm that the Service Company made no significant changes in its charging practices during the audit period that significantly affect the validity of these prior findings.

The following Exhibit summarizes the direct and allocated charges from the Service Company for utility-related functions to DE-Ohio FE&G for a six-month period.[113]

112/ Order Ruling on Audit Recommendations, Docket No. E-7, Sub 795B, issued July 3, 2008. The North Carolina Utilities Commission issued a November 18, 2008 order granting Duke Energy's request for additional time to demonstrate compliance with the order, extending the due date to November 2, 2009. The next affiliate transaction audit, which includes an evaluation of the Company's compliance efforts, must start no later than March 18, 2010.

113/ Data provided in response to DR102. Marketing and customer relations is not included in the list: the Service Company appropriately allocates a significant portion of the cost of that function.

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Exhibit VII-10
Charges to DE-FE&G for Selected Utility-Related Services

July to December, 2008 ($000)

	Allocated	Allocated %	Direct	Direct %	Total
T&D System Planning	$382	7 %	$5,058	93 %	$5,440
Gas Engr/Construct.	53	8 %	617	92 %	670
T&D Engr/Construct.	4,313	19 %	18,241	81 %	22,554
Materials Mgmt	883	32 %	1,841	68 %	2,724
Environmental H&S	882	17 %	4,288	83 %	5,170
Rates	377	24 %	1,168	76 %	1,545
Meters	268	24 %	842	76 %	1,110
System Maintenance	914	91 %	93	9 %	1,007
Total	$8,072	20 %	$32,148	80 %	$40,220

As a whole, the Service Company directly charges a relatively large percentage of its total costs for these functions, approximately 80 percent, which is consistent with the project-oriented nature of many of these functions. A large portion of the cost for these functions is for loaded labor, and Silverpoint-Vantage found that the Service Company charged relatively large portions of that labor.[114] Silverpoint-Vantage agrees with the finding in the prior audit that the Service Company has been relatively effective in directly charging total costs for the utility-type shared services that it provides. The one exception is system maintenance; in this case, the majority of charges to DE-Ohio FE&G come from allocations from a Midwest-only pool.[115]

The following Exhibit summarizes the direct and allocated charges from the Service Company to DE-Ohio FE&G for traditional, business-type functions for a six-month period.[116]

114/ Loaded labor includes: labor; overtime; and special pay; payroll taxes; fringe benefits; unproductive time; and incentives.

115/ The majority of system maintenance costs for DE-Carolinas are directly charged; in the Midwest, the majority of costs are charged into the Midwest-only pool rather than being directly charged to individual utilities.

116/ Data provided in response to DR102.

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Exhibit VII-11
Charges to DE-FE&G for Selected Traditional Shared Services

July to December, 2008 ($000)

	Allocated	Allocated %	Direct	Direct %	Total
Accounting	$5,635	104 %	$(210)	-4 %	$5,425
Executive	9,578	98 %	208	2 %	9,786
Finance	1,800	59 %	1,259	41 %	3,059
Human Resources	4,131	> 99 %	15	< 1 %	4,146
Internal Audit	302	100 %	0	0 %	302
Investor Relations	104	100 %	0	0 %	104
IT	16,888	78 %	4,676	22 %	21,564
Legal	1,036	36 %	1,861	64 %	2,897
Planning	1,785	76 %	564	24 %	2,349
Public Affairs	1,383	63 %	821	37 %	2,204
Total	$42,642.00	82 %	$9,404	18 %	$51,836

As a whole, the Service Company directly charged a relatively small percentage of its total costs for these functions, approximately 18 percent. While the Service Company manages to directly charge more costs for the legal and IT functions, primarily because the project-oriented nature those services, the Service Company still relies too heavily on the use of allocation pools for these functions.

Silverpoint-Vantage examined loaded labor charges to DE-Ohio FE&G for these functions over a six-month period to determine how well the Service Company performed in directly charging its loaded labor charges. The auditors found that the Service Company directly charged less than ten percent of its loaded labor costs for all but the accounting and legal functions. Clearly, Service Company employees still relied too heavily on the use of default time distributions to allocation pools rather than positive time reporting during the audit period.

According to prior audit reports, Duke Energy's internal audit group recommended that the company complete time reporting training for all relevant employees by the end of 2007, in order to educate utility and Service Company personnel about charging time directly assignable to a utility or non-utility company. Duke Energy reportedly put this recommendation on hold to allow for the conversion to PeopleSoft and movement to one common time reporting system during 2008.[117] The Company met with difficulties in converting the Midwest to WorkBrain, and so both legacy organizations still have separate time reporting systems. The Company expects to implement a new common time reporting tool in early 2011.[118]

VII-R1 **<u>DE-Ohio should keep PUCO Staff informed of future improvements to Service Company charging practices.</u>** (Refer to Finding VII-F2.)

Prior audit reports on Duke Energy affiliate transactions and cost distribution methods presented two recommendations related to the Service Company's charging practices, specifically:[119]

- increase the percentage of labor that the Service Company directly charges to business units;
- encourage employees to do more positive time reporting.

Silverpoint-Vantage believes that these recommendations remain appropriate. In its Order on the affiliate transaction audit of DE-Carolinas, the North Carolina Utilities Commission concluded the following.[120]

- The Service Company should identify and implement methods to increase the percentage of direct labor charged to business units.
- It is appropriate for DE-Carolinas to encourage employees to do more positive time reporting, which should result in more appropriate cost assignment.

The lack of a common time reporting tool is not a satisfactory reason for the Company to delay needed training in this regard.

The Company has implemented changes to address these concerns beginning in 2010. The Service Company's charging practices have a direct bearing on DE-Ohio FE&G's cost of providing regulated service. It is therefore important that the Company keep the Commission and Staff apprised of interim changes until the next audit in Ohio. Silverpoint-Vantage recommends that DE-Ohio FE&G, upon request, make available to Commission Staff and future auditors the final reports from any third-party audits of Duke Energy affiliates that address these issues.

117/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36.

118/ Interview of November 16, 2009. The Company plans to begin implementation during the Summer of 2010.

119/ Final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36.

120/ Order Ruling on Audit Recommendations, Docket No. E-7, Sub 795B, issued July 3, 2008.

E. DATA REVIEW AND TESTING

VII-F3 Testing identified no significant errors in the Service Company's treatment of DE-Ohio FE&G direct and allocated charges to DE-Ohio FE&G.

Service Company accounting personnel adequately explained and supported the direct and allocated charges selected by the auditors as test items. Silverpoint-Vantage concluded that all charges appeared to be handled correctly and appropriately charged to DE-Ohio FE&G.

The Service Company provided itemized data showing direct and allocated charges to all client companies during the 18-month audit period.[121] Silverpoint-Vantage selected as test items approximately fifty categories of charges such as labor and associated loaders, journal entries, depreciation, hardware/software purchases and maintenance, and invoices for outside services, base load labor contracts, or consultants. All test items had been either directly charged to DE-Ohio FE&G or charged to allocation pools of which DE-Ohio FE&G received a portion. These charges totaled approximately $20 million, and included both small and large items, the largest being a $10 million direct charge to DE-Ohio FE&G for an increase in its environmental claim reserve. Service Company accounting personnel explained and reconciled all direct change and allocation pool test items, and provided adequate supporting documentation for the charges. Silverpoint-Vantage substantiated the accuracy and appropriateness of DE-Ohio FE&G's portion of the allocated pool charges.

[121]/ As previously noted, the data excluded direct charges from specific Service Company Human Resources responsibility centers for employee-related costs.

VIII. PRE- AND POST-MERGER CHARGES

A. INTRODUCTION

In this chapter, Silverpoint-Vantage analyzes trends in A&G costs since the merger, and considers the effect of changes in Service Company allocation methods and corporate downsizing on DE-Ohio FE&G's A&G costs.[122] Silverpoint-Vantage also examines Service Company charges by function to investigate the merger's effect on DE-Ohio FE&G's A&G costs in more detail.

B. A&G COST TRENDS

There are no readily available reports that separately identify the A&G costs of DE-Ohio's regulated businesses. The Company's FERC Form 1 reports reflect the combined A&G costs of the regulated electric business and the Ohio portion of the Commercial Power business unit, but exclude the regulated gas business. Nevertheless, Silverpoint-Vantage found FERC Form 1 information a reasonable basis from which to evaluate overall trends in DE-Ohio's A&G costs.[123] The following Exhibit illustrates A&G costs from FERC Form 1 reports for the years 2005 to 2008.

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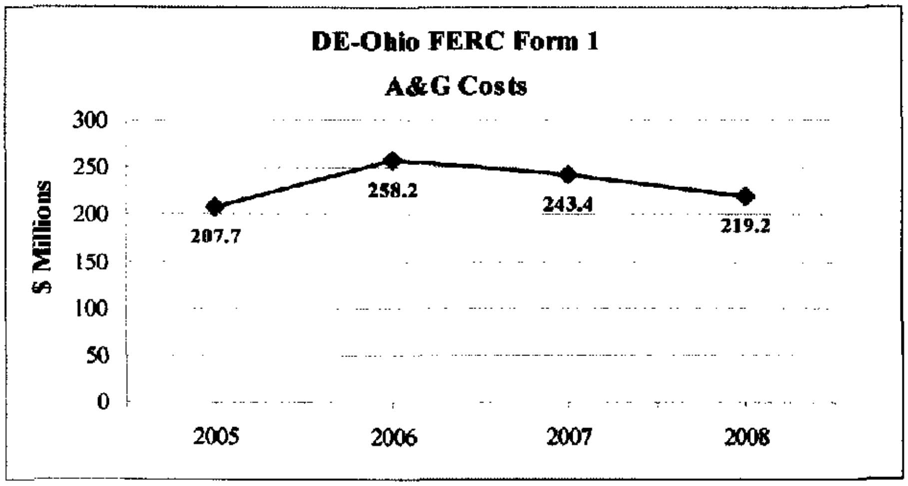
[122] Silverpoint-Vantage has presented a simplified analysis for illustrative purposes. The analysis is based on nominal dollars that do not take into account inflation, and it does not reflect any adjustments for other factors such as load growth.

[123]/ In 2005, the Cinergy Service Company charged DE-Ohio's regulated electric and gas business and commercial power segment a total of $226 million in A&G costs (DR94). This amount is consistent with $207.7 million in A&G costs for DE-Ohio's regulated electric and commercial power segments as reported on FERC Form 1, which excludes the natural gas business.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-1
DE-Ohio FERC Form 1 - A&G Costs



VIII-F1 **A sizable portion of the increase in DE-Ohio FE&G's A&G is due the costs to achieve the merger and its benefits, and the cost to achieve the Spectra spin-off.**

Since the merger, Duke Energy has incurred approximately $323 million in costs associated with its corporate initiatives, *i.e.*, the acquisition of Cinergy on one hand, and the divestiture of Spectra on the other. DE-Ohio FE&G's share of these costs, which are primarily charged to A&G accounts, has been approximately ten percent, or $30 million. These costs, along with other one-time adjustments, are not part of the true cost of providing regulated utility services. When the effects of these extraordinary charges are taken into account, the overall growth in A&G since the merger has been relatively modest. Silverpoint-Vantage estimates DE-Ohio FE&G's A&G cost increase from 2005 to 2008 at approximately 10 percent. The growth in A&G costs for DE-Ohio's electric business and commercial power segments from 2004 to 2005, by comparison, was 17 percent.[124]

A&G costs rose sharply, by approximately $50 million, in the year of the merger, and continued at relatively high levels into 2007. The increase in 2006 is partially due to extraordinary charges from the Service Company for Duke Energy's costs to achieve the

[124]/ DE-Ohio's FERC Form 1 report shows total A&G costs of $177.5 million in 2004 and $207.7 million in 2005.

merger and its benefits, and to achieve the Spectra spin-off. These charges, which totaled $323 million over the last four years, are summarized on the following Exhibit[125]

Compliance Audit of Duke Energy Ohio

Exhibit VIII-2
Merger Cost-to-Achieve and Spectra Divestiture Costs
($ Millions)

	Merger Cost-to-Achieve	Spectra Spin-off	Total
2006	$128.0	$50.2	$178.2
2007	54.5	17.9	72.4
2008	43.9	-	43.9
2009	28.3	-	28.3
Total	$254.70	$68.1	$323

Although the divestiture of Duke Energy's natural gas business did not occur until January 2007, Duke Energy incurred the largest portion of the cost to achieve the Spectra spin-off during 2006. Similarly, more than half of Duke Energy's cost to achieve the merger and its benefits thus far was incurred in 2006. The Service Company generally treats these expenses as governance-level costs that it allocates to all business units using three-factor formula percentages; which for DE-Ohio's regulated electric business and commercial power segments in 2006 totaled 12 percent.[126] In 2006, these business segments received $21 million (*i.e.*, 12 percent of $178.2 million) of these extraordinary costs, which the Company charges primarily to A&G accounts; as such, the cost of these corporate-level initiatives accounted for nearly half of the $50 million increase in total A&G costs.

In 2007, the DE-Ohio segments' share of these extraordinary costs increased to 20 percent, or $14 million (*i.e.*, 20 percent of $72.4 million).[127] The following Exhibit illustrates the effect of these extraordinary costs on the trend in total A&G cost; it is apparent that the cost of these Duke Energy corporate initiatives is one of the primary causes of increases in A&G cost.

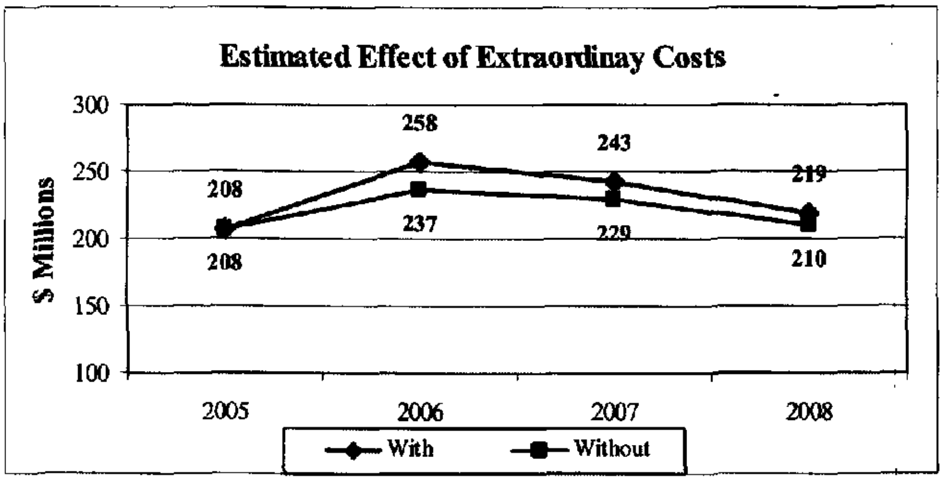
125/ Response to DR92.

126/ DE-Ohio FE&G and Commercial Power business unit governance three-factor formula percentages for 2006 were 6.5% and 9.11%, respectively, or 15.61% in total. The auditors used 12 percent to approximate the effect of excluding the DE-Ohio natural gas business and the non-Ohio portion of Commercial Power.

127/ DE-Ohio FE&G and the Commercial Power business unit governance three-factor percentages for 2007 were 9.66% and 11.67%, respectively, or 21.33% in total. The auditor used 20 percent to approximate the effect of excluding the DE-Ohio natural gas business and the non-Ohio Commercial Power segment, which had been significantly downsized. The auditors used the same estimate for 2008.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-3
Estimated Effect of Extraordinary Costs



Silverpoint-Vantage investigated whether part of the increase in A&G costs for DE-Ohio's regulated electric business and commercial power segments was caused by a substantial change to the methods DE-Ohio uses to split costs between its natural gas and electric business segments. Both before and after the merger, the Company based these allocations primarily on factors such as revenues, labor, inventory, and customers, none of which are affected by the merger.[128] As such, the auditors expect that minor changes to gas and electric allocation methods would have only a minimal effect.

The auditors were not able to quantify the impact on A&G costs of a significant change in capitalization policy. While this change primarily impacts utility T&D O&M, it also influences the treatment of some Service Company costs, a portion of which DE-Ohio charges to A&G.[129] Cinergy, which had more liberal capitalization policies, adopted the more conservative policies and methods of Duke Energy after the merger. Previously, DE-Ohio and its affiliates directly charged some employee labor costs to capital and expense accounts according to pre-determined distributions that were not subsequently trued up to actual experience. Under the Duke Energy method, companies charge labor to expense accounts and move costs to CWIP capital accounts later as necessary.[130]

128/ Response to Data Request #37.

129/ For example, distribution O&M costs rose from $36 million in 2005 to $49 million in 2007 and $54 million in 2008; some portion of the increase is likely due to changes in capitalization policy.

130/ Interviews of November 16, 2009 and February 16, 2010.

Silverpoint-Vantage examined A&G costs at the FERC account level to hopefully obtain further insights into the effect of the merger on A&G costs. The following Exhibit summarizes A&G expenses for the DE-Ohio regulated electric and commercial power business segments by individual FERC account.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-4
DE-Ohio Form 1 A&G Expenses by Account

Acct #	FERC Account	2005	2006	2007	2008
920	A&G Salaries	$76,011,557	$76,600,913	$70,497,470	$61,915,704
921	Office Supplies and Expenses	20,943,933	53,401,159	46,563,722	34,823,736
922	Less: Admin Expense Credit	(153,444)	(176,336)	(89,539)	(87,929)
923	Outside Services	27,010,424	25,995,378	26,886,992	39,715,130
924	Property Insurance	2,677,915	6,522,637	8,991,445	10,954,389
925	Injuries and Damages	6,001,374	9,466,585	7,204,198	11,881,822
926	Employee Pensions/Benefits	47,475,767	51,766,839	52,482,158	34,365,193
927	Franchise Requirements				1,601
928	Regulatory Com. Expense	5,614,448	8,661,611	2,482,296	3,580,862
929	Less Duplicate Charge Credit	(1,307,806)	(1,515,766)	(1,016,546)	(6,306,536)
930.1	General Advertising		6,982	6,804	1,311
930.2	Miscellaneous General	3,896,477	6,317,006	5,350,310	8,233,047
931	Rents	16,640,380	17,993,294	20,591,845	17,289,756
	Total A&G Operations	$204,811,025	$255,040,302	$239,951,155	$216,368,086
935	Maintenance-General Plant	2,873,992	3,139,220	3,405,530	2,874,316
	Total A&G	207,685,017	258,179,522	243,356,685	219,242,402

The costs to achieve the merger and the Spectra spin-off are reflected primarily in A&G salaries, office supplies and expenses, outside services, and employee benefits accounts.

According to Company accounting personnel, costs in individual FERC accounts in 2005 are comparable to those in 2008, but not the intermediate years. Part of the increase in office supplies and expenses (account 921) in 2006 was caused by limitations in the interface between the legacy Cinergy and legacy Duke Power accounting systems. From the time of the merger in 2006 until the middle of 2007, DEBS had to charge all A&G costs to DE-Ohio, other than salaries, benefits, and taxes (accounts 408, 920 and 926), to office supplies and expenses. As a result, the growth in other accounts, such as outside services (account 923), is not reflected accurately until 2008.[131]

The Company's explanation for the apparent variability in the distribution of A&G costs among accounts is reasonable. Such variability, however, rules out a meaningful trend analysis of individual A&G cost categories for the four year period. One notable exception is the change in employee pension and benefit expenses, which decreased by approximately $18 million from 2007 to 2008.

In October 2008, the Service Company issued a $20 million credit to DE-Ohio to reflect a reduction in its reserve for other post-employment benefits (OPEB). The Company reportedly asked state commissions how to handle this adjustment, and was advised that it should book the entire credit in 2008.[132] The $18 million decrease in DE-Ohio's regulated electric and commercial power employee pension and benefits expense is roughly equivalent to its share of the $20 million OPEB credit.[133] Silverpoint-Vantage believes that this decrease is not truly reflective of changes in the cost of services provided by the Service Company but instead the result of an accounting adjustment.

The following Exhibit shows A&G costs for the DE-Ohio regulated electric and commercial power segments as reported on FERC Form 1, compared to A&G costs that Silverpoint-Vantage has adjusted to remove the cost of corporate initiatives and the OPEB accounting adjustment.

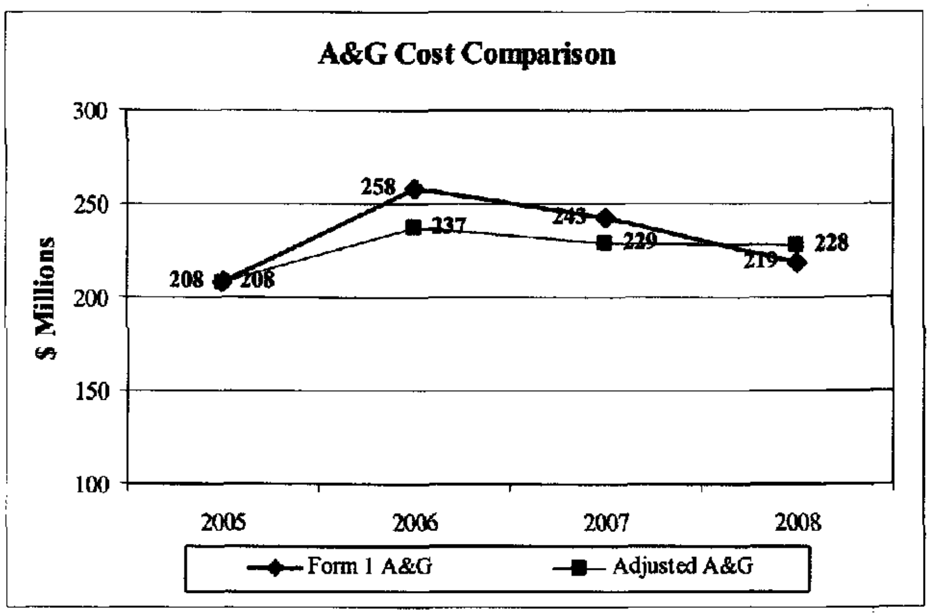
131/ Interviews of November 16, 2009 and February 3, 2010. Accounting personnel stated that DEBS could charge any Midwest A&G account after the PeopleSoft update in 2007.

132/ Interview of February 3, 2010. Accounting personnel indicated that $12 million of the credit was charged to DE-Ohio FE&G O&M, and the rest was either capitalized or charged to DE-Ohio non-regulated operations.

133/ Silverpoint-Vantages assumed that $2 million of the credit pertained to the DE-Ohio natural gas business. All employee benefits costs flow to account 926 unless capitalized; therefore some portion of the $18 million variation could also be attributable to changes in the level of capital programs.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-5
A&G Cost Comparison



Silverpoint-Vantage believes that this adjusted trend line provides clearer insight into the effect of the merger on the cost of the utility and business functions provided by the Service Company, and in turn, the effect on DE-Ohio's A&G costs. A comparison of the costs in 2008 to those in 2005 is a better gauge of the mid-term impact of the merger on DE-Ohio's A&G costs. A&G costs in the years 2006 and 2007 reflect cost inefficiencies that are not unexpected during corporate transition, which, in the case of Duke Energy, was necessary both as a result of the merger and as a result of major corporate divestitures.

The adjusted trend line suggests that pre-merger A&G costs for the DE-Ohio regulated electric and commercial power segments have increased approximately ten percent, or $20 million ($228 versus $208), by 2008. Silverpoint-Vantage believes that ten percent represents a reasonable proxy for the A&G growth rate that was actually experienced by DE-Ohio FE&G's regulated natural gas and electric businesses.

C. CHANGES TO SERVICE COMPANY ALLOCATION METHODS

The service agreement in place before the merger closely resembles the Service Company Agreement in effect today.[134] As with the current agreement, costs for functions provided

[134]/ The agreement, dated August 30, 2004, was provided in response to Data Request #20.

by the Service Company were based on fully distributed costs. Silverpoint-Vantage compared Cinergy Service Company cost allocation methods to those in use today to determine whether any of the growth in DE-Ohio FE&G's A&G charges since the merger may be attributable to changes in these methods.

The allocation factors that the Cinergy Service Company used to distribute the cost of its utility-related functions to the Midwest utilities before the merger were essentially the same as those used by DEBS and DESS after the merger. For example, allocation of T&D engineering and construction costs is still based on construction spending, and allocation of system maintenance costs is still based on circuit miles. The primary difference for these functions is that some Service Company pools now also include DE-Carolinas.[135]

DE-Ohio FE&G's share of the Midwest utility-only pools has remained rather constant. The following Exhibit shows, as an example, the sales and number-of-customers allocation ratios used to distribute certain Midwest marketing and customer relations pools before and after the merger.[136]

Compliance Audit of Duke Energy Ohio

Exhibit VIII-6
Comparison of Marketing and Customer Relations

Midwest-only Pool Allocation Percentages

Allocation Factor	DE-Ohio FE&G %	DE-Indiana %	DE-Kentucky %
# of Midwest customers			
2005	52.96	36.32	10.72
2008	52.61	36.59	10.80
Midwest sales			
2005	56.70	34.69	8.61
2008	51.12	39.46	9.42

In addition, as discussed in Chapter VII, the Service Company directly charges most of its cost for utility-related functions, except for marketing and customer relations. As such, most costs for utility-related functions are unaffected by allocation methods. Also, most of the cost of these functions is ultimately charged to accounts other than A&G accounts.

135/ The Service Company typically uses these broader pools to distribute common management costs.

136/ Silverpoint-Vantage used LOB C12 for the number of customer and LOB S06 for sales as listed in the 2005 allocation percentages provided in response to Data Request #20.

Changes in allocation methods are more evident for the business functions and are arguably more important because a significant portion of the cost of these functions flows to A&G. The following Exhibit summarizes the allocation factors in use before and after the merger.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-7
Comparison of Allocation Factors for Traditional Business Functions

January to June, 2009

Function	Cinergy Services Agreement	Current Service Company Agreement
Finance; Accounting	Wt. Avg. - Sales/Construct. Expend.	Three-factor formula
Facilities	# of employees (to Service Co only)	Square footage ratio
Legal	Wt. avg. of customers, employees, and total construction expenditures	Three-factor formula
Public Affairs	# of customers	Three-factor formula (Gov/Ent); wt. avg. of cust/employ. (Utility)
HR; IT - PC Support	# of employees	# of employees
Exec.; Planning; Invest. Rel.; Int. Aud.; Enviro. Mgmt/Policy; IT Mgmt/Support	Sales	Three-factor formula[137]
IT - Data Center/Ops.	CPU seconds	CPU seconds
IT - Communications	# of employees	# of servers
IT - Software Develop./IT Mgmt/Support[138]	CPU seconds	Either CPU or Number of Servers

Only a few allocation factors remained the same, namely those for human resource, PC support, and data center costs. The most obvious difference is the switch to the three-factor formula as the general allocator. The Cinergy Service Company used sales as its primary general allocator, although it also used in some cases the weighted average of two or more factors.

Silverpoint-Vantage ultimately found that it was not possible to estimate the effect of the change in allocation factors. One reason is that the functional allocation pools changed along with the allocation factors. While the current Service Company generally organizes its functions into governance-, enterprise-, and utility-level services, the Cinergy Service Company did not. The Cinergy Service Company also had many more pools. For example, the current Service Company maintains eight pools that it allocates using the number-of-

137/ Only the utility-level environmental services pool is still allocated using a sales ratio.

138/ The IT software development pool was eliminated, and the function became part of the IT management and support pool.

employee ratio; the Cinergy Service Company had at least twenty. The composition and nature of allocation pools before and after the merger are not necessarily comparable.[139] Also, DE-Ohio FE&G's pre- and post-merger allocation percentages for business functions are generally not comparable because the client companies included in the calculations are different.

D. EFFECT OF CORPORATE DOWNSIZING

In addition to the Spectra spin-off, Duke Energy also divested its Duke Energy North America (DENA) plants along with Cinergy's marketing and trading function. The obvious result of this corporate downsizing was that by 2007 the Service Company had fewer client companies over which to spread its costs. The Service Company also ceased to support Crescent Resources, a Duke Energy real estate subsidiary. The effect of this corporate downsizing on three-factor formula allocation percentages, for example, was quite significant, as shown on the following Exhibit. [140]

Compliance Audit of Duke Energy Ohio

Exhibit VIII-8
Three-Factor Formula Percentages

	DEO FE&G	DEK	DEI	DEC	DEGT/ Field Svc	Comm. Power	Internat/ Other
Governance 2006	6.50%	1.52%	11.01%	36.55%	28.85%	9.11%	6.46%
Governance 2007	9.66%	2.81%	16.07%	53.55%		11.67%	6.14%
Enterprise 2006	8.12%	1.88%	13.71%	45.54%	15.40%	11.29%	4.06%
Enterprise 2007	10.25%	2.99%	17.09%	56.91%		12.46%	0.30%

DE-Ohio FE&G's governance three-factor formula percentage increased by almost 50 percent, from 6.5 percent in 2006 to 9.6 percent in 2007; its enterprise-level percentage grew from 8.12 to 10.25 percent in the same time period.[141]

Estimating the effect of the corporate downsizing on DE-Ohio FE&G's Service Company charges in general, and the A&G portion of those charges in particular, is difficult. The auditors do not have Service Company data for 2006, and cannot separately identify DENA

139/ In some instances the Service Company replaced common pools with, for example, separate natural gas and electric pools, or separate transmission and distribution pools.

140/ Data for 2006 and 2007 taken from final reports in the audits of the merger-related agreements of DE-Indiana and DE-Kentucky provided in response to Data Request #36.

141/ Utility-level three-factor formula percentages were not affected.

charges. Silverpoint-Vantage can, however, estimate the effect on remaining business units as a whole due to the Service Company's loss of Spectra and Crescent Resources as client companies.

The following Exhibit summarizes total Service Company charges to all Duke Energy business units during the last six months of 2006, prior to corporate downsizing. Silverpoint estimated the total charges for the first six months of 2007 based on actual charges for the first three months of the year.[142]

Compliance Audit of Duke Energy Ohio

Exhibit VIII-9
Comparison of Total Service Company Charges ($ Millions)

	July-Dec. 2006 Actual	Jan.-March 2007 Actual	Estimated 6 Mo. 2007	Six Month Difference
Allocated	$551.0	$220.7	$441	$110
Direct	444.2	197.1	$395	50
Total	$995.2	$417.8	$835	$160

The difference in total Service Company charges between the two six-month periods, or the decrease in Service Company costs after the divestitures, is approximately $160 million. Approximately $50 million of the reduction in allocated charges, however, is due to a decrease in 2007 of the charges for the costs to achieve the merger and Spectra spin-off.[143] The reduction in Service Company charges attributable to true reductions in the cost of providing services to client companies is therefore likely closer to $110 million.

Silverpoint-Vantage compared the net $110 million reduction to the $141 million in actual charges from the Service Company to the Duke Energy natural gas business units and to Crescent Resources in the last six month of 2006, which are summarized on the next table.[144]

142/ Duke Energy North Carolina Report, pages 26-27.

143/ Extraordinary costs fell from $178.2 million in 2006 to $72.4 million in 2007; Silverpoint-Vantage assumed that approximately half of the $106 million decrease occurred in the first half of the year.

144/ Charges to the Duke Energy Gas Transmission and Field Services business units for July to December 2006 taken from Final Report on Duke Energy's Affiliate Transactions, filed with the North Carolina Utilities Commission on October 1, 2007 in Docket No. E-7, Sub 795B (Duke Energy North Carolina Report), page 26. The Service Company provided some services to Spectra in 2007 under a separate contract, but charges totaled less than $20 million. (Duke Energy North Carolina Report, page 68.)

Compliance Audit of Duke Energy Ohio

Exhibit VIII-10
Service Company Charges to Spectra and Crescent
July-December 2006 - ($ Millions)

	Spectra	Crescent
Allocated charges	$87.8	$10.1
Direct charges	43.3	-
Total	$131.1	$10.1

The analysis implies that approximately $30 million in charges otherwise allocated to Crescent Resources and Spectra in a six month period (or $60 million for the entire year) could not be avoided. Assuming DE-Ohio FE&G received ten percent of these costs, its Service Company charges were approximately $6 million higher in 2007 because of the downsizing; A&G costs were approximately $4 million higher for the year.[145]

The effect is more modest than one might ordinarily expect. After the divestitures, the number of Service Company employees did not significantly decrease, so it is reasonable to assume that total labor costs declined only marginally. However, that is likely not the case for other types of Service Company costs. Direct costs previously charged by the Service Company to the divested business units should have essentially disappeared. The size of allocation pools certainly declined after the divestitures to reflect decreases in the Duke Energy's cost of outside services (*e.g.*, accounting, auditing, and bank service fees) and the avoidance of user-based costs for the employees of divested companies (*e.g.*, hardware and software purchases and leases, and PC support).

E. SERVICE COMPANY FUNCTIONAL ANALYSIS

Charges from the Service Company to DE-Ohio FE&G flow into many different FERC accounts, including T&D O&M expense, customer and sales expense, CWIP, and A&G. The vast majority of DE-Ohio FE&G's A&G costs originate at the Service Company. In order to obtain further insights into how the utility's A&G costs have changed since the merger, Silverpoint-Vantage compared charges by function for two comparable time periods. Based on the availability and consistency of available accounting data, the auditors selected the last six months of 2005 and 2008.[146] While this function-by-function analysis is far from

[145]/ Silverpoint-Vantage used DE-Ohio FE&G's governance three-factor formula percentage to develop the estimate of Service Company charges. The auditors estimated that 60 percent of DE-Ohio's Service Company charges flowed to A&G accounts based on 2008 actual charges.

[146]/ The auditors intended to conduct a year-over-year comparison. However, Cinergy implemented a new version of BDMS in April 2005, and accounting data from the first three months of the year are substantially different from the rest of the year.

precise, it does offer some insights into the changes in A&G costs since the merger. Overall, the decrease in A&G costs in some functions was outweighed by increases in others.

The following Exhibit summarizes the allocated and direct Service Company charges to DE-Ohio FE&G for the two periods.[147]

Compliance Audit of Duke Energy Ohio

Exhibit VIII-11
Comparison of Service Company Charges to DE-Ohio FE&G ($000)

	July-December 2005	July-December 2008
Allocated charges	$71,246	$68,761
Direct charges	16,940	87,857
Total	$88,186	$156,618

Total Service Company charges grew over the three-year time period by nearly 80 percent. As was discussed in Chapter VII, the primary increase to Service Company charges in recent years has been in direct charges, rather than allocated ones. The same is true for the growth in A&G charges since the merger, as is evident in the following Exhibit, which summarizes total Service Company direct and allocated charges to DE-Ohio FE&G, grouped by FERC account categories.

147/ Data for the analysis in this section were provided in response to DR94 and 102.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-12
DE-Ohio FE&G Service Company Charges by FERC Account

FERC Account	July-Dec 2005 Allocated	July-Dec 2005 Direct	% Direct	July-Dec 2008 Allocated	July-Dec 2008 Direct	% Direct
107-108 (CWIP)	$144,903	$12,482,796	99%	$678	$38,556,059	100%
Other 100s	2,440,355			96,473	7,334,876	99%
400s	711,000	424,105	37%	2,133,764	2,449,886	53%
500-550s	9,756	900	8%	300,474	480,280	62%
560-570s (Tran O&M)	1,002,487	389,258	28%	51,437	2,089,547	98%
580-590s (Dist O&M)	1,099,627	1,329,221	55%	251,466	2,311,802	90%
700-800s	311,591	474,663	60%	4,742	-381,028	101%
900-910s (Customer)	6,406,770	363,157	5%	6,558,629	18,659,131	74%
920-930s (A&G)	59,119,101	1,476,166	2%	59,363,487	16,356,466	22%
Total	**$71,245,590**	**$16,940,266**	**19%**	**$68,761,150**	**$87,857,019**	**56%**

In this six-month pre- and post-merger period comparison, total A&G charges to DE-Ohio FE&G grew by approximately 25 percent; allocated A&G charges remained essentially constant, while direct A&G charges grew by $15 million.[148] During the six-month period of 2005, nearly 70 percent of DE-Ohio FE&G's Service Company charges flowed to A&G accounts, compared to only 48 percent in the six-month period of 2008. This shift was caused by growth in other cost categories, such as customer accounts expenses and capital spending.

Silverpoint-Vantage compared the two six-month periods, and found that DE-Ohio FE&G's A&G costs for Service Company functions such as human resources and internal auditing have fallen since the merger. For a comparable six-month period, total A&G charges fell by over 50 percent, as did total Service Company charges, as summarized on the next table.

148/ It should be noted that the growth during these six-month periods is not necessarily comparable to that in the earlier A&G cost trend analysis, as Service Company charges are higher in the second half of the year.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-13
Service Company Charges to DE-Ohio FE&G ($000)

	Total Charges		A&G	
	July-Dec 2005	July-Dec 2008	July-Dec 2005	July-Dec 2008
Human resources	$8,040	$4,146	$7,640	$4,007
Accounting[149]	$5,607	$2,629	$5,838	$1,504
Internal auditing	632	302	624	289
Investor relations	186	104	181	100
Right-of-Way	790	(428)	95	49
Meters	1,392	1,110	263	89
Total	$16,647	$7,863	$14,641	$6,038

The significant reduction in human resources and meter function A&G costs was, for example, due to reductions in labor costs; the decrease in A&G costs for internal audit, on the other hand, was due to a decrease in outside services. The reductions in A&G costs for these functions are in some cases due to near-term merger synergies.

Silverpoint-Vantage found that A&G costs for two utility-related Service Company functions also fell for a comparable six-month period, as summarized in the following Exhibit.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-14
Service Company Charges to DE-Ohio FE&G ($000)

	Total Charges		A&G	
	July-Dec 2005	July-Dec 2008	July-Dec 2005	July-Dec 2008
Power Engr./Const.	6,270	670	421	99
System Planning	2,484	5,440	842	356
Total	$8,754	$6,110	$1,263	$455

It is difficult, however, to generalize about the reason for the decrease in A&G costs, as it

149/ It is not clear whether Service Company depreciation charges were included here or in Finance in the 2005 six-month period; during 2008, depreciation charges are part of the executive function.

may have been driven by the nature of the work or other factors. System planning costs increased primarily due to an accrual for MISO costs, which flowed to T&D accounts and therefore had no impact on A&G costs. Charges for power engineering and construction decreased, primarily due to a $4 million difference in CWIP, again with no effect on A&G costs.[150]

For another group of Service Company functions, shown on the next table, A&G costs increased significantly, most of which was caused by actual increases in spending on behalf of DE-Ohio FE&G.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-15
Service Company Charges to DE-Ohio FE&G ($000)

	Total Charges		A&G	
	July-Dec 2005	July-Dec 2008	July-Dec 2005	July-Dec 2008
Environmental	$255	$5,170	$220	$4,861
Facilities	2,263	16,636	2,146	6,293
Mkt/Cust. Rel.	8,724	38,608	1,645	6,147
IT	8,836	21,564	7,973	16,630
Rates	508	1,546	339	1,504
Facilities ROR		879		879
Total	$20,586	$84,403	$12,323	$36,314

The large increase in environmental charges, for example, is due primarily to nearly $4 million in environmental clean-up costs during the six-month period in 2008 that did not exist during the comparable period in 2005, all of which was charged to A&G accounts. The significant increase in facilities charges was the result of a series of critical infrastructure projects, including improvements to buildings and data centers. While a large portion of the cost of these capital improvements was charged to CWIP, a significant portion flowed to A&G accounts. The significant increase in A&G for the marketing and customer relations function is largely due to charges from outside contractors for new IT program development.[151]

150/ Interview of February 16, 2010.

151/ Interview of February 16, 2010. A large part of the increase in total Service Company charges in 2008 is due to direct charges for bad debt expense, interest rate hedging, deferred demand side management costs, and losses on the sale of customer accounts; these costs had been accounted for as DE-Ohio FE&G intra-company charges in 2005.

While some portion of the increase in A&G costs for the IT function is due to increased spending for IT initiatives, some is also due to the change in DE-Ohio FE&G's capitalization policy.[152] Charges from the Facilities Rate-of-Return (ROR) allocation pool in the six-month period in 2008 are for DE-Ohio FE&G's share of cost-of-capital charges made by DE-Carolinas to DEBS for space in its buildings; all of this cost flows to A&G accounts.

A&G costs for one group of utility-related functions increased significantly since the merger, as shown in the following Exhibit.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-16
Service Company Charges to Business Units ($000)

	Total Charges		A&G	
	July-Dec 2005	July-Dec 2008	July-Dec 2005	July-Dec 2008
T&D Eng./Const.	4,779	22,554	472	4,432
System Maint.	2,298	1,007	535	1,057
Materials Mgmt.	931	2,724	220	673
Transportation	1,969	1,193	<1	652
Total	$9,977	$27,478	$1,227	$6,814

In some cases the increase in A&G costs coincides with an increase in total Service Company charges for the function, but in other cases not. It is difficult to generalize about the reason for the increase in A&G costs, as it may have been driven by the nature of the work or other factors. An increase in A&G costs for some functions may also be reflective of the change in DE-Ohio FE&G's capitalization policy after the merger.

A large portion of the T&D engineering and construction charges during the six-month period of 2008, for example, flowed to CWIP rather than A&G accounts. Most of the increase in Service Company charges for the materials management function resulted from moving DE-Ohio FE&G utility personnel to the Service Company, which ordinarily should not cause an increase in A&G costs. Accounting personnel indicated that some Midwest utility personnel who previously directly charged their time may now, after moving to the Service Company, have begun to charge time into general allocation pools that flow to A&G accounts.[153]

152/ Interview of February 16, 2010.

153/ Interview of February 16, 2010.

A comparison of DE-Ohio FE&G's A&G costs for several business functions for the two six-month periods are summarized in the following Exhibit.

Compliance Audit of Duke Energy Ohio

Exhibit VIII-17
Service Company Charges to DE-Ohio FE&G ($000)

	Total Charges		A&G	
	July-Dec 2005	**July-Dec 2008**	**July-Dec 2005**	**July-Dec 2008**
Finance	27,962	3,059	27,461	2,891
Public Affairs	$1,216	$2,204	$1,003	$1,450
Executive	2,623	9,786	2,286	9,523
Planning	<1	2,349	<1	1,054
Legal	421	2,897	362	2,865
Rent		2,342		2,342
CTA Deprec.		1,148		1,148
CTA IT/Plan.				919
Total	$32,222	$23,785	$31,112	$22,192

Some of the changes in costs are difficult to analyze. Legal charges for the 2005 six-month period, for example, appear artificially low because of large accounting adjustments that moved these costs to other areas.

The large part of the decrease in finance A&G costs is due to a change in the accounting treatment of employee incentives. Prior to the merger and until 2007, incentives for Cinergy affiliate employees were recorded using high-level journal entries originating from the finance group. Now, incentives are included in the labor loaders applied to all Service Company labor charges for each function. The decrease in finance A&G costs is therefore offset by increases in A&G salary costs in other Service Company functions. The decrease also partially offset by charges for costs to achieve the merger and its benefits in the six-month period of 2008.

Accounting personnel indicated that part of rise in A&G costs in the executive function during the 2008 six-month period is due to approximately $2 million in accruals for employee-related costs such as stock options and for corrections in unproductive labor costs. It also reflects approximately $4 million in Service Company depreciation charges not included in this function during the comparable period in 2005.[154]

[154]/ Interview of February 16, 2010.

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