

# Large Filing Separator Sheet

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07-590-GA-ALT  
07-591-GA-AAM

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Schedules S-4.2

FILE

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In The Matter of the Application of  
Duke Energy Ohio, Inc. for an  
Increase in Gas Rates

Case No. 07-589-GA-AIR

In the Matter of the Application of  
Duke Energy Ohio, Inc. for Approval  
of an Alternative Rate Plan for its  
Gas Distribution Service

Case No. 07-590-GA-ALT

In the Matter of the Application of  
Duke Energy Ohio, Inc. for Approval  
to Change Accounting Methods

Case No. 07-591-GA-AAM

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VOLUME 4

SCHEDULE S-4.2  
(PART 1 OF 3)

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**Duke Energy Ohio, Inc.  
Case No. 07-589-GA-AIR**

**Management Policies, Practices & Organization of  
Duke Energy Corporation**

**Schedule S-4.2**

**Volume 1 of 3**

**DUKE ENERGY CORPORATION  
DUKE ENERGY OHIO  
SUMMARY OF MANAGEMENT POLICIES, PRACTICES AND ORGANIZATIONAL  
SCHEDULE S-4.2**

**TABLE OF CONTENTS**

**VOLUME 1 of 3**

|  | <b><u>Page Nos.</u></b> |
|--|-------------------------|
| <b>FINANCE</b>   |                         |
| <b>Corporate Controller</b>                              |                         |
| Accounting   | 11                      |
| Corporate Financial Controls                             | 337                     |
| <b>Commercial Business Financial Operations</b>          | 344                     |
| <b>Corporate Treasurer</b>                               |                         |
| Treasury   | 351                     |
| Financial Planning & Analysis                            | 409                     |
| O&M and Capital Budgeting and Regulated Business Support | 413                     |
| Insurance & Claims                                       | 418                     |
| Risk Management  | 422                     |
| <b>Financial Re-engineering</b>                          | 427                     |
| <b>Tax</b>   | 431                     |
| <b>Investor Relations</b>                                | 440                     |
| <b>Supply Chain</b>                                      | 445                     |
| <b>Rates</b>   | 495                     |

**DUKE ENERGY CORPORATION  
DUKE ENERGY OHIO  
SUMMARY OF MANAGEMENT POLICIES, PRACTICES AND ORGANIZATIONAL  
SCHEDULE S-4.2**

**TABLE OF CONTENTS**

**VOLUME 2 of 3**

|   | <b><u>Page Nos.</u></b> |
|---|-------------------------|
| <b>STRATEGY, POLICY &amp; REGULATORY ACTIVITIES</b> |                         |
| Technology  | 506                     |
| Environmental, Health & Safety                      | 509                     |
| Energy Efficiency                                   | 514                     |
| Strategy & Planning                                 | 517                     |
| Sustainability & Community Affairs                  | 521                     |
| Foundation  | 562                     |
| Business Relations                                  | 570                     |
| Economic Development                                | 574                     |
| Government & Regulatory Affairs                     | 579                     |
| Federal Government Affairs                          | 584                     |
| Federal Regulatory Policy                           | 589                     |
| Corporate Communication                             | 593                     |
| <b>LEGAL</b>  |                         |
| Legal Department                                    | 603                     |
| Audit Services                                      | 618                     |
| Corporate Secretary and Ethics & Compliance         | 629                     |
| Securities and Financial Reporting                  | 663                     |
| <b>CORPORATE ADMINISTRATION</b>                     |                         |
| Information Technology                              | 668                     |
| Enterprise Operations Services                      | 803                     |
| Human Resources                                     | 818                     |
| Enterprise Field Services                           | 848                     |

**DUKE ENERGY CORPORATION  
DUKE ENERGY OHIO  
SUMMARY OF MANAGEMENT POLICIES, PRACTICES AND ORGANIZATIONAL  
SCHEDULE S-4.2**

**TABLE OF CONTENTS**

**VOLUME 3 of 3**

|  | <b><u>Page Nos.</u></b> |
|--|-------------------------|
| <b>U.S. FRANCHISED ELECTRIC &amp; GAS BUSINESSES UNIT (FE&amp;G)</b> |                         |
| <b>Customer Service</b>  | 861                     |
| <b>Gas Operations</b>  |                         |
| Gas Engineering  | 921                     |
| Commercial Operations  | 965                     |
| Construction & Maintenance   | 976                     |
| Gas Performance Support  | 988                     |
| <b>Power Delivery</b>  |                         |
| Electric Systems Operations  | 998                     |
| Midwest Field Operations   | 1011                    |
| Performance Support  | 1032                    |
| Central Operations   | 1043                    |
| Asset Management   | 1053                    |
| <b>Engineering &amp; Technical Services</b>                          | 1061                    |
| <b>Enterprise Asset Management</b>                                   | 1090                    |
| <br><b>COMMERCIAL BUSINESS UNIT (CBU)</b>                            |                         |
| <b>Corporate Development and Mergers &amp; Acquisitions</b>          | 1096                    |
| <b>Midwest Generation Operations</b>                                 | 1101                    |
| <b>Portfolio Risk Management</b>                                     | 1118                    |
| <b>Coal Group</b>  | 1124                    |
| <b>Regional Transmission Organization &amp; Market Services</b>      | 1129                    |
| <b>Commodity Logistics</b>   | 1133                    |
| <b>Generation Dispatch &amp; Real Time Operation</b>                 | 1138                    |
| <b>Commercial Analytics</b>  | 1144                    |

**DUKE ENERGY**  
**DUKE ENERGY OHIO, INC.**  
**CROSS REFERENCE TO STANDARD FILING REQUIREMENTS**  
**REQUIREMENT: CHAPTER 11 (B) (9) TO RESPONSIBLE COMPANY DEPARTMENT**

| <u>Reference</u>                                    | <u>Functional Area</u>                                    | <u>Responsible Company/Department</u>                | <u>Page No.</u> |
|---|---|--|-----------------|
| <b>(a) <u>PLANT OPERATIONS AND CONSTRUCTION</u></b> |   |  |                 |
| <b>(a)(1)</b>                                       | <b>Plant/Facilities Planning Process</b>                  | Environmental Health & Safety Policy                 | 509             |
|   |   | Federal Government Affairs                           | 584             |
|   |   | Sustainability & Community Affairs                   | 521             |
|   |   | Gas Engineering                                      | 921             |
|   |   | Gas Commercial Operations                            | 965             |
|   |   | Midwest Field Operations                             | 1011            |
|   |   | Asset Management                                     | 1053            |
|   |   | Engineering & Technical Services                     | 1061            |
|   |   | Portfolio Risk Management                            | 1118            |
|   |   | Coal Group   | 1124            |
|   |   | Regional Transmission Organization & Market Services | 1129            |
|   |   | Generation Dispatch & Real Time Operations           | 1138            |
|   |   |  |                 |
| <b>(a) (ii)</b>                                     | <b>Operations and Maintenance Policies And Procedures</b> | Gas Engineering                                      | 921             |
|   |   | Gas Commercial Operations                            | 965             |
|   |   | Gas Construction and Maintenance                     | 976             |
|   |   | Gas Performance Support                              | 988             |
|   |   | Electric System Operations                           | 998             |
|   |   | Midwest Field Operations                             | 1011            |
|   |   | Central Operations                                   | 1043            |
|   |   | Engineering & Technical Services                     | 1061            |
|   |   | Midwest Generation Operations                        | 1101            |
|   |   | Portfolio Risk Management                            | 1118            |
|   |   | Regional Transmission Organization & Market Services | 1129            |
|   |   | Commodity Logistics                                  | 1133            |
|   |   | Generation Dispatch & Real Time Operations           | 1138            |
| <b>(a)(iii)</b>                                     | <b>Plant Productivity and Performance Evaluation</b>      | Gas Commercial Operations                            | 965             |
|   |   | Electric System Operations                           | 998             |
|   |   | Performance Support                                  | 1032            |
|   |   | Midwest Generation Operations                        | 1101            |
|   |   | Portfolio Risk Management                            | 1118            |
|   |   | Regional Transmission Organization & Market Services | 1129            |
|   |   | Generation Dispatch & Real Time Operations           | 1138            |

**DUKE ENERGY**  
**DUKE ENERGY OHIO, INC.**  
**CROSS REFERENCE TO STANDARD FILING REQUIREMENTS**  
**REQUIREMENT: CHAPTER 11 (B) (9) TO RESPONSIBLE COMPANY DEPARTMENT**

| Reference                         | Functional Area                             | Responsible Company/Department                       | Page No. |
|-----------------------------------|---|--|----------|
| (a)(iv)                           | Customer and Usage Growth Forecasting       | Energy Efficiency                                    | 514      |
|                                   |   | Strategy & Planning                                  | 517      |
|                                   |   | Midwest Generation Operations                        | 1101     |
|                                   |   | Commodity Logistics                                  | 1133     |
|                                   |   | Commercial Analytics                                 | 1144     |
| (a)(v)                            | Demand and Capacity Load Forecasting        | Energy Efficiency                                    | 514      |
|                                   |   | Strategy & Planning                                  | 517      |
|                                   |   | Asset Management                                     | 1053     |
|                                   |   | Commodity Logistics                                  | 1133     |
|                                   |   | Commercial Analytics                                 | 1144     |
| (a)(viii)                         | Construction Project Management and Control | Gas Engineering                                      | 921      |
|                                   |   | Gas Construction and Maintenance                     | 976      |
|                                   |   | Midwest Field Operations                             | 1011     |
|                                   |   | Engineering & Technical Services                     | 1061     |
| (a)(ix)                           | Research and Development                    | Environmental, Health & Safety                       | 509      |
|                                   |   | Energy Efficiency                                    | 514      |
|                                   |   | Sustainability & Community Affairs                   | 521      |
|                                   |   | Federal Government Affairs                           | 584      |
|                                   |   | Gas Engineering                                      | 921      |
|                                   |   | Engineering & Technical Services                     | 1061     |
| (a)(x)                            | Environmental Management                    | Environmental Health & Safety                        | 509      |
|                                   |   | Policy   |          |
|                                   |   | Sustainability & Community Affairs                   | 521      |
|                                   |   | Federal Government Affairs                           | 584      |
|                                   |   | Engineering & Technical Services                     | 1061     |
|                                   |   | Portfolio Risk Management                            | 1118     |
|                                   |   | Regional Transmission Organization & Market Services | 1129     |
|                                   |   | Generation Dispatch & Real Time Operations           | 1138     |
| (b) <u>FINANCE AND ACCOUNTING</u> |   |  |          |
| (b)(i)                            | Cash Management                             | Commercial Business Financial                        | 344      |
|                                   |   | Operations   |          |
|                                   |   | Treasury   | 351      |
|                                   |   | Financial Planning & Analysis                        | 409      |
|                                   |   | Regulated Business Support                           | 413      |



**DUKE ENERGY  
DUKE ENERGY OHIO, INC.  
CROSS REFERENCE TO STANDARD FILING REQUIREMENTS  
REQUIREMENT: CHAPTER 11 (B) (9) TO RESPONSIBLE COMPANY DEPARTMENT**

| <u>Reference</u> | <u>Functional Area</u>   | <u>Responsible Company/Department</u>            | <u>Page No.</u> |
|------------------|--|--|-----------------|
| (b)(ii)          | Accounting Systems & Financial Reporting   | Accounting                                       | 11              |
|                  |  | Corporate Financial Controls                     | 337             |
|                  |  | Commercial Business Financial                    | 344             |
|                  |  | Operations                                       |                 |
|                  |  | Treasury   | 351             |
|                  |  | Regulated Business Support                       | 413             |
|                  |  | Financial Re-engineering                         | 427             |
|                  |  | Tax  | 431             |
| (b)(iii)         | Budgeting and Forecasting  | Commercial Business Financial                    | 344             |
|                  |  | Operations                                       |                 |
|                  |  | Treasury   | 351             |
|                  |  | Financial Planning & Analysis                    | 409             |
|                  |  | Regulated Business Support                       | 413             |
| (b)(iv)          | Financial Planning Process and Objectives  | Accounting                                       | 11              |
|                  |  | Commercial Business Financial                    | 344             |
|                  |  | Operations                                       |                 |
|                  |  | Treasury   | 351             |
|                  |  | Regulated Business Support                       | 413             |
|                  |  | Risk Management                                  | 422             |
|                  |  | Financial Re-engineering                         | 427             |
|                  |  | Gas Performance Support                          | 988             |
|                  |  | Technology                                       | 506             |
|                  |  | Corporate Development and Mergers & Acquisitions | 1096            |
| (b)(v)           | Materials and Inventory Management and Control                                       | Supply Chain                                     | 445             |
|                  |  | Enterprise Field Services                        | 848             |
|                  |  | Enterprise Asset Management                      | 1090            |
|                  |  | Coal Group                                       | 1124            |
| (b)(vi)          | Internal Auditing  | Corporate Financial Controls                     | 337             |
|                  |  | Audit Services                                   | 618             |
|                  |  | Ethics & Compliance                              | 629             |
| (c)              | <u>RATES</u>   |  |                 |
| (c)(i)           | The System or Programs for Managing Rate Related Operations and Rate Reform Projects | Rates & Regulatory Accounting                    | 495             |

**DUKE ENERGY**  
**DUKE ENERGY OHIO, INC.**  
**CROSS REFERENCE TO STANDARD FILING REQUIREMENTS**  
**REQUIREMENT: CHAPTER 11 (B) (9) TO RESPONSIBLE COMPANY DEPARTMENT**

| <u>Reference</u> | <u>Functional Area</u>                         | <u>Responsible Company/Department</u> | <u>Page No.</u> |
|------------------|--|---------------------------------------|-----------------|
| (c)(ii)          | Rate Program Analytical Process                | Rates & Regulatory Accounting         | 495             |
| (c)(iii)         | Implementation Management                      | Rate & Regulatory Accounting          | 495             |
| (c)(iv)          | Customer Involvement                           | Rate & Regulatory Accounting          | 495             |
| (c)(v)           | Commission and Staff Reporting                 | Accounting<br>Rate Department         | 11<br>495       |
| <b>(d)</b>       | <b><u>COMMUNICATION AND PUBLIC AFFAIRS</u></b> |                                       |                 |
| (d)(i)           | Customer Service and Information               | Business Relations (OH & KY)          | 570             |
|                  |  | Economic Development                  | 574             |
|                  |  | Corporate Communications              | 593             |
|                  |  | Customer Service                      | 861             |
| (d)(ii)          | Credit and Collections                         | Customer Services                     | 861             |
| (d)(iii)         | Customer Conservation Programs                 | Energy Efficiency                     | 514             |
| (d)(iv)          | Marketing                                      | Strategy & Planning                   | 517             |
|                  |  | Customer Service                      | 861             |
| (d)(v)           | External Relations                             | Investor Relations                    | 440             |
|                  |  | Environmental Health & Safety         | 509             |
|                  |  | Policy                                |                 |
|                  |  | Sustainability & Community Affairs    | 521             |
|                  |  | Foundation                            | 562             |
|                  |  | Business Relations (OH & KY)          | 570             |
|                  |  | Economic Development                  | 574             |
|                  |  | Government & Regulatory Affairs       | 579             |
|                  |  | Federal Government Affairs            | 584             |
|                  |  | Federal Energy Policy                 | 589             |
|                  |  | Corporate Communications              | 593             |
|                  |  | Customer Service                      | 861             |

**DUKE ENERGY**  
**DUKE ENERGY OHIO, INC.**  
**CROSS REFERENCE TO STANDARD FILING REQUIREMENTS**  
**REQUIREMENT: CHAPTER 11 (B) (9) TO RESPONSIBLE COMPANY DEPARTMENT**

| <u>Reference</u>  | <u>Functional Area</u>                | <u>Responsible Company/Department</u> | <u>Page No.</u> |
|---|---------------------------------------|---------------------------------------|-----------------|
| <b>(e) <u>ADMINISTRATIVE &amp; CORPORATE SUPPORT SERVICES</u></b> |                                       |                                       |                 |
| (e)(i)  | Transportation                        | Enterprise Operations Services        | 803             |
|   |                                       | Enterprise Field Services             | 848             |
| (e)(ii)   | Legal                                 | Legal Department                      | 603             |
|   |                                       | Securities & Financial Reporting      | 663             |
| (e)(iii)  | Data Processing                       | Information Technology                | 668             |
| (e)(iv)   | Management Information Systems        | Information Technology                | 668             |
| (e)(v)  | Insurance                             | Insurance & Claims                    | 418             |
|   |                                       | Risk Management                       | 422             |
| (e)(vi)   | Land Management                       | Enterprise Operations Services        | 803             |
| (e)(vii)  | Records Management                    | Accounting                            | 11              |
|   |                                       | Tax                                   | 431             |
|   |                                       | Corporate Communications              | 593             |
|   |                                       | Enterprise Operations Services        | 803             |
|   |                                       | Gas Engineering                       | 921             |
| <b>(f) <u>HUMAN RESOURCES</u></b>                                 |                                       |                                       |                 |
| (f)(i)  | Salary & Benefit Administration       | Human Resources                       | 818             |
| (f)(ii)   | Recruiting and Selection              | Human Resources                       | 818             |
| (f)(iii)  | Training and Career Development       | Human Resources                       | 818             |
| (f)(iv)   | Performance Evaluations and Appraisal | Human Resources                       | 818             |
| (f)(v)  | Work Force Productivity               | Human Resources                       | 818             |

**DUKE ENERGY  
DUKE ENERGY OHIO, INC.  
CROSS REFERENCE TO STANDARD FILING REQUIREMENTS  
REQUIREMENT: CHAPTER 11 (B) (9) TO RESPONSIBLE COMPANY DEPARTMENT**

| <u>Reference</u> | <u>Functional Area</u>                     | <u>Responsible Company/Department</u>   | <u>Page No.</u>     |
|------------------|--|---|---------------------|
| <b>(g)</b>       | <b><u>INTEGRATED RESOURCE PLANNING</u></b> |   |                     |
| (g)(i)           | IRP Process and Objectives                 | Strategy & Planning   | 517                 |
| (g)(ii)          | DSM Policies and Procedures                | Strategy & Planning   | 517                 |
| (g)(iii)         | Alternative Resource Evaluation Process    | Strategy & Planning   | 517                 |
| (g)(iv)          | Rate and Bill Impact Evaluation Process    | Rates & Regulatory Accounting   | 495                 |
| (g)(v)           | Customer Involvement                       | Strategy & Planning<br>Business Relations (OH & KY)   | 517<br>570          |
| (g)(vi)          | Financial Requirements Generated by IRP    | Strategy & Planning   | 517                 |
| (g)(vii)         | Innovative Rate and Tariff Process         | Rates & Regulatory Accounting<br>Regional Transmission Organization<br>& Market Services<br>Generation Dispatch & Real Time<br>Operations | 495<br>1129<br>1138 |

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

I. Policy and Goal Setting

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

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

II. Strategic Planning

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

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

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

### III. Organizational Structure

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

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

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

### IV. Responsibilities

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

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

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

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

The duties of the Fixed Assets group include:

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

The duties of the Derivative and Revenue Accounting group include:

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

The specific duties of the Wholesale Accounting group include:

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

The duties of the Consolidated Financial Reporting group include:

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

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

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

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

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

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

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

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



V. Practices and Procedures

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

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

VI. Decision Making and Control

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

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

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

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

to ensure that the Financial Statements include the most current and appropriate financial disclosures.

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

#### VII. Internal and External Communication

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

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

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

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

#### VIII. Goal Attainment and Qualification

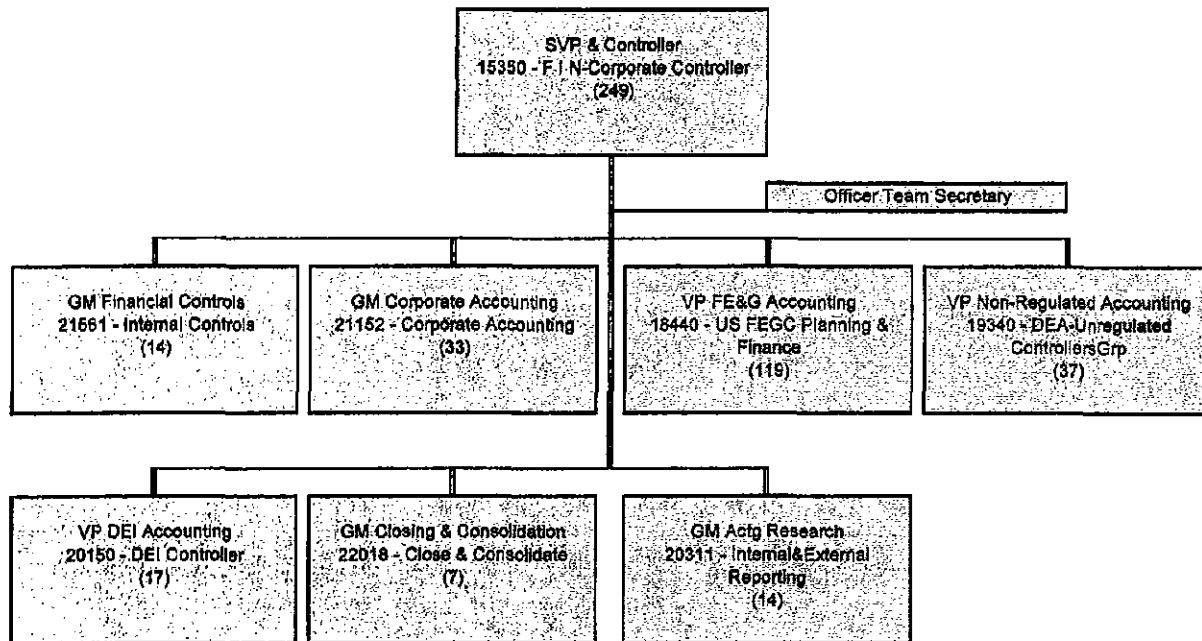
Performance measures are established annually and approved by the Duke Energy Compensation Committee. These performance measures include items that are

critical to the enterprise as well as departmental items that support and align with enterprise measures. Enterprise measures may include EBIT, ROE, etc. Departmental measures may include items such as timely and accurately closing the books and reporting financial results, and timely response to data request. Actual performance against these measures is tracked and reported to all employees.

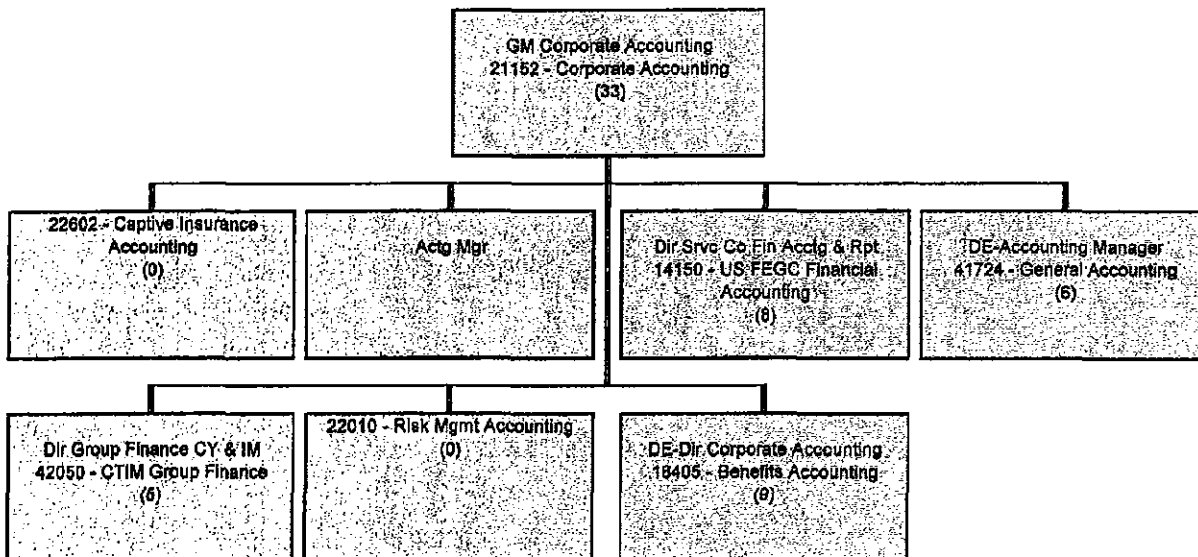
In addition, employees receive annual performance reviews to measure and report progress toward individual goals and performance against expectations.

# DUKE ENERGY CORPORATION MANAGEMENT STRUCTURE

## Senior Vice President & Controller

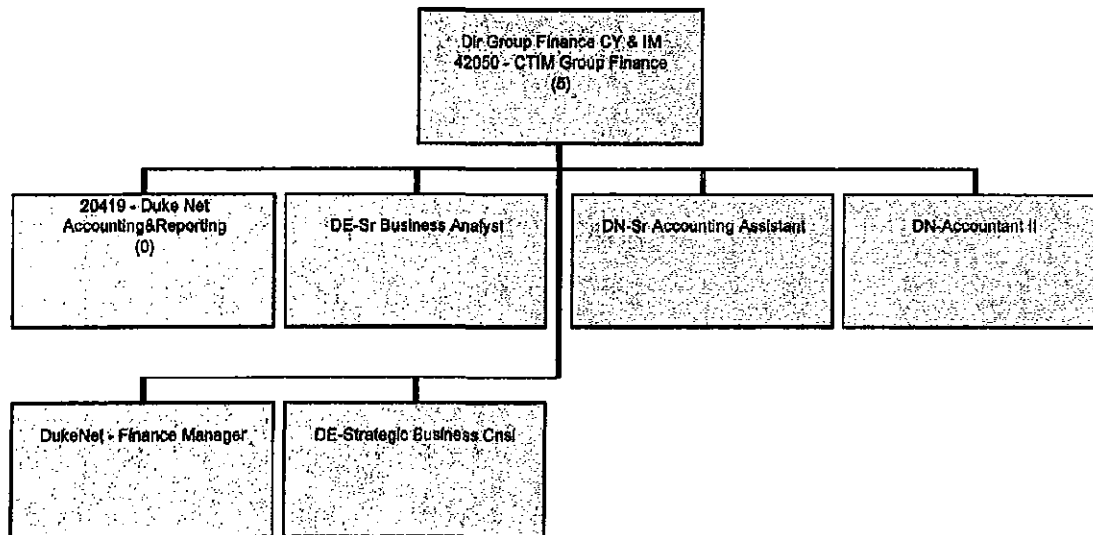


## General Manager Corporate Accounting

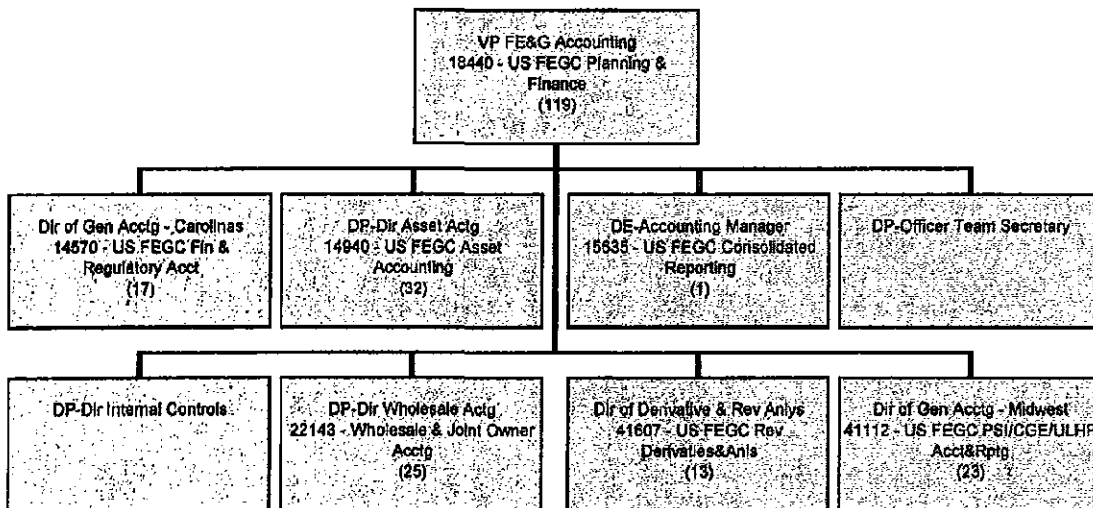


# DUKE ENERGY CORPORATION MANAGEMENT STRUCTURE

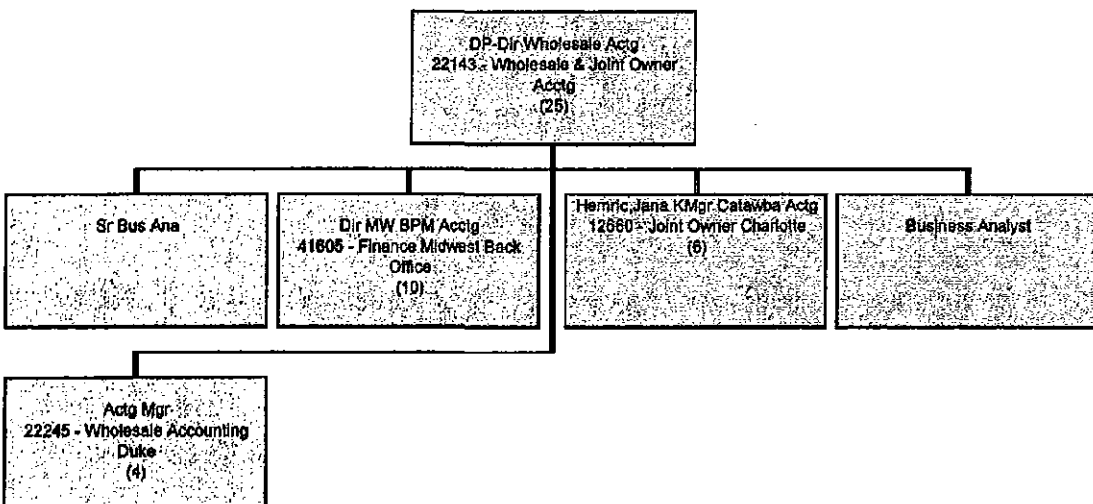
## Director Group Finance, CY&IM



## Vice President FE&G Accounting

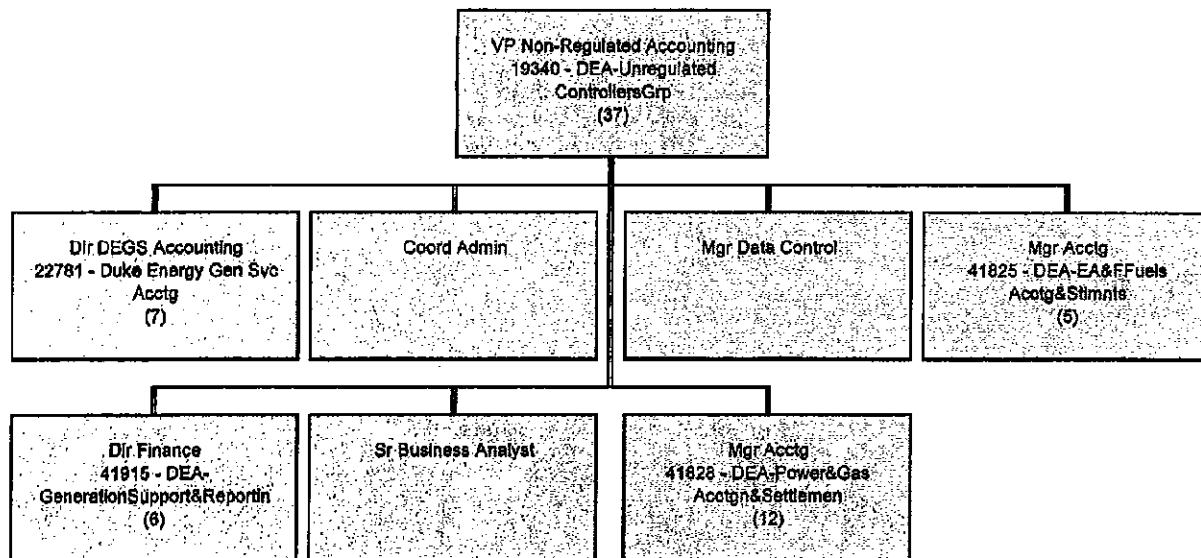


## Director Wholesale Accounting

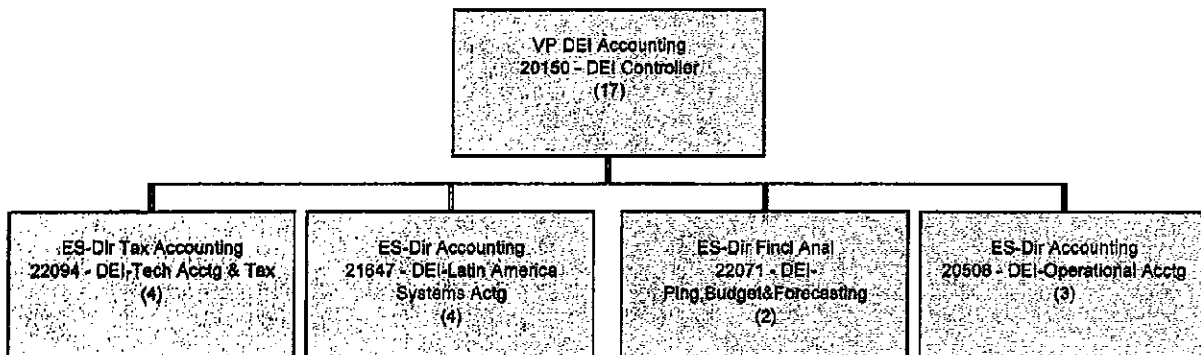


## DUKE ENERGY CORPORATION MANAGEMENT STRUCTURE

### Vice President Non-Regulated Accounting

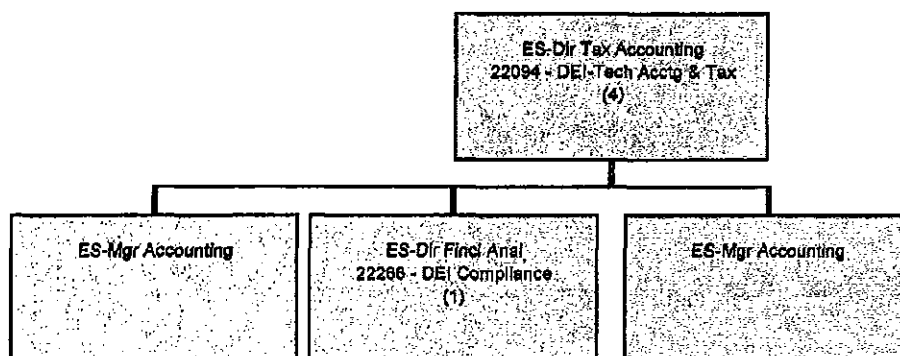


### Vice President DEI Accounting

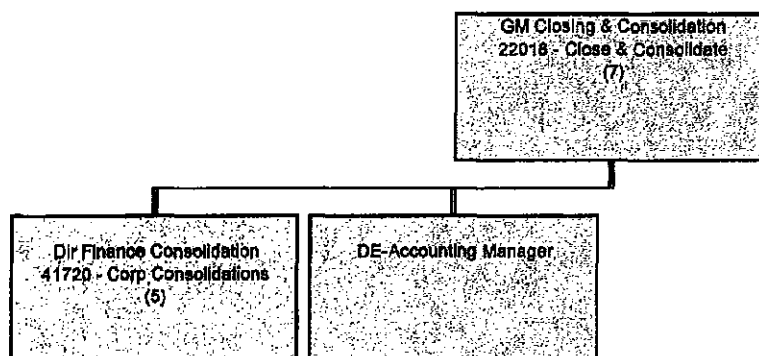


## DUKE ENERGY CORPORATION MANAGEMENT STRUCTURE

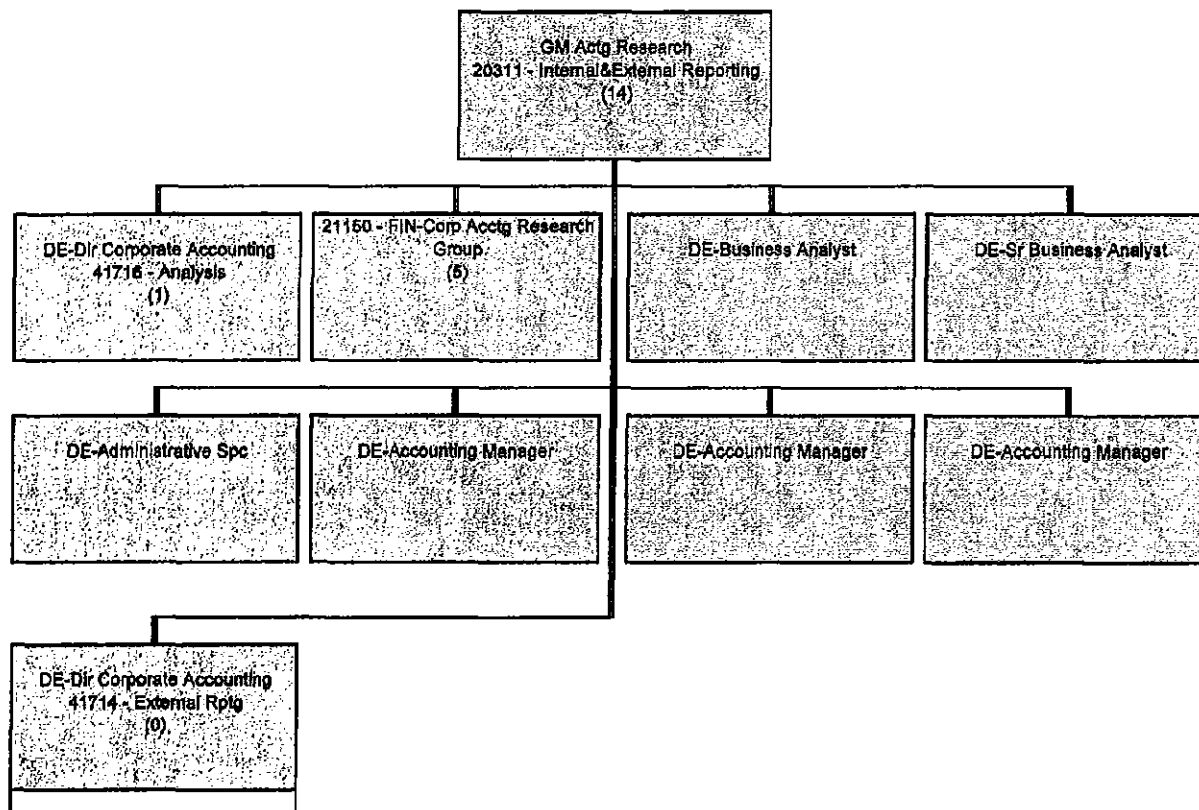
### Vice President Tax Accounting



### GM Closing & Consolidation



### GM Accounting Research



| <b>Tracking Sheet - List of Internal Controls and Financial Controls Policies</b>   |                                |                                |
|---|--------------------------------|--------------------------------|
|   | <b>Current Revision Date *</b> | <b>Original Effective Date</b> |
| <b>Accounting and Financial Reporting</b>   |                                |                                |
| Account Analysis and Reconciliation   | 4/1/2007                       | 4/30/2001                      |
| Accounting for Asset Impairments, Assets Held for Sale and Discontinued Operations, Including Equity Method Investments (SFAS No. 144 and APB No. 18) | 12/15/2006                     | 12/1/2004                      |
| Accounting for Claims between Captive Insurer and Affiliates  | 3/1/2007                       | 12/16/2004                     |
| Accounting for Defined Benefit Pension Plans and Other Post-Retirement Benefit Plans  | 12/15/2006                     | 12/1/2004                      |
| Accounting for Goodwill   | 12/15/2006                     | 12/1/2004                      |
| Accounting for Intercompany Transactions  | 8/31/2005                      | 7/31/2004                      |
| Accounting for Regulated Entities (SFAS No. 71)   | 12/15/2006                     | 12/1/2004                      |
| Accounting for Risk Management and Hedging Activities   | 12/15/2006                     | 12/1/2004                      |
| Documentation and Consultation for Significant Accounting and Reporting Matters   | 2/1/2007                       | 9/1/2003                       |
| Financial Statement Disclosure of Related Party Transactions  | 12/15/2006                     | 12/15/2004                     |
| Form 8-K Requirements and Filing Procedure  | 6/1/2008                       | 8/23/2004                      |
| Journal Entry Creation and Approval Requirements for Non-System Generated Journals  | 1/22/2007                      | 9/30/2003                      |
| Other Comprehensive Income Accounting Procedures  | 3/1/2007                       | 12/31/2003                     |
| Preparing & Reviewing Financial Schedules, Statements, or Reports   | 1/22/2007                      | 3/31/2004                      |
| Property/Business Interruption Reserve Eliminations in Consolidation  | 3/1/2007                       | 12/31/2004                     |
| Reclassification of Realized Income Statement Activity in Consolidation - Net vs. Gross   | 4/1/2007                       | 9/30/2003                      |
| Revenue and Accounts Receivable   |                                | 8/31/2000                      |
| Revenue Recognition   | 12/15/2006                     | 12/1/2004                      |
| Roles and Responsibilities in Accounting for Major Transactions, New Accounting Issues and Significant Non-recurring Entries                          | 9/30/2004                      | 7/1/2004                       |
| U.S. GAAP Compliance Checklist  | 2/1/2007                       | 12/1/2004                      |
| <b>Expenditures</b>   |                                |                                |
| Accounts Payable and Imprest Petty Cash   | 7/11/2006                      | 8/31/2000                      |
| Approval of Annual Budget   | 2/25/2003                      | 8/31/2000                      |
| Approval of Business Transactions   | 4/1/2006                       | 7/1/2000                       |
| Check Signing   | 4/1/2006                       | 8/31/2000                      |
| Delegation of Authority   | 4/1/2006                       | 8/31/2000                      |
| Employee Expenses   | 11/1/2006                      | 8/31/2000                      |
| Purchasing Controls Policy  | 2/1/2007                       | 3/31/2004                      |
| <b>External Auditor</b>   |                                |                                |
| Engaging the External Auditor for Services  | 6/28/2005                      | 4/24/2003                      |
| Hiring Policy for Employees and Former Employees of the External Auditor  | 7/1/2005                       | 4/24/2003                      |
| <b>Fixed Assets</b>   |                                |                                |
| Property, Equipment and Inventory Policy  |                                | 8/31/2000                      |
| <b>Other Internal Controls</b>  |                                |                                |
| Creation, Dissolution or Restructuring of Legal Entities and Subsidiaries   | 4/1/2007                       | 3/25/2004                      |
| Sarbanes-Oxley Change Control   | 2/1/2007                       | 10/1/2004                      |
| Surety Bonds  | 1/1/2005                       | 9/26/2000                      |
| <b>Payroll</b>  |                                |                                |
| Payroll Policy  |                                | 8/31/2000                      |



| Tracking Sheet - List of Internal Controls and Financial Controls Policies |                               |                               |
|--|-------------------------------|-------------------------------|
|  | Current<br>Revision<br>Date * | Original<br>Effective<br>Date |
| <b>Risk Management</b>   |                               |                               |
| Business Continuity and Crisis Management Policy                           | 7/6/2004                      | 7/1/1998                      |
| Commodity Risk Management  | 4/1/2006                      | 5/24/2004                     |
| Credit Policy  | 4/1/2006                      | 7/15/2003                     |
| Credit Risk Limits   | 4/1/2006                      | 4/1/2006                      |
| Loan Policy  | 4/1/2006                      | 1/7/2002                      |
| <b>Summary of Internal Controls and Financial Controls Policies</b>        |                               |                               |
| Summary of Internal Controls and Financial Controls Policies               |                               | 12/16/2004                    |
| <b>Taxes</b>   |                               |                               |
| Accounting for Income Taxes  | 3/31/2007                     | 6/30/2004                     |
| Property Tax   | 3/31/2007                     | 8/31/2000                     |
| Relations with Tax Authorities   | 3/31/2007                     | 8/31/2000                     |
| Sales and Use Tax  | 3/31/2007                     | 8/31/2000                     |
| Tax Reserves Policy  | 3/31/2007                     | 12/31/2004                    |
| <b>Treasury</b>  |                               |                               |
| Accounting for Cash Overdrafts   | 4/26/2006                     | 3/31/2006                     |
| Bank Account and Check Disbursement Policy                                 | 4/1/2006                      | 8/31/2000                     |
| Cash Management Policy   | 4/1/2006                      | 3/10/2000                     |
| Financing Activity and Financial Risk Management Policy                    | 4/1/2006                      | 4/1/2006                      |
| Intercompany Funding Policy  | 4/1/2006                      | 11/1/2004                     |
| Wire Transfer Policy   | 1/1/2007                      | 8/31/2000                     |

\* If no Revision Date is indicated, it is the same as the Effective Date and/or there have been no revisions.  
This list was last updated on 4-1-07.

## Account Analysis and Reconciliation Policy

|                        |                       |
|------------------------|-----------------------|
| <b>Applicability:</b>  | Applies to Enterprise |
| <b>Originator:</b>     | Corporate Controller  |
| <b>Approval:</b>       | Corporate Controller  |
| <b>Effective Date:</b> | 04/30/2001            |
| <b>Revision Date:</b>  | 04/01/2007            |
| <b>Reissue Date:</b>   | 04/01/2007            |

### **Statement of Purpose and Philosophy**

The purpose of this policy is to provide guidelines for analyzing and reconciling balance sheet account balances. Routine account analysis and reconciliation is a foundation for strong internal controls and ensuring an accurate general ledger and financial statements. This policy is applicable to all business units/corporate areas.

### **Policy Expectations**

- Each business unit/corporate area should ensure account analysis and reconciliation procedures, at a minimum, comply with the requirements of this policy.

### **Accountabilities: Roles and Responsibilities**

#### **Corporate Controller**

- Maintain a policy for account analysis and reconciliation processes to help ensure that business units/corporate areas maintain accurate general ledger and financial statement account balances.

#### **Business Units/Corporate Areas**

- Implement routine account analysis and reconciliation procedures sufficient to ensure balance sheet accounts and financial statements are accurate, including reconciling to supporting schedules and documentation which substantiate ending balances.
- Ensure account analysis and reconciliations, and necessary corrections, are completed in a timely manner. Reconciliations shall be performed by the last working day of the month following the General Ledger month for which accounts are being reconciled, e.g., March General Ledger account balances shall be reconciled by the last working day in April.
- Reconcile High Risk Accounts on a monthly basis.
- Reconcile Low Risk Accounts at least every three months.
- Define each account as either High Risk or Low Risk. See the "Standards and Requirements" section below for the definition of High Risk Accounts and Low Risk Accounts. It is anticipated that High Risk Accounts and Low Risk Accounts would be a subset of the Chart of Accounts.
- Perform account reconciliations at the General Ledger (GL) account chartfield level, or a level that includes more than one GL account chartfield where the activity in the grouping of accounts is similar and can be reconciled together.

- Ensure the account reconciliation documentation is reviewed by management, or management designee, as evidenced by a signature and date. Each business unit/corporate area is responsible for maintaining this documentation.
- Ensure the "Exceptions Report - Unreconciled Accounts" report is accurate and timely, and management adequately monitors results.
- Use the "Exceptions Report - Unreconciled Accounts" report to report to the Corporate Controller (submit reports to Corporate Internal Controls) any exception items, Accounts Not Analyzed and/or Accounts Not Current, as described in the Guidelines section below that meet the following thresholds for the applicable registrant:

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

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

This report should be submitted by the last work day of each month. Report exception items on a GL account chartfield basis.

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

#### **Standards and Requirements**

- **Account Definition**- Each balance sheet account should be described adequately to enable a clear determination of proper transactions in the account.
- **Comparative and Trend Analysis**- Comparative metrics, such as dollar or percent change, or other appropriate measures, should be established to identify significant account fluctuations that need accelerated detail journal analysis. If unusual comparisons or trends cannot be reasonably explained, closely review transactions to identify and correct errors. Metrics should be easily generated and updated.
- **Documentation**- Documentation should be maintained to support the amounts in accounts, analysis and reconciliation of each account, correcting entries, and the management review process.
- **Electronic Reconciliations**- The reconciliation process must be documented for an automated reconciliation performed using software applications or computer programs. Management must review and approve the automated process to ensure that the appropriate controls are in place to perform an adequate reconciliation. The electronic reconciliation must be reviewed to ensure that the reconciliation was performed adequately. At a minimum, print

summary documentation to provide evidence of the reconciliation. Documentation should be maintained to support that the electronic reconciliation was reviewed for adequate reconciliation and must be signed and dated by management or their designee.

- **Frequency-** Balance sheet accounts must be routinely analyzed or reconciled at least quarterly to ensure accuracy of financial statements. High Risk Accounts should be analyzed or reconciled monthly.
- **High Risk Accounts-** Accounts which should be reconciled on a monthly basis even if the balance contained in the accounts is below the applicable registrant materiality threshold level (see Materiality Thresholds), e.g., Cash and Cash Equivalents, Trading and Hedging Accounts, and Clearing Accounts and accounts with subsidiary ledgers. Business units/corporate areas will define which accounts are high risk for their unit. In addition to account balance, other factors which business unit/corporate areas may consider when defining the risk of an account may include the nature of the account, complexity of transactions, volume of transactions, variability of account balance, regulatory and audit impacts, and other factors deemed applicable. Business units/corporate areas must maintain documentation of accounts deemed to be high risk which includes the rationale used to classify accounts as High Risk Accounts.
- **Low Risk Accounts-** Accounts which contain activity deemed to be of a low risk nature that can be reconciled on a quarterly basis, even if the balances are greater than the applicable registrant materiality threshold (see Materiality Thresholds) level, e.g., accounts which contain balances which amortize on a prorated basis. Business units/corporate areas will define which accounts are low risk for their unit. In addition to account balance, other factors which business unit/corporate areas may consider when defining the risk of an account may include the nature of the account, complexity of transactions, volume of transactions, variability of account balance, regulatory and audit impacts, and other factors deemed applicable. Business units/corporate areas must maintain documentation of accounts deemed to be Low Risk which includes the rationale used to classify accounts as Low Risk Accounts.
- **Materiality Thresholds-** For purposes of classifying an account as either High Risk or Low Risk, the following materiality thresholds should be considered for each registrant:

| Entities                                       | Threshold (in dollars) |
|--|------------------------|
| Duke Energy Carolinas, LLC and subsidiaries    | \$11,500,000           |
| Duke Energy Indiana, Inc. and subsidiaries     | \$3,500,000            |
| Duke Energy Ohio, Inc. and subsidiaries        | \$3,000,000            |
| All other Duke Energy Corporation subsidiaries | \$21,000,000           |

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

## **Guidelines**

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

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

|                 |                       |
|-----------------|-----------------------|
| Applicability:  | Applies to Enterprise |
| Originator:     | Corporate Controller  |
| Approval:       | Corporate Controller  |
| Effective Date: | 12/01/2004            |
| Revision Date:  | 12/15/2006            |
| Issue Date:     | 12/15/2006            |

### **Statement of Purpose and Philosophy**

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

### **Policy Expectations and Scope**

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

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

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

- Property, plant and equipment
- Assets under capital leases of lessees

- Long-lived assets of lessors subject to operating leases
- Intangibles subject to amortization
- Long-term prepaid assets

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

### **Materiality**

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

### **Accountability: Roles and Responsibilities**

#### **Corporate Controller's Department -**

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

#### **Business/Corporate Unit -**

- Monitor for impairment indicators.
- Ensure that any required recoverability/impairment analyses for assets to be held and used and any investments accounted for using the equity method are performed in a timely manner and that the appropriate support/documentation is prepared and retained for the analyses.
- Ensure all reporting requirements of assets held for sale are accumulated and reported to the Corporate Controller's Department in accordance with the established reporting timetable.
- Ensure proper support/documentation exists for the six criteria which must be met in order to classify assets as held for sale.
- Ensure proper support/documentation exists for the determination of fair value of the assets classified as held for sale, including support for the discount rate used if a discounted cash flow approach is used to determine fair value.
- Ensure that appropriate consideration is given to discontinued operations presentation when assets are disposed of or classified as held for sale.

Notify the Corporate Controller's Department upon determining that any asset impairment exists and coordinate with the Corporate Controller's Department to assess the need to file a Form 8-K for any material asset impairments. This section

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

#### Standards/Requirements/Background Information

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

#### Background

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

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

#### Supporting Guidance

This section contains discussions of the following topics:

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

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

#### Long-Lived Assets to be Held and Used

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



significant decrease in the market price of a long-lived asset (asset group)

significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

A current expectation that, *more likely than not*,<sup>1</sup> a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

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

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

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

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

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

shall be included in an asset group to be tested for impairment only if the asset group is or includes a reporting unit (the

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

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

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

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

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

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

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

#### *Practicable Considerations in Preparing Estimates of Future Cash Flows for Recoverability*

- **General Considerations** - the assumptions used in estimating future cash inflows should be reasonable in relation to the assumptions used in developing other information used for comparable periods, such as internal budgets and projections and accruals related to incentive compensation plans.
- **Cash Flow Estimation Period** - The cash flow estimation period should be based upon the long-lived asset's remaining useful life to the entity. Thus, the process of estimating a long-lived asset's remaining useful life is very important because it directly impacts the number of periods over which operating cash flows are to be estimated in performing a recoverability test. When long-lived assets are grouped for purposes of performing the recoverability test, the remaining useful life of the asset group should be based upon the useful life of the "primary asset." The "primary asset" is defined as the principal long-lived tangible asset being depreciated or identifiable intangible asset being amortized that is the most significant component

asset from which the group derives its cash-flow-generating capacity. A primary asset of an asset group therefore cannot be and or an intangible asset not being amortized. Factors that an entity should consider in determining whether a long-lived asset is the primary asset are: a) whether other assets of the group would have been acquired by the entity without the asset, b) the level of investment that would be required to replace the asset, and c) the remaining useful life of the asset relative to other assets of the group.

- **Asset-Related Expenditures** - For a long-lived asset (group) that is "held and used," estimates of future cash flows used to test for recoverability shall be based on the existing service potential (i.e., "as is") of the "primary asset" on the date it is tested. Therefore, estimates of future cash flows used in that test should exclude the cash flows associated with asset-related expenditures that would enhance the existing service potential of the "primary asset" that is in use. The cash flow estimates would include cash flows (including estimated salvage values) associated with future expenditures necessary to maintain the existing service potential, including those that replace the service potential of component parts of a long-lived asset or component assets (other than the primary asset) of an asset group.
- Generally, debt should not be included in an asset group because the lowest level of identifiable cash flows will typically not include cash flows associated with debt (i.e., the principal payments associated with the debt). However, in rare instances, if the lowest level of identifiable cash flows includes cash flows associated with debt principal payments and it is not practical to eliminate those cash flows (which would be more likely to occur when the asset group is a business or reporting unit), then the debt should be included in the asset group (i.e., netted with the carrying amounts of the assets of the group) so as to maintain an appropriate comparison. This basis adjustment provides the same result as if the debt principal payments have been excluded (e.g., debt with a carrying value of \$100, would have undiscounted cash flows of \$100). SFAS No. 144 prohibits the inclusion of interest expense in assessing the recoverability of long-lived assets.
- **End of Estimation Period Cash Flows** - because a long-lived asset's value is not depleted over its depreciable life, assuming proceeds on sale in cash flow estimates is appropriate.

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

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

The following interpretation of this issue is from KPMG:

211B10. Should an entity perform the recoverability test using pre-tax or after-tax cash flows?

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

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

ditionally, Aspen Publishing's Accounting Research Manager has a similar interpretation:

## 6. Inclusion of Income Taxes in Statement 144 Analyses

### i) Inclusion of Income Taxes in Undiscounted Cash Flows

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

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

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

| <b>Assumptions:</b>  | <b>Scenario A</b> | <b>Scenario B</b> | <b>Scenario C</b> |
|--|-------------------|-------------------|-------------------|
| Book carrying amount of Asset Z (a)                          | 10,000            | 10,000            | 10,000            |
| Tax basis of Asset Z (e)                                     | 6,000             | 6,000             | 6,000             |
| Temporary difference   | 4,000             | 4,000             | 4,000             |
| Deferred tax liability (assuming 40% tax rate) (b)           | 1,600             | 1,600             | 1,600             |
| Pretax undiscounted cash flows (c)                           | 11,000            | 10,000            | 9,700             |
| <b>Pretax Comparison:</b>                                    |                   |                   |                   |
| Pretax undiscounted cash flows                               | 11,000            | 10,000            | 9,700             |
| Book carrying amount   | 10,000            | 10,000            | 10,000            |
| Impairment?  | No                | No                | Yes               |
| <b>After-tax Comparison:</b>                                 |                   |                   |                   |
| Pretax undiscounted cash flows (c)                           | 11,000            | 10,000            | 9,700             |
| Future taxes payable (see (d) below)                         | 2,000             | 1,600             | 1,480             |
| After-tax cash flows [(c) – (d)]                             | 9,000             | 8,400             | 8,220             |
| Book carrying amount less deferred tax liability [(a) – (b)] | 8,400             | 8,400             | 8,400             |
| Impairment?  | No                | No                | Yes               |
| <b>Calculation of future taxes payable:</b>                  |                   |                   |                   |
| Pretax undiscounted cash flows (c)                           | 11,000            | 10,000            | 9,700             |
| Depreciation deductions (e)                                  | 6,000             | 6,000             | 6,000             |
| Future taxable income  | 5,000             | 4,000             | 3,700             |
| Future taxes payable (assuming 40% tax rate) (d)             | 2,000             | 1,600             | 1,480             |

When performing the after-tax comparison, the book carrying amount must be reduced by the deferred tax liability to arrive

the appropriate amount to compare to the after-tax cash flows."

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

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

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

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

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

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

**7-13. Interaction Between Statement 133 and Statement 144**  
**Question:** May cash flows from derivative instruments designated in qualifying cash flow hedges under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, be considered in determining whether the carrying value of a long-lived asset is recoverable under paragraph 7 of SFAS No. 144? **Response:** No. Paragraph 34 of SFAS No. 133 requires that companies apply impairment provisions of generally accepted accounting principles each period after applying hedge accounting for the period. Paragraph 34 of SFAS No. 133 prohibits a company from considering the fair value or expected cash flows of a hedging instrument in applying impairment provisions of other GAAP.

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

olving the test to an oil and gas property, the oil and gas producer's estimate of future cash flows should not include cash flows of the instruments designated in qualifying cash flow hedges of oil and gas sales related to the property.

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

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

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. However, in some cases, the application of SFAS No. 157 may change Duke Energy's current practice for measuring and disclosing fair values under other accounting pronouncements that require or permit fair value measurements. For Duke Energy, SFAS No. 157 is effective as of January 1, 2008 and must be applied prospectively except in certain cases.

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

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

*Disclosure Requirements (paragraph 26 of SFAS No. 144)*

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

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

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

A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange for a similar productive long-lived asset, or in a distribution to owners in a spinoff) shall continue to be classified as held and used until it is disposed of. If an asset (asset group) that is to be exchanged for a similar productive long-lived asset (asset group) or distributed to owners in a

When an asset is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test shall be based on the use of the asset for its remaining useful life, assuming that the disposal transaction will not occur.

Long-Lived Assets to be Distributed in a Spinoff

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

Long-Lived Assets to be Disposed Of by Sale

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

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

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

Criteria for Classification as Held for Sale

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

Management, having the authority to approve the action, commits to a plan to sell the asset (or group of assets, referred to as "disposal group").

*Management must be of the proper level and have the proper authority to be able to commit the entity to a plan to sell.*

*If Board approval is required, or management seeks such approval, in order to sell an asset, the entity has not committed to a plan to sell the asset until Board approval is granted (this position is consistent with that previously expressed by the SEC in Staff Accounting Bulletin Topic 5P1 (from SAB 100)). Executive management or Board approval of an overall budget or forecast that contains information on potential asset dispositions does not constitute approval for the purposes of this item if subsequent more*

of Board approval (e.g. individual asset dispositions) will be required. However, explicit Board approval to proceed with the sales of the asset may constitute the requisite level of approval, depending upon the specific facts and circumstances, even if subsequent Board approval will be required under the Company's delegation of authority policy to execute a specific transaction.

Public announcements concerning an entity's consideration of selling do not meet the definition of "committing to a plan to sell the asset" if subsequent approval is required (such as from an executive committee or board of directors).

2. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).

Any requirement the Company may have to hold or operate the asset for a certain future period of time would not allow the asset to be available for immediate sale. As an example, if an entity did not intend to sell a property until certain renovations or improvements are completed (in order to increase the value), the asset would not be available for immediate sale until the renovations or improvements are completed. Additionally, any requirement of an entity to continue to operate an asset in order to complete pending customer orders would not allow the asset to be available for immediate sale.

Any third party requirements to hold or operate the facility for a certain period of time which are outside of the entity's control (such as pending regulatory approvals) would not preclude the asset from being available for immediate sale as long as it is expected the requirement or pending approval will not permanently delay the sale of the asset.

An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated.

This would include engagement of investment bankers, deploying of internal staff to market the long-lived asset for sale, etc. The sale of the asset (disposal group) is probable (i.e. "likely to occur") and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as explained below:

The term "recognition as a completed sale" is interpreted to mean the transaction meets the requirements to be recognized as a sale under the accounting literature, such as SFAS No. 66, "Sales of Real Estate", within a one year timeframe.

An asset held for sale beyond one-year is outside of the control of the company, held for sale classification may still be appropriate if any of the following conditions are met (the following are the specific items from paragraph 31 of SFAS No. 144):

- If at the date an entity commits to a plan to sell a long-lived asset (disposal group) the entity reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (group) that will extend the period required to complete the sale and (1) actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained from the buyer and (2) a firm purchase commitment is probable within one year of the date an entity commits to a plan to sell the asset;

If an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a long-lived asset (disposal group) previously classified as held for sale that will extend the period required to complete the sale and (1) actions necessary to respond to the conditions have been or will be timely initiated and (2) a favorable resolution of the delaying factors is expected; or,

If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a long-lived asset (disposal group) previously classified as held for sale is not sold by the end of that period and (1) during the initial one-year period the entity initiated actions necessary to respond to the change in circumstances, (2) the asset (group) is being actively marketed at a price that is reasonable given the change in circumstances, and (3) the six criteria for classification as held for sale are met.

The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value.

- "Reasonable sales price" is interpreted as no greater than an asset's fair value

"Actively marketed" means that the asset (disposal group) is being marketed for sale by the Company. This can be directly



*by the Company through an offering memorandum, through investment bankers or brokers, etc.*

Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

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

*Subsequent Measurement (paragraph 37 of SFAS No. 144)*

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

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

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

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

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

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

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

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

reported in discontinued operations in the Statement of Operations.

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

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

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

A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group.

The gain or loss recognized and if not separately presented on the face of the income statement, the caption in the income statement that includes that gain or loss.

If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations.

If applicable, the segment in which the long-lived asset (disposal group) is reported under Statement 131.

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

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

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

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

"Other Hot Topics

Impairment of Equity Method Investments  
Guidance – See paragraph 19(h) of APB 18

discounted cash flow methodology is not an appropriate means of assessing whether an equity method investment is impaired other than "other than temporary" loss in value"

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

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

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

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

- The length of the time and the extent to which the market value has been less than cost;

- The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a significant part of the business that may affect the future earnings potential; or

- The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

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

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

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

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

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

*Financial Statement Presentation and Classification*

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

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

*Discontinued Operations*

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

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

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

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

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

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

FASB No. 144).

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

**Assessment Period**

3. The Task Force reached a consensus that the appropriate assessment period should include the point at which the component initially meets the criteria to be classified as held for sale or is disposed of through one year after the date the component is actually disposed of. The assessment should be based on all facts and circumstances, including management's intent and ability to (a) eliminate the cash flows of the disposed component from its operations and (b) not have significant continuing involvement in the operations of the disposed component. For one year after a component has been disposed of, an entity should reassess whether the criteria in paragraph 42 are expected to be met only when significant events or circumstances occur that may change its current assessment. If the occurrence of a significant event or circumstance at any time during the assessment period results in an expectation that the criteria in paragraph 42 will not be met by the end of the assessment period, the component's operations should not be presented as discontinued operations. If the occurrence of a significant event or circumstance at any time during the assessment period results in an expectation that the criteria in paragraph 42 will be met by the end of the assessment period, the component's operations should be presented as discontinued operations. Reclassification into and out of discontinued operations for 1 periods presented may be required during the assessment period.

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

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

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

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

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

Further, if, after Statement 144 is initially applied, a component of an entity will be abandoned through the liquidation or run-off of

operations, that component should not be reported as a discontinued operation in accordance with Statement 144 until all operations, including run-off operations, cease."

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

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

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

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

FAS No. 144 specifically does not apply to investments in equity securities accounted for under the cost or equity method, and PB No. 18 does not address the topic of discontinued operations presentation. Additionally, it is unlikely that an investment accounted for under the cost or equity method would qualify as a 'component of an entity', as prescribed by SFAS No. 144. Operations and cash flows of an equity method investment usually cannot be clearly distinguished, operationally and for financial

reporting purposes from the rest of an entity (the investor), and thus would not qualify as a disposal group. As pointed out in Deloitte & Touche's interpretations of SFAS No. 144, in November of 2001 the FASB Board clarified that the disposal of an equity method investment, by itself, should not be reported as a discontinued operation under SFAS No. 144, as paragraph 5 excludes investments in equity securities accounted for by the equity method from the scope of SFAS No. 144. Accordingly, unless it is part of a larger disposal group that represents a component of an entity, sale of an equity method investment usually would not be reported as a discontinued operation in the Statement of Operations.

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

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

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

#### INTERCOMPANY SALES TO A DISCONTINUED OPERATION

ASB 144: 43-5

Issued February 14, 2003]

Question

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

Will N continue to purchase paper from N to sell to outside customers. Therefore, N will continue to have sales to X that will not be eliminated once it is no longer a related party.

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

No. If the sales from N to X that have not been passed on to outside customers should be shown in the continuing operations of N. For example: N sells paper to X for \$6 with a cost of \$4. N's profit is \$2. X sells paper to outside customers for \$7 with a cost (X's purchase price from N) of \$6. X's profit is \$1. In the consolidated financial statements of N, the intercompany sales of \$6 will be eliminated along with the \$6 cost of sales, leaving a profit of \$3. The \$3 margin will come through as \$2 in continuing operations (representing the sales from N to X) and \$1 in discontinued operations (representing the sales from X to the outside customers). Next year (assuming the same facts) when N sells paper to X, it will have the same \$6 sale, \$4 cost of sale and \$2 profit in its continuing operations (and will not have the additional \$1 profit from sales to the outside customers).

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

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

#### EC Form 8-K Reporting Requirements

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

#### Accounting Policy

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

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

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

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



abilities classified as held-for-sale will need to be evaluated for classification as current or non-current. Normally, those assets and liabilities will retain their previous current or noncurrent classification (as held and used) and will be disclosed under the provisions of paragraph 46 of SFAS No. 144.

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

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

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

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

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

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

Equity method investments should be assessed for impairment when conditions exist that indicate that the fair value of the

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

#### Reporting and Disclosure Requirements

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

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

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

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

#### Presentation of Discontinued Operations

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

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

- o The operations and cash flows related to the asset will be eliminated from ongoing operations following the sale; and
- o The Company will not have any significant continuing involvement with the operations of the asset following the sale.

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

Discontinued operations presentation is appropriate, subject to materiality considerations, if both of the following conditions are met:

- o The operations and cash flows related to the asset will be eliminated from ongoing operations following the sale; and
- o The Company will not have any significant continuing involvement with the operations of the asset following the sale.

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

The difference between the carrying value of the investment and the investor's underlying equity in the net assets of the investee is reversed by the write-down. Any subsequent increases in the value of the investment should not be recognized until realized.

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

#### Presentation of Discontinued Operations

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

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

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

Discontinued operations presentation is appropriate, subject to materiality considerations, if both of the following conditions are met:

- The operations and cash flows related to the asset will be eliminated from ongoing operations following the sale; and
- The Company will not have any significant continuing involvement with the operations of the asset following the sale.

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

## Accounting for Claims Between Captive Insurer and Affiliates

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

**Effective Date:** 12/30/2004  
**Revision Date:** 03/01/2007  
**Reissue Date:** 03/01/2007

### **Statement of Purpose and Philosophy**

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

### **Policy Expectations and Scope**

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

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

### **Materiality**

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

### **Accountability: Roles and Responsibilities**

**Business/Corporate Unit Controllers**

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

**Continuity, Insurance, and Security Services (CISS)**

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

**Corporate Controller's Department**

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

**Background**

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

**Bison Insurance Company Limited (Bison)**

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

NorthSouth Insurance Company Limited (NorthSouth)

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

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

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

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

During the policy year, affiliates recognize premium expense and remit payments to the Captive insurance entity. On the financial records of the Captive entity, premium receipts are recognized as revenue over the policy period. Through inter-company accounting, the premium expense recognized by the business unit and the corresponding revenue recorded by Bison is eliminated at the consolidated level. See separate guidance titled "Accounting Process to Record Intercompany Insurance Activity."

This policy is meant to derive consistency between amounts recorded as reserves by the Captive (which represent liabilities to the affiliated Duke Energy entities) and amounts recorded as receivables by the business/corporate units (which represent reimbursement amounts due from the Captive for insured events). The policies written by the Duke Energy Captive entities represent indemnity policies which dictate that the Captive is responsible for directly reimbursing the

business/corporate unit for covered losses only to the extent the losses have been actually incurred by the business/corporate unit. Therefore, the Captive insurer is not directly responsible for making payments directly to third parties.

### **Procedural Details**

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

#### **Procedure for Business Units Recording Insured Events**

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

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

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

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

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

| <u>A/C #</u> |                  | <u>Dr</u> | <u>Cr</u> |
|--------------|------------------|-----------|-----------|
| xxx-xx       | Accrued expenses | xxx       |           |
| xxx-xx       | Cash             |           | xxx       |

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



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

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

| <u>A/C #</u> |  | <u>Dr</u> | <u>Cr</u> |
|--------------|--|-----------|-----------|
| 0146960      | A/R NonProp/Non BI Interco                   | xxx       |           |
| xxx-xx       | Operating expenses (per incident deductible) | xxx       |           |
| xxx-xx       | Accrued expenses                             |           | xxx       |

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

Affiliate: PeopleSoft business unit number of the Captive Insurer.

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

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

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

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

| <u>A/C #</u> |  | <u>Dr</u> | <u>Cr</u> |
|--------------|--|-----------|-----------|
|--------------|--|-----------|-----------|

|        |                  |     |     |
|--------|------------------|-----|-----|
| xxx-xx | Accrued expenses | xxx |     |
| xxx-xx | Cash             |     | xxx |

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

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

| <u>A/C #</u> |                            | <u>Dr</u> | <u>Cr</u> |
|--------------|----------------------------|-----------|-----------|
| xxx-xx       | Cash                       | xxx       |           |
| 0146960      | A/R NonProp/Non BI Interco |           | xxx       |

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

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

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

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

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

Affiliate: PeopleSoft business unit number of the Captive Insurer

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

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

2) The business unit expends cash to replace the damaged equipment and capitalizes the replacement cost:

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

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

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

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

| <u>A/C #</u> |                     | <u>Dr</u> | <u>Cr</u> |
|--------------|---------------------|-----------|-----------|
| xxx-xx       | Cash                | xxx       |           |
| 0146990      | A/R Prop/BI Interco |           | xxx       |

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

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

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

2) The business unit expends cash to repair the damaged equipment and expenses the repair:

| <u>A/C #</u> |                              | <u>Dr</u> | <u>Cr</u> |
|--------------|------------------------------|-----------|-----------|
| xxx-xx       | Operating expenses (repairs) | xxx       |           |
| xxx-xx       | Cash                         |           | xxx       |

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

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

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

Affiliate: PeopleSoft business unit number of the Captive Insurer

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

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

The amount of the A/R Prop/BI Interco will be for the amount expended by the business unit less the per incident deductible with Captive. Therefore, the net income statement impact of the above entries (operating expenses) is the per incident deductible.

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

| <u>A/C #</u> |  | <u>Dr</u> | <u>Cr</u> |
|--------------|--|-----------|-----------|
|--------------|--|-----------|-----------|

|         |                     |     |
|---------|---------------------|-----|
| xxx-xx  | Cash                | xxx |
| 0146990 | A/R Prop/BI Interco | xxx |

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

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

| <u>A/C #</u> |  | <u>Dr</u> | <u>Cr</u> |
|--------------|--|-----------|-----------|
| 0146990      | A/R Prop/BI Interco                          | xxx       |           |
| xxx-xx       | Operating expenses (per incident deductible) | xxx       |           |
| xxx-xx       | Accrued expenses                             |           | xxx       |

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

Affiliate: PeopleSoft business unit number of the Captive Insurer

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

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

*Scenario F - Same as Scenario E above except amount of claim is below the business unit per incident deductible with the Captive Insurer.*

Accounting for this transaction will follow Scenario A above.

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

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

| <u>A/C #</u> |                            | <u>Dr</u> | <u>Cr</u> |
|--------------|----------------------------|-----------|-----------|
| 0146990      | A/R Prop/BI Interco        | xxx       |           |
| 0495030      | Captive Revenue BI Interco |           | xxx       |

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

Affiliate: PeopleSoft business unit number of the Captive Insurer

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

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

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

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

| <u>A/C #</u> |                     | <u>Dr</u> | <u>Cr</u> |
|--------------|---------------------|-----------|-----------|
| xxx-xx       | Cash                | xxx       |           |
| 0146990      | A/R Prop/BI Interco |           | xxx       |

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

#### Cash Flow Reporting

For property claims related to the replacement of a business unit's owned property which has been damaged in an insured event, any amounts received as reimbursement from the wholly-owned Captive Insurer to the business/corporate unit should not be netted against the capital expenditure.

Rather, these reimbursements should be classified in the same way the expenditure is classified by the Captive entity to ensure elimination in the consolidated statement of cash flow.

**Regulatory Accounting Treatment Under SFAS No. 71**

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

**Standards/Requirements**

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

| <u>Account</u>      | <u>Purpose</u>   |
|---------------------|--|
| 0146960<br>Business | All captive receivables (i.e. - general liability), except receivables for Property and Interruption claims                    |
| 0146990             | Receivables for Property and Business Interruption claims only   |
| 0421120             | This account captures the BU gain, if any, from replacement of property  |
| 0495030             | This account captures the revenues recognized from captive coverage of business interruption claims                            |
| 0421040             | This account captures the revenues recognized from captive coverage of business interruption claims (Franchised Electric only) |

The PeopleSoft business unit numbers for the captive companies are as follows:

|       |                                      |
|-------|--------------------------------------|
| 10006 | Bison Insurance Company Limited      |
| 10221 | NorthSouth Insurance Company Limited |

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

|                        |                       |
|------------------------|-----------------------|
| <b>Applicability:</b>  | Applies to Enterprise |
| <b>Originator:</b>     | Corporate Controller  |
| <b>Approval:</b>       | Corporate Controller  |
| <b>Effective Date:</b> | 12/01/2004            |
| <b>Revision Date:</b>  | 12/15/2006            |
| <b>Reissue Date:</b>   | 12/15/2006            |

### **Statement of Purpose and Philosophy**

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

### **Policy Expectations and Scope**

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

### **Materiality**

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

### **Accountability: Roles and Responsibilities**

Corporate Controller's Department -



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

Business/Corporate Unit –

Ensure all reporting requirements for the defined benefit pension and other post-retirement benefit plans are accumulated and reported to the Corporate Controller's Department in accordance with the established reporting timetable.

Ensure proper support/documentation exists for amounts recorded related to the defined benefit pension and other post-retirement plans (Corporate Accounting records the amounts for all business units for all plans)

Ensure that the accounting for the defined benefit pension and other post-retirement plans is applied consistently between periods.

**Standards/Requirements/Background Information**

This section contains the following subsections:

- Background Information
  - Summary of Defined Benefit and Defined Contribution Plans
  - Other Postretirement Benefits
  - Benefit Plan Asset Management
- Supporting Accounting Guidance
- Accounting Policy

**Background Information**

**Summary of Defined Benefit and Defined Contribution Plans**

This policy contains separate discussion in certain areas for the following:

- Duke Energy
- Cinergy Corp ("Cinergy")
- Westcoast Energy Inc. ("Westcoast")

Duke Energy acquired Westcoast in 2002 and merged with Cinergy in 2006. Westcoast has maintained separate benefit plans, largely because these plans cover Canadian employees. Under the terms of the merger, Duke Energy and Cinergy will maintain separate plans until at least the end of 2007. New employees participate in the Duke Energy or Cinergy pension plans depending on the subsidiary to which they are assigned.

Effective 1/1/2007, Westcoast and its benefits plans will be spun off to Spectra and will not be subject to this policy for accounting periods beginning after that date.

#### Duke Energy

Duke Energy and its subsidiaries maintain a non-contributory defined benefit retirement plan. It covers its U.S. employees using a cash balance formula. Under a cash balance formula, a plan participant accumulates a retirement benefit consisting of pay credits that are based upon a percentage (which may vary with age and years of service) of current eligible earnings and current interest credits.

Duke Energy also sponsors employee savings plans that cover substantially all of its U.S. employees. Duke Energy contributes to the plan a matching contribution equal to 100% of before-tax employee contributions, of up to 6% of eligible pay per pay period.

Duke Energy also maintains a non-qualified, non-contributory defined benefit retirement plan which covers certain U.S. executives.

#### Cinergy

Cinergy maintains a qualified defined benefit pension plans that cover substantially all of its United States employees meeting certain minimum age and service requirements. During 2002, eligible Cinergy employees were offered the opportunity to make a one-time election, effective January 1, 2003, to either continue to have their pension benefit determined by the traditional defined benefit pension formula or to have their benefit determined using a cash balance formula. A similar election was provided to certain union employees at a later time.

The traditional defined benefit program utilizes a final average pay formula to determine pension benefits. These benefits are based on years of participation, age at retirement; and the applicable average Social Security wage base.

Benefits are accrued under the cash balance formula based upon a percentage of pension eligible earnings plus interest. In addition, participants with the cash balance formula may request a lump-sum cash payment upon termination of their employment, which may result in increased cash requirements from pension plan assets. At the effective time of the election, benefits ceased accruing under the traditional defined benefit pension formula for employees who elected the cash balance formula. There was no change to retirement benefits earned prior to the effective time of the election. The pension benefits of all non-union and certain union employees hired after December 31, 2002 are calculated using the cash balance formula.

In addition, Cinergy sponsors non-qualified pension plans (plans that do not meet the criteria for certain tax benefits) that cover officers, certain other key employees, and non-employee directors. Cinergy began funding certain of these non-qualified plans through a rabbi trust in 1999.

Cinergy sponsors employee savings plans that cover substantially all of its U.S. union and non-union employees. Cinergy contributes to the plan a matching contribution equal to 100% of the first 3% of pre-tax contributions from base pay plus 50% of the next 2% of pre-tax contributions from base pay. An additional incentive match of a maximum of 1% of base pay is based upon meeting corporate goals.

#### Westcoast

Westcoast and its subsidiaries maintain contributory and non-contributory defined benefit and defined contribution retirement plans covering substantially all of its employees. The defined benefit plans provide retirement benefits based on each plan participant's years of service and final average earnings. Under the defined contribution plans, company contributions are determined according to the terms of the plan and based on each plan participant's age, years of service and current eligible earnings.

Westcoast also provides non-registered defined benefit supplemental pensions to all designated employees who retire under a defined benefit registered pension plan and whose pension is limited by the maximum pension limits under the Income Tax Act (Canada).

#### **Other Post-Retirement Benefits**

##### Duke Energy

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

##### Cinergy

Cinergy provides certain health care and life insurance benefits to its retired United States employees and their eligible dependents. These benefits are subject to minimum age and service requirements. The health care benefits include medical coverage, dental coverage, and prescription drugs and are subject to certain limitations, such as deductibles and co-payments.

In January 2004, Cinergy announced to its employees the creation of a new retiree Health Reimbursement Account (HRA) option, which will impact the postretirement healthcare benefits provided by Cinergy. HRAs are bookkeeping accounts that can be used to pay for qualified medical expenses after retirement. The majority of employees had the opportunity during the Fall of 2004 to make a one-time election to remain in Cinergy's current retiree healthcare program or to move to the new HRA option. Approximately 40 percent of Cinergy's employees elected the new HRA option. The HRA option has no effect on current retirees receiving postretirement benefits from

Cinergy. As is the case under the current retiree health program, employees who participate in the HRA option, generally, will become eligible to receive their HRA benefit only upon retirement on or after the age of 50 with at least five years of service.

#### Westcoast

Westcoast provides health care and life insurance benefits for its retired employees on a non-contributory basis. Employees are eligible for these benefits if they have met age and service requirements at retirement, as defined in the plans. Effective December 31, 2003, a new plan was implemented for all non bargaining employees and the majority of bargaining employees. The new plan will apply for employees retiring on and after January 1, 2006. The new plan is predominantly a defined contribution plan as compared to the existing defined benefit program.

### **Employee Benefit Plan Asset Management and Administration**

#### Duke Energy and Cinergy Plans

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

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

#### Westcoast Plans

Westcoast assets for registered pension plans are maintained by a Master Trust. The investment objective of the master trust is to achieve reasonable returns on trust assets, subject to a prudent level of portfolio risk, for the purpose of enhancing the security of benefits for participants. The asset allocation targets were set after considering the investment objective and the risk profile with respect to the trust. Canadian equities are held for their high expected return. Non-Canadian equities are held for their high expected return as well as diversification relative to Canadian equities and debt securities. Debt securities are also held for diversification.

#### Benefit Plan Administration

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

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

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

- Funding Valuation - determines appropriate liabilities and funding requirements based on rules and regulations of applicable pension regulatory groups. These two items are used to calculate any cash contribution required for the ongoing plan. The Funding Valuation is performed at September 30<sup>th</sup> and the additional minimum liability is booked as of December 31<sup>st</sup> in compliance with SFAS No. 87.
- Expense Valuation - determines the expense of the ongoing plan for accounting purposes for the following year.
- Accrued Benefits Valuation - determines liabilities for benefits accrued as of the valuation date.

#### Funding

Duke Energy's general policy for all of its qualified plans (including Cinergy) is to fund amounts on an actuarial basis to provide assets sufficient to meet benefits to be paid to plan participants.

#### Supporting Accounting Guidance

This section primarily contains references to, and excerpts from, the most significant or applicable GAAP authoritative literature, primarily the following Statements of Financial Accounting Standards (SFAS):

SFAS No. 87, "Employers' Accounting for Pensions"

SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits"

SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions"

SFAS No. 132R, "Employers' Disclosures about Pensions and Other Post Employment Benefits – An Amendment of FASB Statements No. 87, 88 and 106"  
SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Benefit Plans"

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

SFAS No. 158 was issued in September 2006 as a first step to comprehensively reconsider the accounting for pensions and other post-employment benefits ("OPEB"). The following is an excerpt from SFAS No. 158:

**"Summary**

This Statement improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This Statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

This Statement requires an employer that is a business entity and sponsors one or more single-employer defined benefit plans to:

- a. Recognize the funded status of a benefit plan—measured as the difference between plan assets at fair value (with limited exceptions) and the benefit obligation—in its statement of financial position. For a pension plan, the benefit obligation is the projected benefit obligation; for any other postretirement benefit plan, such as a retiree health care plan, the benefit obligation is the accumulated postretirement benefit obligation.
- b. Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statement No. 87, *Employers' Accounting for Pensions*, or No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements.

c. Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions).

d. Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

This Statement also applies to a not-for-profit organization or other entity that does not report other comprehensive income. This Statement's reporting requirements are tailored for those entities.

This Statement amends Statement 87, FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, Statement 106, and FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, and other related accounting literature. Upon initial application of this Statement and subsequently, an employer should continue to apply the provisions in Statements 87, 88, and 106 in measuring plan assets and benefit obligations as of the date of its statement of financial position and in determining the amount of net periodic benefit cost.

#### **Reasons for Issuing This Statement**

The Board issued this Statement to address concerns that prior standards on employers' accounting for defined benefit postretirement plans failed to communicate the funded status of those plans in a complete and understandable way. Prior standards did not require an employer to report in its statement of financial position the overfunded or underfunded status of a defined benefit postretirement plan. Those standards did not require an employer to recognize completely in earnings or other comprehensive income the financial effects of certain events affecting the plan's funded status when those events occurred.

Prior accounting standards allowed an employer to recognize in its statement of financial position an asset or liability arising from a defined benefit postretirement plan, which almost always differed from the plan's overfunded or underfunded status. Those standards allowed an employer to:

a. Delay recognition of economic events that affected the costs of providing postretirement benefits—changes in plan assets and benefit obligations—and recognize a liability that was sometimes significantly less than the underfunded status of the plan.

b. Recognize an asset in its statement of financial position, in some situations, for a plan that was underfunded.

Prior standards relegated information about the overfunded or underfunded status of a plan to the notes to financial statements. That information was in the form of a reconciliation of the overfunded or underfunded status to amounts recognized in an employer's statement of financial position. The Board was told that presenting such information only in the notes made it more difficult for users of financial statements to assess an employer's financial position and ability to satisfy postretirement benefit obligations.

The Board concluded that such reporting, together with other features of the existing standards, did not provide representationally faithful and understandable financial information and might lead to the inefficient allocation of resources in the capital markets. This Statement is the first step in a project to comprehensively reconsider Statements 87, 88, 106, 132(R), and related pronouncements."

The effective date for the changes to the balance sheet recognition provisions and the disclosure provisions of SFAS No. 158 is effective for Duke Energy as of December 31, 2006 and the effective date for the measurement provisions is effective as of December 31, 2008, with early application encouraged.

#### Financial Statement Recognition and Presentation

##### *Recognition of Assets and Obligations on the Balance Sheet – Pension Plans and OPEB*

Under SFAS No. 158, the asset/liability presentation in the balance sheet is based on the net funded status of the plan, which for a defined benefit plan represents the difference between the projected benefit obligation and the fair value of the plan assets, and for an OPEB plan represents the difference between the accumulated postretirement benefit obligation and the fair value of the plan assets.

##### *Presentation in Other Comprehensive Income ("OCI") and Accumulated OCI ("AOCI") – Pension Plans and OPEB"*

Gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to SFAS No. 87 should be recognized as a component of other comprehensive income, net of tax. Amounts recognized in AOCI, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of SFAS Nos. 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those statements.

##### *Determination of Net Period Pension Cost ("Income Statement Recognition")*

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

The net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan or providing OPEB includes

- Service cost,
- Interest cost,



- Actual return on plan assets,
- Amortization of unrecognized prior service cost,
- Gain or loss and
- Amortization of the unrecognized net transition asset or liability.

Measurement of Employee Benefit Plan Cost (Expense), Obligations and Assets,

Measurement of Cost (Expense) and Obligations – Pension Plans

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

The service component of net periodic pension cost, the projected benefit obligation, and the accumulated benefit obligation are based on an attribution of pension benefits to periods of employee service and on the use of actuarial assumptions to calculate the actuarial present value of those benefits. Actuarial assumptions reflect the time value of money (discount rate) and the probability of payment (assumptions as to mortality, turnover, early retirement, and so forth). See SFAS No. 87, ¶139.

Measurement of Plan Assets – Pension Plans

For purposes of measuring the funded status of a benefit plan, plan investments, whether equity or debt securities, real estate, or other, shall be measured at their fair value as of the measurement date. The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value shall be measured by the market price if an active market exists for the investment. If no active market exists for an investment but such a market exists for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a current rate commensurate with the risk involved. See SFAS No. 87, ¶149. As noted above, the fair value of the plan assets is combined with the projected benefit obligation to arrive at the appropriate asset/liability presentation in the balance sheet.

Measurement of Cost (Expense) and Obligations -- OPEB

Contributions expected to be received from active employees toward the cost of their postretirement benefits and from retired plan participants are treated similarly for purposes of measuring an employer's expected postretirement benefit obligation. That obligation is measured as the actuarial present value of the benefits expected to be provided under the plan, reduced by the actuarial present value of contributions expected to be received from the plan participants during their remaining active service and postretirement periods. In determining the amount of the contributions expected to be received from those participants toward the cost of their postretirement benefits, consideration is given to any related substantive plan provisions, such as an employer's past practice of consistently increasing or reducing the contribution rates. An obligation to return contributions received from employees who do not attain eligibility for

postretirement benefits and, if applicable, any interest accrued on those contributions shall be recognized as a component of an employer's postretirement benefit obligation. See SFAS No. 106, ¶27. Under SFAS No. 158, the asset/liability presentation in the balance sheet is based on the net funded status of the plan.

Measurement of Plan Assets – OPEB

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

Assets not segregated in a trust, or otherwise effectively restricted, so that they cannot be used by the employer for other purposes are not plan assets for purposes of accounting for OPEB, even though the employer may intend that those assets be used to provide postretirement benefits. Those assets shall be accounted for in the same manner as other employer assets of a similar nature and with similar restrictions. Amounts accrued by the employer but not yet paid to the plan are not plan assets for purposes of accounting for OPEB. See SFAS No. 106, ¶63-64.

Settlements and Curtailments of Obligations

**Settlement** - For a settlement of an employee benefit obligation, the gain or loss subject to recognition is the difference between the (a) cost of the settlement and (b) unrecognized net gain or loss plus unrecognized transition assets.

- For pension benefits, such gain or loss must be recognized in earnings if the entire projected benefit obligation is settled (a prorata amount of the gain or loss must be recognized if only part of the projected benefit obligation is settled). (SFAS No. 88, ¶ 9-11)
- For OPEB, a settlement gain (prorated if only part of the projected benefit obligation is settled) must first reduce the remaining unrecognized transition obligation and the remainder is recognized in income. A settlement loss (prorated if only part of the projected benefit obligation is settled) is recognized in income. (SFAS No. 106, ¶ 92-93)

**Curtailment** - For a benefit plan curtailment, the reduction in unrecognized prior service cost (which includes the cost of plan amendments and any remaining unrecognized transition obligation) is recognized as a loss. If the change in accumulated benefit obligation is a gain and exceeds the unrecognized net loss (if any), it is a curtailment gain. If the change in accumulated benefit obligation is a loss and exceeds the unrecognized net gain (if any), it is a curtailment loss. See SFAS No. 88, ¶12-14 regarding pensions and SFAS No. 106, ¶97-99 for OPEB.

A plan is terminated when the obligation is settled and the plan ceases to exist. If a plan termination occurs and the plan is not replaced by a successor defined benefit plan, both a

settlement and a curtailment have occurred (whether or not the employees continued to work for the employer). (SFAS 106 ¶100)

#### Measurement Dates

Under SFAS No. 158, effective for the year ending December 31, 2008 (for calendar-year public companies), an employer is required to measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions). Early application is encouraged. SFAS No. 158 contains certain transition provisions to address the change from a measurement date of September 30, which has been historically been used by Duke Energy, to a December 31 measurement date. Duke Energy currently intends to adopt the change in measurement date effective January 1, 2007 by remeasuring plan assets and benefit obligations as of that date, pursuant to the transition requirements of SFAS No. 158. Net periodic benefit cost for the three-month period between September 30, 2006 and December 31, 2006 will be recognized, net of tax, as a separate adjustment of retained earnings as of January 1, 2007, except for any gain or loss arising from any curtailment or settlement, if any, during that three-month period, which would be recognized in earnings in 2006. Additionally, changes in plan assets and plan obligations between September 30, 2006 and December 31, 2006 not related to net periodic benefit cost will be recognized, net of tax, as an adjustment to OCI.

#### Disclosures

Disclosures required in notes to the financial statements include the following:

- (1) Components of net periodic employee benefit costs
- (2) Reconciliation of funded status to amounts recognized in the balance sheet
- (3) Amounts recognized in the balance sheets
- (4) Assumptions used,
- (5) Assumptions and sensitivities related to health care cost trend rates
- (6) Actuarial gains/losses and prior service costs (a) recognized as OCI for current periods, (b) that will be recognized in OCI in the following year and (c) the balances in AOCI

Matters specific or unique to Duke Energy are primarily discussed in the "Accounting Policy" section below.

#### Accounting Policy

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

Application to Duke Energy subsidiaries

Subsidiaries of Duke Energy which participates in a plan sponsored by its parent should generally follow the accounting required in SFAS Nos. 87 and 106 for multiemployer plans, thereby recognizing as net pension cost the required contribution for the period and recognizing as a liability any contributions due and unpaid. However, depending upon the nature of the arrangements between the parent and subsidiary, other amounts may be recorded. Regardless of the amounts recorded, adequate disclosures should be provided to indicate the amounts recorded.

Measurement

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

Assumptions -- Rate of Return

The expected long-term rate of return for plan assets uses a weighted average calculation of expected returns based primarily on future expected returns across asset classes considering the use of active asset managers.

Assumptions -- Discount rate

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

Assumptions -- Health Care Trends

Duke Energy uses a health care trend rate which reflects the near and long-term expectation of increases in medical costs.

Net Periodic Pension Cost

Service Costs -- OPEB

OPEB benefit costs are accrued over an employee's active service period to the date of full benefits eligibility.

Actuarial Gains and Losses

Actuarial gains and losses are amortized over the average remaining service period of the active employees.

Actual Return on Plan Assets

Duke Energy determines the market-related value of plan assets using a calculated value that recognizes changes in fair value of the plan assets over five years.

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

Amortization of Prior Service Costs

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

Settlements and Curtailments

Duke Energy recognizes a curtailment when an event reduces the expected years of future service of 10% or more of active plan participants or eliminates the accrual of defined benefits for some or all of the future services of 10% or more of active plan participants.

Measurement Date

Duke Energy plans to convert from using a September 30 measurement date to using a December 31 measurement date effective January 1, 2007 pursuant to the transition requirements of SFAS No. 158.

Accounting by Regulated Entities

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

**Key Terms**

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

**Related Policies, Standards, or Procedures**

Enterprise-level Policy: Other Comprehensive Income Accounting Procedures

"Accounting for Regulated Entities (SFAS No. 71)".

Duke Energy's *Life Tracks* Benefit Program Booklets

Administrative Information

Duke Energy Retirement Savings Plan: Summary Plan Description and Prospectus

Duke Energy Retirement Cash Savings Plan

## Accounting for Goodwill

|                        |                       |
|------------------------|-----------------------|
| <b>Applicability:</b>  | Applies to Enterprise |
| <b>Originator:</b>     | Corporate Controller  |
| <b>Approval:</b>       | Corporate Controller  |
| <b>Effective Date:</b> | 12/01/2004            |
| <b>Revision Date:</b>  | 12/15/2006            |
| <b>Reissue Date:</b>   | 12/15/2006            |

### Statement of Purpose and Philosophy

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

### Policy Expectations and Scope

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

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

### Materiality

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

### Accountability: Roles and Responsibilities

Corporate Controller's Department -

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

Business/Corporate Unit -

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

**Standards/Requirements**

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 142, which superseded the previous guidance for intangible assets prescribed in APB Opinion No. 17,



"Intangible Assets". Duke Energy adopted SFAS No. 142 effective January 1, 2002. SFAS No. 142 requires goodwill to be tested for impairment annually, and does not allow goodwill to be amortized.

***Supporting Guidance***

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

***Goodwill Definition and Recognition:***

Goodwill is defined in SFAS No. 142 as follows:

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

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

***When to Test Goodwill for Impairment:***

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

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

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

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

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

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

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

*Interplay of SFAS No. 142 with Other Asset Impairment Literature:*

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

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

*Goodwill Impairment Testing by a Subsidiary:*

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

*Goodwill Impairment Testing When a Noncontrolling Interest Exists:*

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

*Disposal of All or a Portion of a Reporting Unit:*

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

However, if the business to be disposed of was never integrated into the reporting unit after its acquisition and thus the benefits of the acquired goodwill were never realized by the rest of the reporting unit, the current carrying amount of that acquired goodwill shall be included in the carrying amount of the business to be disposed of. That situation might occur when the acquired

business is operated as a stand-alone entity or when the business is to be disposed of shortly after it is acquired. When only a portion of goodwill is allocated to a business to be disposed of, the goodwill remaining in the portion of the reporting unit to be retained shall be tested for impairment in accordance with paragraphs 19–22 (using its adjusted carrying amount). [paragraph 39, SFAS No. 142]

*Equity Method Investments:*

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

*Assigning Goodwill to Reporting Units:*

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

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

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

*Deferred Income Taxes:*

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

EITF Issue No. 02-13, "Deferred Income Tax Considerations in Applying the Goodwill Impairment Test in FASB Statement No. 142," reached a consensus on several issues related to deferred income taxes and goodwill impairment. First, it is a matter of judgment when deciding whether to estimate the fair value of a reporting unit based on a purchase or sale in a taxable or nontaxable transaction. Consideration should be given to how other marketplace participants would view the transaction and the feasibility of the structure and whether there are any laws or regulations that could impact the ability to treat the sale as nontaxable. Second, the issue decided that deferred income taxes should be included in the carrying value of the reporting unit; regardless of whether the fair value of the reporting unit will be determined assuming it would be bought or sold in a taxable or nontaxable transaction. Finally, when estimating the fair value of the reporting unit in Step 1 of the impairment test, the issue determined that an entity should use its existing income tax bases if the assumed structure used to estimate the fair value of the reporting unit was a nontaxable transaction, and it should use new income tax bases if the assumed structure was a taxable transaction.

*Disclosure Requirements:*

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

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

- o If a recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons therefore and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.

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

*SEC Form 8-K Reporting Requirements:*

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

**Accounting Policy**

Duke Energy evaluates goodwill for potential impairment under the guidance of SFAS No. 142, "Goodwill and Other Intangible Assets" (SFAS No. 142). Goodwill shall not be amortized. As such, Duke Energy has designated August 31 as the date it performs the annual review for impairment for its reporting units. In accordance with the provisions of paragraph 30 of SFAS No. 142, Duke Energy performs the annual review for impairment at the reporting unit level, which has been determined to be an operating segment or one level below. (See Appendix A for guidance on determining reporting units.) Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. Goodwill of a reporting unit shall be tested for impairment at an interim date if the events or circumstances, described in paragraph 28 of SFAS No. 142 (describe above) exist. If none of these above certain circumstances or events have occurred, and the three requirements in paragraph 27 of SFAS No. 142 are met, no new impairment assessment need be performed. The business unit shall document that there were no triggering events during the current year and that these requirements were met. This documentation shall be provided in accordance with the established annual testing timetable for the respective reporting unit.

*Recognition and Measurement of an Impairment Loss:*

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

See Appendix B for guidance on measuring fair value and the discussion of the valuation considerations in EITF Issue No. 02-13 in the "Deferred Income Taxes" section above. Duke Energy often uses a discounted cash flow analysis to determine fair value of a reporting unit as quoted

market prices or market multiples for other operations that would be sufficiently comparable are usually not available. Key assumptions in the determination of fair value include the use of an appropriate discount rate, estimated future cash inflows and estimated run rates of operation, maintenance, general and administrative costs, income taxes and other applicable costs and expenses. In estimating cash flows, Duke Energy incorporates expected growth rates, the extent of regulatory stability and the estimated ability to renew contractual and other arrangements as well as other factors into its revenue and expense forecasts.

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

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

*Allocation of Corporate Goodwill to Reporting Units:*

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

Reporting Requirements – At each quarterly and annual reporting period:

- The aggregate amount of goodwill shall be presented as a separate line item in the balance sheet.
- The aggregate amount of goodwill impairment losses shall be presented as a separate line item in the income statement as part of income from continuing operations. A goodwill impairment loss associated with a discontinued operation shall be included (on a net-of-tax

basis) within the results of discontinued operations.

- See above for disclosure requirements for the carrying amount of goodwill and for any goodwill impairment loss recognized.

**Key Terms**

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

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



## Accounting for Intercompany Transactions

|                        |                       |
|------------------------|-----------------------|
| <b>Applicability:</b>  | Applies to Enterprise |
| <b>Originator:</b>     | Corporate Controller  |
| <b>Approval:</b>       | Corporate Controller  |
| <b>Effective Date:</b> | 07/31/2004            |
| <b>Revision Date:</b>  | 08/31/2005            |
| <b>Reissue Date:</b>   | 08/31/2005            |

### Outline

- I. Policy Intent/Philosophy
- II. Policy Expectations
- III. Policy Definitions
- IV. Policy Requirements
  - A. Timing
  - B. Dispute Resolution
  - C. Methods for Recording Intercompany Transactions
    - Automated IC or InterUnit Billing
    - Manual Balancing
    - Automated Crossbill
  - D. Settlements
    - Settlement of Wholly Owned Affiliate Transactions
    - Settlement of Non Wholly Owned Affiliate Transactions
  - E. Accounting for Non-Routine Transactions
  - F. Consolidations/Eliminations
  - G. Account Reconciliations
- V. Roles and Responsibilities
  - A. Corporate Controller
  - B. Business Unit Controllers
  - C. Enterprise Intercompany Process Owner
  - D. Corporate/Business Unit Intercompany Process Owners
  - E. Seller/Sender and Purchaser/Receiver
- VI. Appendices

### I. Policy Intent/Philosophy

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

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

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

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

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

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

## **II. Policy Expectations**

All corporate/business unit personnel of Duke Energy involved with the recording of intercompany transactions shall:

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

## **III. Policy Definitions**

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

**Business Unit Controller or his/her designee "BU Controller"** - defined as the person(s) who is in the role of Controller for each of the consolidated subsidiaries of Duke Energy Corporation or his/her designee.

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

**Corporate Intercompany Process Owner "Corp/BU IPO"** - defined as the person who is in the role of Intercompany Process Owner for Duke Energy Corporation.

**Business Unit Intercompany Process Owner "Corp/BU IPO"** - defined as the person who is in the role of Intercompany Process Owner for each of the consolidated subsidiaries of Duke Energy Corporation.

**Seller/Sender Corporate or Business Unit "Seller/Sender"** - defined as the corporate or business unit who is selling the product/service or sending the charge. For intercompany cash sweeps or other cash-related transactions between Duke Capital LLC or PanEnergy Corp and any other business unit, the Corporate Controller's Department will be responsible for all journal entries

and all Seller/Sender activities no matter whether Duke Capital LLC or PanEnergy is sending or receiving cash.

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

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

#### **IV. Policy Requirements**

##### **A. Timing**

In accordance with the dates established by the Corporate Controller and published in the Calendar,

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

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

##### **B. Dispute Resolution**

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

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

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

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

**C. Methods for Recording Intercompany Transactions**

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

- **Automated IC or InterUnit Billing**

All intercompany transactions required for recording loans, cash sweeps, or that generate the booking of revenue and generation of a receivable where both affiliates are on the enterprise PeopleSoft ledger shall be recorded using the Automated IC Method or, where available, the InterUnit Billing Method. The Automated IC Method only handles US \$ denominated transactions; any non US \$ denominated transactions shall be exempt from using this method. Both the Automated IC Method and the IUB Method automatically generate the Purchaser/Receiver transaction based on the Seller/Sender transaction. The Automated IC Method is available to all business units within the enterprise PeopleSoft general ledger. The IUB Method can only be used by business units that have implemented the intercompany functionality within the PeopleSoft billing module.

The unrealized mark-to-market of intercompany hedges or other derivative balances are also exempt from using this method and exempt from using intercompany designated accounts (refer to section IV, F below for Policy Requirements regarding Consolidations/Eliminations of intercompany hedges and other derivatives.)

- **Manual Balancing**

Although manual balancing is not the preferred method for recording inter-business unit transactions, manual balancing can be used when deemed necessary. Examples include: intercompany transactions that are required for recording investment/equity, intercompany derivatives, non-U.S. dollar denominated transactions or, in the case where the transaction is with an affiliate who is not on the enterprise-wide PeopleSoft sourced general ledger.

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

- **Automated Crossbill**

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

**D. Settlements**

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

reclassification to intercompany advances, intercompany notes receivable or payable or reclassification to equity.

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

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

- **Settlement of Wholly Owned Affiliate Transactions**

Transactions between affiliates that are **wholly owned** by Duke Energy, and do not cross country borders, are generally not settled in cash unless there is a specific business reason, or contractual obligation to do so. All wholly owned intercompany balances not settled in cash shall be reclassified to the intercompany advance account on a one month lag by the Enterprise IPO, or his/her designee (i.e., prior month balances are reclassified during the current month), except for federal and state taxes payable which shall be reclassified to the intercompany advance account annually. At least once per quarter, the Enterprise IPO will be responsible for reviewing the intercompany advance account of any SEC registrant of Duke Energy to determine whether any of the balances should be converted to a note or equity. The Enterprise IPO shall consult with the BU Controller, Corporate Treasurer's Department-Business Unit Finance, and the Tax Department to evaluate the impacts, if any (i.e., debt/equity ratio, tax, etc.) and will coordinate with the appropriate subject matter experts prior to reclassifying any of the balances. Refer to the Intercompany Funding Policy and Business Unit Capitalization Protocol documentation for additional information.

- **Settlement of Non Wholly Owned Affiliate Transactions**

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

**E. Accounting for Non-Routine Transactions**

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

**F. Consolidations/Eliminations**

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

The Enterprise IPO will also review a reconciliation of the unrealized mark-to-market of intercompany hedges and other derivatives that are reflected in 3rd party Unrealized Gains or Losses accounts on the balance sheet to ensure accurate elimination of all balances and the proper effect on consolidated financial statement line items.

When the unrealized mark-to-market of intercompany hedges and other derivatives are recorded to 3rd party accounts, the Seller/Sender or Purchaser/Receiver in business units that "sleeve" derivative transactions between an affiliate and a 3rd party should ensure the unrealized mark-to-market for both the intercompany transaction and the related 3rd party transaction are recorded to the same consolidated income statement line item and thus have a net zero impact on the consolidated income statement. See also Reclassification of Realized Income Statement Activity in Consolidation - Net vs. Gross Policy regarding the income statement impact of intercompany hedges and other derivatives transactions.

**G. Account Reconciliations**

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

**V. Roles and Responsibilities**

**A. Corporate Controller**

- Ensure by policy, procedure, review and sign off that all business and corporate units are recording intercompany transactions on a timely, accurate and consistent basis;
- Designate an individual who will serve as Intercompany Process Owner at each of the corporate units as well as at the enterprise level;
- Establish and enforce a cutoff date for each accounting period for recording, reconciling and eliminating intercompany transactions and resolving any out of balances which will be published in the Calendar;
- Address disputed intercompany transactions between business units and/or corporate that remain unresolved after close of workday 1 of the following accounting period and is ultimately responsible for ensuring resolution;
- Perform final review and sign off of monthly Intercompany Schedule of Disputed Balances, Intercompany Out of Balance Report (including any out of balance associated with the unrealized mark-to-market of intercompany hedges and other derivatives recorded in 3rd party accounts on the balance sheet) and other reports as deemed necessary to ensure the propriety of intercompany balances and the effect of the eliminations on consolidated financial statement line items;
- Perform general administration of the Policy, including periodic review and update for changes in accounting standards, business conditions and other factors;
- When accounting for non-routine transactions, ensure the accounting for intercompany transactions is considered and that any identified affiliate transactions are accurately recorded and eliminated during the consolidations processing.

**B. Business Unit Controllers**

- Ensure assigned business units are recording intercompany transactions on a timely, accurate and consistent basis and are in compliance with the Policy and all related policies and procedures;

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

**C. Enterprise Intercompany Process Owner**

- Ensure each of the Corp/BU IPO's are in compliance with the Policy;
- Ensure all disputed balances between affiliates are resolved by maintaining the Intercompany Schedule of Disputed Items and administering the Dispute Resolution Procedure (Refer to attached Appendix A for the Dispute Resolution Procedure);
- Ensure all intercompany balances are accurately and timely eliminated during the consolidations processing by monitoring the Intercompany Out of Balance Report (including any out of balance associated with the unrealized mark-to-market of intercompany hedges and other derivatives recorded in 3rd party accounts on the balance sheet), reviewing other reports as deemed necessary to ensure the propriety of intercompany balances and the effect of the eliminations on consolidated financial statement line items and administering the Eliminations Procedures (Refer to attached Appendix E for the Eliminations Procedures);
- Ensure the Corp/BU IPO's facilitate the accurate and timely settlement of all Duke Energy affiliate transactions in accordance with related contractual documentation or tariffs, either through cash settlement, reclassification to intercompany advances, intercompany notes receivable or payable or reclassification to equity;
- Provide training of the Policy to all corporate/business unit personnel involved in the recording of intercompany transactions.

**D. Corporate/Business Unit Intercompany Process Owners**

- Ensure assigned corporate/business units are in compliance with the Policy;
- Maintain the Intercompany Schedule of Disputed Items for assigned corporate/business unit and ensure that all disputed items are resolved per the Policy;
- Ensure all intercompany balances are accurately and timely eliminated during the consolidations processing by monitoring the Intercompany Out of Balance Report, reviewing other reports as deemed necessary to ensure the propriety of intercompany balances and the effect of the eliminations on consolidated financial statement line items and administering the Eliminations Procedures for assigned business/corporate units (Refer to attached Appendix E for the Eliminations Procedures);
- Ensure the accurate and timely settlement of all assigned Duke Energy affiliate transactions in accordance with related contractual documentation or tariffs, either through cash settlement, reclassification to intercompany advances, intercompany notes receivable or payable or reclassification to equity.
- Notify the Corp/BU IPO of the Seller/Sender business unit and the Enterprise IPO when the Purchaser/Receiver business unit is capitalizing any intercompany transactions

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

- Seller/Sender is responsible for contacting the Purchaser/Receiver by phone, email or any other reasonable method prior to recording intercompany transactions to verify the

accuracy and mutual agreement of all charges, volumes, values, and the account chartfields and shall make every effort to resolve any discrepancies prior to recording intercompany transactions to the general ledger. Exceptions by the Seller/Sender in contacting the Purchaser/Receiver prior to recording intercompany transactions may be granted for routine transactions (e.g. allocations) and must be approved in advance by the Enterprise IPO;

- Seller/Sender shall record all intercompany transactions by the deadline as published in the Calendar;
- Seller/Sender is responsible for properly documenting all transactions prior to recording journal entries in accordance with The Journal Entry Creation and Approval Requirements for Non-System Generated Journals Policy, which encompasses the Create/Check/Review guidelines;
  - For intercompany cash sweeps or other cash-related transactions between Duke Capital LLC or PanEnergy Corp and any other business unit, the Corporate Controller's Department will be responsible for all journal entries and all Seller/Sender activities no matter whether Duke Capital LLC or PanEnergy is *sending or receiving cash*;
  - Purchaser/Receiver is responsible for reviewing and verifying all charges received and notifying the Seller/Sender of any charges that were not recorded as previously agreed;
  - Purchaser/Receiver is responsible for updating the Intercompany Schedule of Disputed Items and working with the Seller/Sender to ensure all disputed items are resolved by close of workday 1 of the following accounting period.

## VI. Appendices

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



## ***Accounting for Intercompany Transactions Policy***

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### **Appendix A – Intercompany Dispute Resolution Procedure**

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#### **Philosophy**

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

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

#### **Procedure**

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

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

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

### Intercompany Schedule of Disputed Items

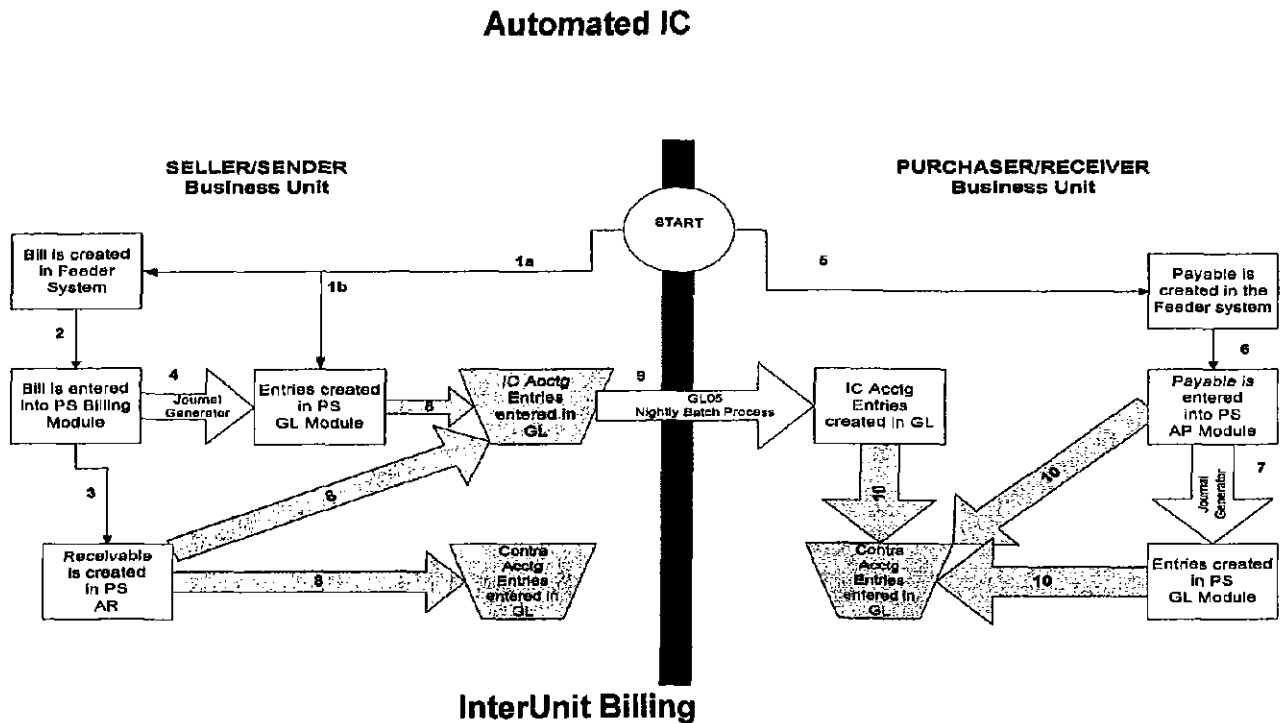
### Intercompany Schedule of Disputed Items

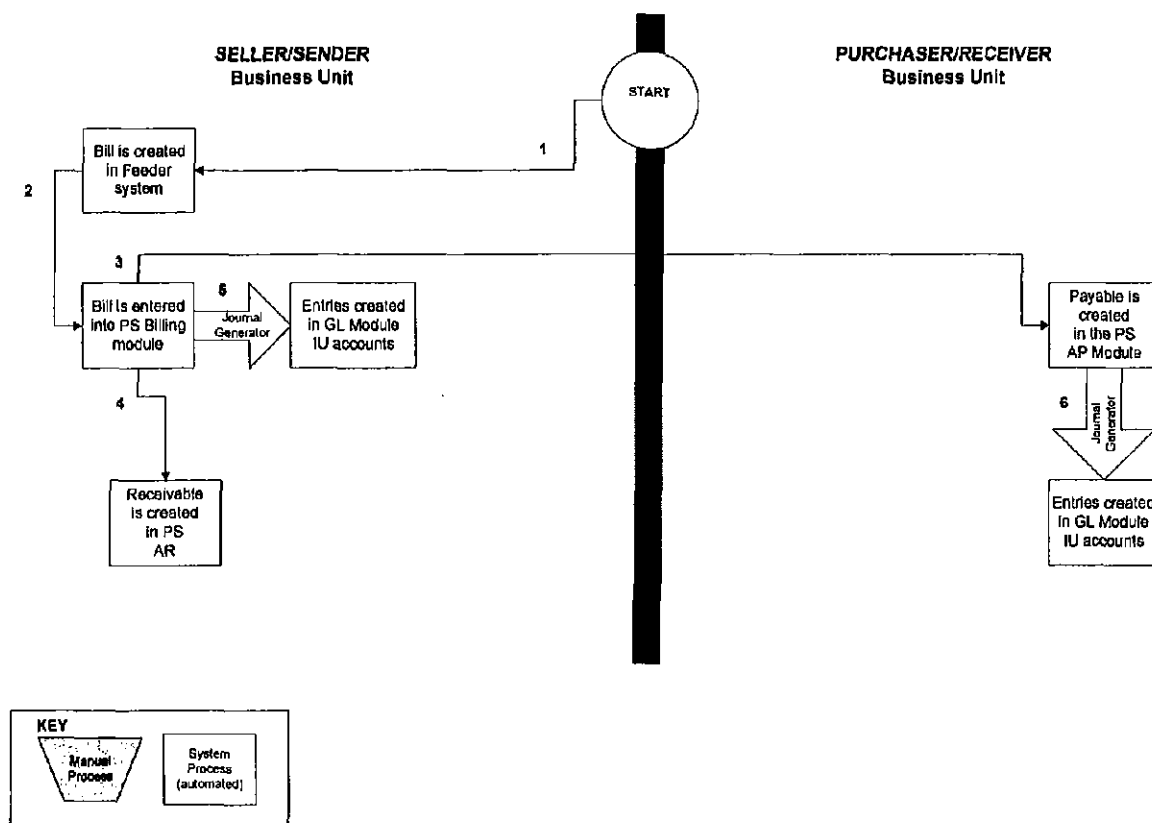
Duke Energy

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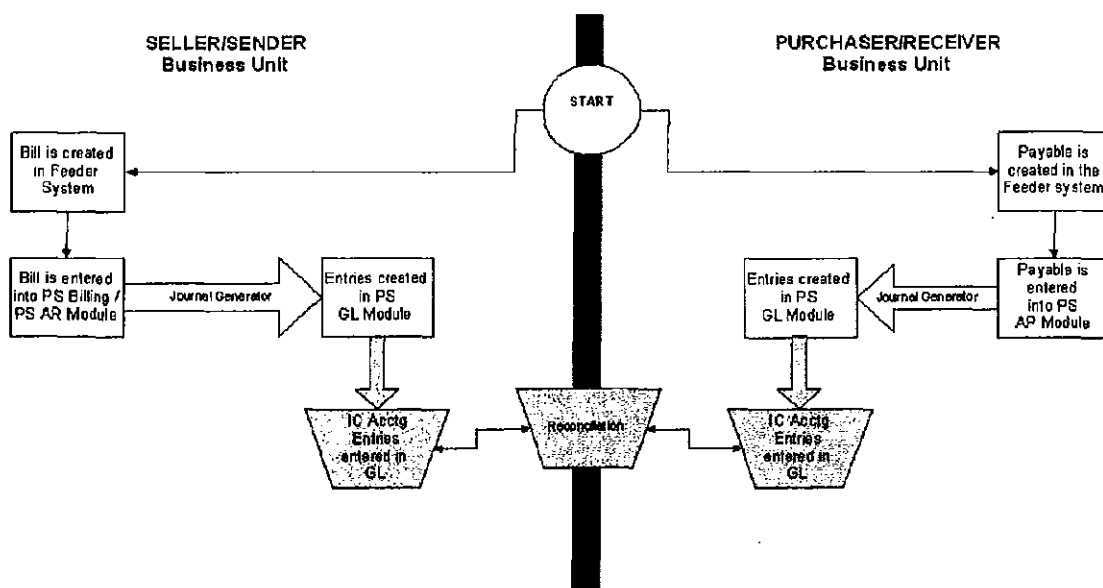
## Accounting for Intercompany Transactions Policy

### Appendix B – Methods for Recording Intercompany Transactions

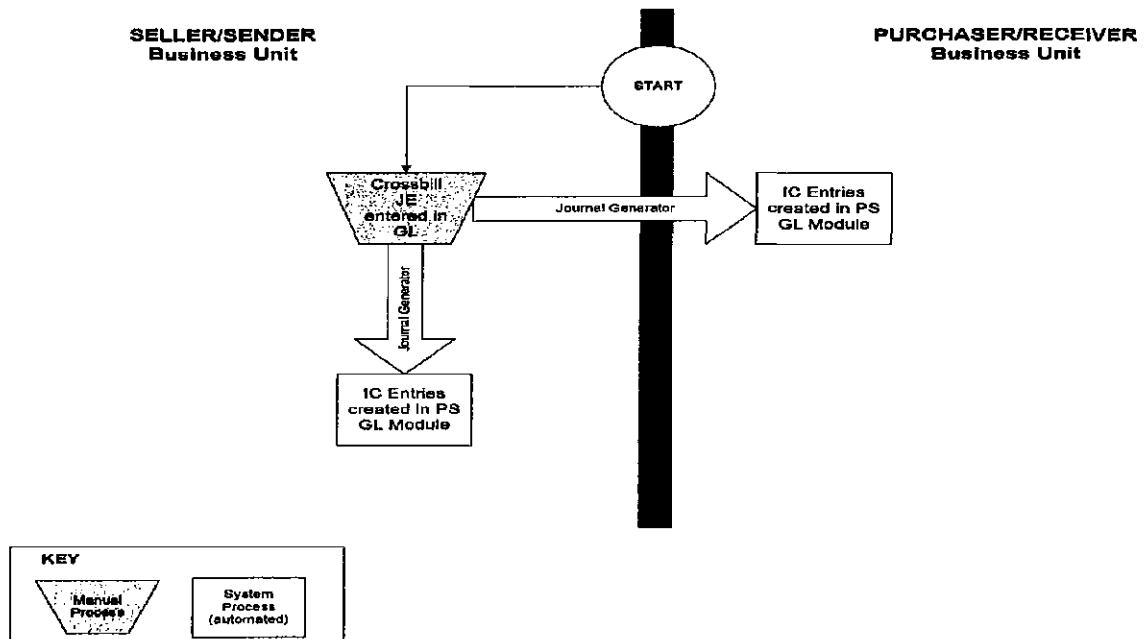




## Manual Balancing



### Automated Crossbill



## ***Accounting for Intercompany Transactions Policy***

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### **Appendix C – Intercompany Accounts and Definitions**

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Designated intercompany accounts shall be used when recording intercompany transactions to the general ledger. Designated intercompany accounts can be found on the Duke Energy portal, on the Financial Management Information System (FMIS) website under FMIS Reference Lookup Tool (<http://dewwww/fmis/HTML/Lookups/HTML/chartfield.htm>). The best method for identifying intercompany accounts from the chartfield reference guide is via intercompany GAAP nodes. To identify intercompany GAAP nodes, each one generally contains "cons," "consol," "con" or "IC" in the title.

In addition to identification through the intercompany GAAP nodes, designated intercompany accounts can be identified by the account number or description:

- Automated IC accounts can be easily identified as all accounts begin with "IC" (e.g. account IC12331 is used for intercompany A/R cash settlements). These accounts are to be used when recording intercompany transactions using the Automated IC Process. Do not use these accounts for reclassifying entries for analysis, FERC or GAAP reporting requirements, etc.
- Accounts used for the InterUnit Billing (IUB) method can be identified through the account description that always begins "IUB" (e.g. account 149500 description is IUB A/R Actual).
- Manual Balancing and Crossbill accounts generally indicate they are intercompany accounts in the account description (e.g. Intercompany Cash, Interco AP, LT Notes Payable-Affiliates).

Contra accounts shall be used when reclassifying intercompany transactions that were originally recorded using the Automated IC process. These are the only accounts to be used for reclassifying entries for analysis, FERC or GAAP reporting requirements, etc. Contra accounts can also be found on the Duke Energy portal, on the Financial Management Information System (FMIS) website under FMIS Reference Lookup Tool (<http://dewwww/fmis/HTML/Lookups/HTML/chartfield.htm>). The chartfield reference guide provides detailed accounts for each GAAP node. Contra accounts are designated as such in the account description and are included in 3<sup>rd</sup> party GAAP nodes.

**Accounting for Intercompany Transactions Policy**

**Appendix D – Manual Balancing Method Approval  
Request Form**

DATE / TIME:

ORIGINATING BUSINESS UNIT:

OTHER BUSINESS UNIT(S) IMPACTED:

CHANGE DESCRIPTION:

REASON FOR CHANGE REQUEST:

1. CHANGE DETAILS

IS CHANGE TEMPORARY OR PERMANENT:

IF TEMPORARY, ACCTG PERIOD(S) IMPACTED

IS CHANGE RECURRING, OR ONE TIME:

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

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

4. ADDITIONAL COMMENTS:

SUBMITTED BY:

PHONE:

ORIGINATING BU APPROVAL:

BU 1 APPROVAL:

BU 2 APPROVAL:

BU 3 APPROVAL:

CORPORATE CONTROLLER APPROVAL  
(IF REQUIRED BY POLICY):

ENTERPRISE IPO APPROVAL:

MISCELLANEOUS  
COMMENTS:

ATTACHMENTS:

***Accounting for Intercompany Transactions Policy***

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**Appendix E – Eliminations and Out of Balance Materiality Procedures**

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**Philosophy**

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

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

**Procedure**

**Intercompany Out of Balance Reports**

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

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

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

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

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

**Elimination Impact to Consolidated Financial Statement Line Items**

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



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

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

#### **Elimination of Energy Trading Contracts**

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

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

#### **Elimination of Intercompany Profit**

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

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

## **Intercompany Out of Balance Materiality Considerations**

### **A. Quantitative Factors**

The threshold for resolving and adjusting intercompany out of balances in the current period is two tiered and measured in the aggregate (not according to balance sheet or income statement effects):

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

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

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

The enterprise-wide materiality threshold includes both the net out of balance associated with amounts recorded in intercompany accounts and the net out of balance associated with the unrealized mark-to-market of intercompany hedges and other derivatives currently recorded in 3rd party accounts. The net out of balance associated with intercompany hedges and other derivatives will only be factored into the enterprise-wide materiality threshold; these out of balances do not need to be considered for the segment to segment threshold.

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

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

### **B. Qualitative Factors**

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

- mask a change in earnings or other trends
- change a loss into income or vice versa
- concern a segment or other portion of Duke Energy's business that has been identified as playing a significant role in operations or profitability

- affect compliance with regulatory requirements
- affect compliance with loan covenants or other contractual requirements
- have the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- involve concealment of an unlawful transaction

### **C. Roles and Responsibilities**

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

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

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

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

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

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

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

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

be resolved to achieve separate reporting needs and when their BU/Corporate area believes all remaining out of balances are immaterial

### **Intercompany Out of Balance Reports**

The Intercompany Out of Balance Reports are located in the following directory:  
**lmdtpsfax01\psrpt\prd\Consolidating\Out of Balance\Intercompany\month.**

**Descriptions of these files are as follows:**

**P137C133: IC Income Statement OOB:** This file contains all of the Automated IC (system balanced) income statement intercompany accounts, (IC41000; IC51000, etc.). As a result of the system functionality, all transactions are automatically balanced. Thus, this file should always net to zero.

**P137C137: IC Balance Sheet OOB:** This file contains all of the Automated IC (system balanced) balance sheet intercompany accounts (IC13100, IC12331, etc.). As a result of the system functionality, all transactions are automatically balanced. Thus, this file should always net to zero.

**P137C138: InterUnit Accounts:** This report includes only the 0146000 account (and its predecessor 1460047).

**P137C150 and P137C151: DE Total Balance Sheet and Income Stmt report:** These two reports are a complete listing of all manually balanced intercompany accounts, crossbill accounts and the InterUnit accounts.

## ***Accounting for Intercompany Transactions Policy***

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### **Appendix F – Investment and Equity Transactions Procedures**

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#### **Philosophy**

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

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

#### **Procedure**

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

#### **Investment and Equity Transactions**

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

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

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

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

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

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

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

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

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

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

However, the responsibilities of the Seller/Sender defined in this intercompany policy may not correspond to individuals knowledgeable of the likely changes. As such, it is critical that all parties proactively communicate the transactions to be recorded with other business unit or corporate individuals responsible for making the corollary entry on other books. A list of contact names for each business unit and corporate area can be found on the Corporate Controller's website. These contacts, along with the Corporate/BU IPOs, will be notified of legal entity changes and are responsible for communicating within their business unit/corporate area to facilitate the affects of new or changed intercompany relationships.

All equity-related transactions, including dissolutions or restructurings, shall be recorded, reconciled, eliminated and discrepancies resolved in accordance with the dates established by the Corporate Controller and published in the Calendar.

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

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

## Accounting for Regulated Entities (SFAS No. 71)

|                        |                       |
|------------------------|-----------------------|
| <b>Applicability:</b>  | Applies to Enterprise |
| <b>Originator:</b>     | Corporate Controller  |
| <b>Approval:</b>       | Corporate Controller  |
| <b>Effective Date:</b> | 12/01/2004            |
| <b>Revision Date:</b>  | 12/15/2006            |
| <b>Relssue Date:</b>   | 12/15/2006            |

### **Statement of Purpose and Philosophy**

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

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

### **Policy Expectations and Scope**

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

### **Materiality**

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

### **Accountability: Roles and Responsibilities**

Corporate Controller's Department -

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

**Business/Corporate Unit -**

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

**Standards/Requirements/Background Information**

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

**Standards**

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

- SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation"
- SFAS No. 90, "Regulated Enterprises - Accounting for Abandonments and Disallowance of Plant Costs - An Amendment of FASB Statement No. 71"
- SFAS No. 92, "Regulated Enterprises - Accounting for Phase-in Plans - An Amendment of FASB Statement No 71"
- SFAS No. 101, "Regulated Enterprises - Accounting for the Discontinuation of Application of FASB Statement No. 71"
- SFAS No. 109, "Accounting for Income Taxes"
- EITF 92-07, "Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue programs" and
- EITF 97-04, "Deregulation of the Pricing of Electricity - Issues Related to the Application of FASB Statement No. 71 and No. 101"
- SAB Topic 10, "Utility Companies"
- Current Text Section Re6, "Regulated Operations"

**Background**



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

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

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

Summary

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

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

Introduction

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

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

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

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

4. Accounting requirements that are not directly related to the economic effects of rate actions may be imposed on regulated businesses by orders of regulatory authorities and occasionally by court decisions or statutes. This does not necessarily mean that those accounting requirements conform with generally accepted

accounting principles. For example, a regulatory authority may order an enterprise to capitalize<sup>2</sup> and amortize a cost that would be charged to income currently by an unregulated enterprise. Unless capitalization of that cost is appropriate under this Statement, generally accepted accounting principles require the regulated enterprise to charge the cost to income currently.

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

Scope

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

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

<sup>3</sup> (footnote omitted)

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

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

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

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

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

General Standards of Accounting for the Effects of Regulation

9. Rate actions of a regulator can provide reasonable assurance of the existence of an asset.<sup>4a</sup> An enterprise shall capitalize all or part of an incurred cost<sup>5</sup> that would otherwise be charged to expense if both of the following criteria are met:

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

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

a. It is probable<sup>6</sup> that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.

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

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

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

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

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

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

10. Rate actions of a regulator can reduce or eliminate the value of an asset. If a regulator excludes all or part of a cost from allowable costs, the carrying amount of any asset recognized pursuant to paragraph 9 of this Statement shall be reduced to the extent of the excluded cost. Whether other assets have been impaired shall be judged the same as for enterprises in general<sup>6a</sup> and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* shall apply.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

#### **Accounting Policy**

The following topics are discussed in this section

1. Abandonments (SFAS No. 90 "Regulated Enterprises - Accounting for Abandonments and Disallowance of Plant Costs - An Amendment of FASB Statement No. 71")
2. Accrued Compensated Absences (e.g. Vacation)
3. Allowance for Funds Used During Construction or "AFUDC"
4. Asset Retirement Obligation (ARO) Costs
5. Current Assets and Current Liabilities
6. Debt Issuance costs
7. Disallowances of Plant Costs
8. Discontinuation of Application of SFAS No. 71
9. Income Taxes and Investment Tax Credit for Regulated Entities
10. Incurred Costs vs. Allowable Costs
11. Intercompany Profit Elimination

12. Mark-to-market results for certain derivative instruments under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities"
13. Minimum Pension Liabilities
14. Net Regulatory Asset Related to Income Taxes
15. Nuclear property and liability reserves
16. Nuclear decommissioning trust fund
17. Phase-In Plans (SFAS No. 92)
18. Property, Plant and Equipment
19. Rate Changes
20. Reapplication of SFAS No. 71
21. Regulatory Assets
22. Regulatory Accounting vs. U. S. GAAP
23. Regulatory Liabilities
24. Removal Costs
25. Reporting and Disclosure Requirements
26. Unbilled Revenue (meters not read)

### 1. Abandonments

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

3. When it becomes probable<sup>1</sup> that an operating asset or an asset under construction will be abandoned, the cost of that asset shall be removed from construction work-in-process or plant-in-service. The enterprise shall determine whether recovery of any allowed cost is likely to be provided with (a) full return on investment during the period from the time when abandonment becomes probable to the time when recovery is completed or (b) partial or no return on investment during that period. That determination should focus on the facts and circumstances related to the specific abandonment and should also consider the past practice and current policies of the applicable regulatory jurisdiction on abandonment situations. Based on that determination, the enterprise shall account for the cost of the abandoned plant as follows:

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

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

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

range, the guidance of Interpretation 14 shall be applied to determine the loss to be recognized. Accordingly, the most likely period within that range shall be used to compute the present value. If no period within that range is a better estimate than any other, the present value shall be based on the minimum time period within that range.

The following discussion is a brief summary of paragraphs 3-6 and 42-53 of SFAS No. 90. When it becomes probable that an operating plant or plant under construction will be abandoned, the associated cost should be removed from plant-in-service or construction work in progress. A separate, new asset should be established. No loss should be recognized unless it is probable and estimable. Losses should be estimated based on the present value using the incremental borrowing rate of the future revenue stream, if any. This accounting should include any plant asset balances related to asset retirement costs recorded under SFAS No. 143, "Accounting for Asset Retirement Obligations". Further guidance on accounting for an abandonment can be found in FASB Technical Bulletin No. 87-2, "Computation of a Loss on an Abandonment".

### 2. *Accrued Compensated Absences (e.g. Vacation)*

Per SFAS No. 71;

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

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

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

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

Per SFAS No. 71;

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

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

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

Per SFAS No. 92;

8. If specified criteria are met, paragraph 9 of Statement 71 requires capitalization of an incurred cost that would otherwise be charged to expense. An allowance for earnings on shareholders' investment<sup>4</sup> is not "an incurred cost that would otherwise be charged to expense." Accordingly, such an allowance shall not be capitalized pursuant to paragraph 9 of Statement 71.

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

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

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

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

1. Plant, including nuclear fuel, while under construction

2. As part of a qualifying phase-in plan (see the discussion of "Phase-In Plans" below; this is a highly unlikely circumstance for Duke Energy)

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

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

Also, if the commission has so ordered, Duke Energy may accrue AFUDC on other assets for regulatory purposes. For GAAP financial statement purposes, the AFUDC equity component is not recognized until the revenue is billed for the AFUDC equity component.

#### 4. Asset Retirement Obligation (ARO)

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

Effective December 31, 2005, FIN 47, "Accounting for Conditional Asset Retirement Obligations, an interpretation of FAS 143", requires the accrual of Conditional AROs.

See also the section on Cost of Removal.

#### 5. Current Assets and Current Liabilities

From Current Text Section B05,

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



.108 The term *current liabilities* is .... intended to include obligations for items .... such as payables incurred .... in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services".

Current assets and current liabilities, in general, are those assets and liabilities due in one year. However, no portion of regulatory assets or liabilities that are associated with plant (such as the net regulatory assets related to income taxes or the regulatory liability on the gross-up on investment tax credits) are booked as current assets or liabilities.

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

6. Debt issuance costs

Per SFAS No. 71,

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

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

37. If the debt is reacquired for an amount that is less than the enterprise's net carrying amount, the regulator's decision to reduce future rates by amortizing the difference for rate-making purposes imposes a liability on the regulated enterprise (paragraph 11(c)). Accordingly, the enterprise would record the difference as a liability and amortize it over the period during which permitted rates will be reduced. Under U.S. GAAP, unamortized debt issuance costs are immediately expensed for retired debt and modified debt arrangements which are considered "substantially different" under the provisions of EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments". However, if the conditions in paragraphs 9 and 35 to 37 of SFAS No. 71 are met, debt issuance costs related to regulated entities which would be expensed under U.S. GAAP should be deferred as a regulatory asset and amortized over the remaining contractual life of the original debt issuance.

7. Disallowances of Plant Costs

Per SFAS No. 90,

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

<sup>2</sup> footnote omitted

When a direct disallowance of a recently completed plant is probable and estimable, a loss should be recorded, dollar for dollar, for the disallowed amount. This accounting can be different than the requirement under SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" where an undiscounted cash flow approach is used and any impairment loss is measured by comparing the carrying value of a long-lived asset to its fair value. Future depreciation charges should be based on the written down asset basis.

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

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

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

8. Discontinuation of Application of SFAS No. 71

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

4. Failure of an enterprise's operations to continue to meet the criteria in paragraph 5 of Statement 71 can result from different causes. Examples include the following:
- a. Deregulation
  - b. A change in the regulator's approach to setting rates from cost-based rate making to another form of regulation

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

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

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

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

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

SFAS No. 71 can be discontinued for a variety of reasons. Factors to consider may include a persistent and significant under-earning of the allowed rate of return for an extended period of time,

legislation deregulating some portion (typically generation or production) of the business, a rate structure based on long term rate freezes, cost caps or market based regulation of rates.

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

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

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

#### 9. Emission Allowances

Emission allowances are accounted for as intangible assets by Duke Energy. Gains and losses on emission allowances for the regulated utilities, especially the electric utilities, will likely meet the definitions of regulatory liabilities and assets, respectfully, and accordingly should be accounted for as such as appropriate.

#### 10. Impairments

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

Regulatory assets are covered by SFAS 71, abandonments and disallowances are covered by SFAS 90. SFAS 144 applies to long-lived assets, SFAS 142 applies to goodwill and other intangibles. Other assets are covered by other areas of GAAP depending upon the specific nature of the asset – e.g., equity method investments are covered by APB 18, other investments are covered by SFAS 115 and EITF Issue 03-1, notes receivable are covered by SFAS 114, etc.

11. Income Taxes and Investment Tax Credit for Regulated Entities

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

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

- a. Prohibits net-of-tax accounting and reporting
- b. Requires recognition of a deferred tax liability (1) for tax benefits that are flowed through to customers when temporary differences originate and (2) for the equity component of the allowance for funds used during construction
- c. Requires adjustment of a deferred tax liability or asset for an enacted change in tax laws or rates.

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

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

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

Per SFAS No. 101;

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

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

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

For electric operations, investment tax credits are deferred and reported as a credit on the balance sheet rather than a reduction in PP&E. Investment tax credits are amortized as a component of income tax expense over the life of the associated plant. (Note: Gas operations have historically presented differently on the balance sheet. However, during 2005, all ITC on the balance sheet for gas operations was fully amortized.)

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

Per SFAS No. 109;

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

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

#### 12. Incurred Costs vs. Allowable Costs

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

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

Intercompany Profit Elimination

Per SFAS No. 71;

***Intercompany Profit***<sup>10</sup>

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

16. Profit on sales to regulated affiliates shall not be eliminated in general-purpose financial statements<sup>11</sup> if both of the following criteria are met:

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

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

Profits on sales to regulated affiliates should not be eliminated in consolidated results. Intercompany profit on sales from a regulated entity (under SFAS No. 71) to an unregulated affiliate should be eliminated in consolidated results. See also SFAS 71, paragraph 17 and 85-86.

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

Changes in the fair value of derivative instruments designated as cash flow hedges are recorded in Accumulated Other Comprehensive Income (AOCI), a separate component of shareholders' equity on the balance sheet, while changes in the fair value of derivative instruments not designated as cash flow hedges or fair value hedges are recorded immediately in earnings ("mark-to-market" derivatives). For derivative instruments related to regulated entities, the changes in fair value of "mark-to-market" derivatives and cash flow hedges that would otherwise flow through the income statement should be recorded as a regulatory asset or liability, rather than AOCI or earnings, as long as the criteria in paragraphs 9 or 11 of SFAS No. 71, as applicable, are met. Depending upon the specific facts and circumstances, a formal "rate order" may not be required in order to meet the criteria of SFAS No. 71 to classify the balance as either a regulatory asset or liability.

15. Pensions and Other Postretirement Benefits

Situations can exist under which a regulatory asset or liability needs to be recorded for pensions or other postretirement benefits ("OPEB"). A common example of when this can occur is when purchase accounting is applied following a business combination. Paragraph 74 of SFAS 87 and paragraph 86 of SFAS 106 require the elimination of any previously unrecognized prior service costs, transition assets, or actuarial losses in purchase accounting. This results in a liability (or asset) being recognized in the opening balance sheet equal to the funded status of the plan (the

amount by which the projected benefit obligation either exceeds or is less than the plan assets). However, the governing regulatory bodies may mandate that rates reflect recovery of defined benefit costs as expensed pursuant to SFAS 87 and SFAS 106 without giving consideration to the impacts of purchase accounting. With the elimination of all unrecognized prior service costs and actuarial losses, future expense (holding all other assumptions constant) would be lower as a result of purchase accounting.

SFAS 71 governs the conflict between any regulatory requirement that purchase accounting have no impact on ratemaking and the requirement in SFAS 87 and 106 to recognize the underfunded status of the plans. Specifically, paragraph 12 of SFAS 71 states that "actions of a regulator can eliminate a liability only if the liability was imposed by actions of the regulator". Given this guidance, GAAP provides no basis to avoid the incremental liability that often results from the application of the guidance in paragraph 74 of SFAS 87 and paragraph 86 of SFAS 106. However, SFAS 71 allows recognition of a regulatory asset equal to the previous unrecognized actuarial losses and prior service costs. The only constraints (per paragraph 9 of SFAS 71) are that (a) it is probable that future revenue will be allowed to recover that asset, and (b) the future revenue is provided to recover those historically incurred costs rather than future costs. If agreements with the regulatory bodies are to avoid having purchase accounting affect ratemaking, it will likely be appropriate to recognize a regulatory asset and amortize that regulatory asset in a manner consistent with how prior service cost and actuarial losses (which are what the asset relates to) would have been recognized through pension cost. Future revenue necessary to recover that asset is probable given appropriate agreements with those regulators that will allow ratemaking to be based on costs without purchase accounting.

#### 16. Net Regulatory Asset Related to Income Taxes

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

#### 18. Nuclear property and liability reserves



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

19. Nuclear decommissioning trust fund

In accordance with regulatory requirements, Duke Energy has established an external trust fund that holds investments, including debt and equity securities, designated to cover costs to decommission Duke Power's nuclear plants when the operating licenses ultimately expire. Decommissioning of the non-contaminated portion is a removal cost (see separate section below entitled "Removal Costs"). Decommissioning of the contaminated portion is an ARO under SFAS No. 143 because it represents a legal obligation, while decommissioning of the non-contaminated portion is not a legal obligation under SFAS No. 143. In accordance with regulatory requirements, Duke Energy has outsourced the management of the investments in the trust to one or more third parties. Under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", investments in marketable securities, such as debt and equity securities, are classified as trading, held-to-maturity, or available-for-sale. With respect to the nuclear decommissioning trust fund, all the marketable securities held in the trust are classified as available-for-sale. Duke Energy management does not have the ability to hold the securities to maturity, due to the outsourcing of the investment management procedures, nor do the securities qualify for the trading designation as they are not bought and held principally for selling them in the near term. Consequently, under the guidance in SFAS No. 115, the investments are carried at fair value in the consolidated balance sheets.

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

From SFAS No. 92:

3. The term *phase-in* is used in this Statement to refer to any method of recognition of allowable costs (footnote omitted) in rates that meets all of the following criteria:
- a. The method was adopted by the regulator in connection with a major, newly completed plant of the utility or one of its suppliers or a major plant scheduled for completion in the future (hereinafter referred to as a "plant").
  - b. The method defers the rates intended to recover allowable costs beyond the period in which those allowable costs would be charged to expense under GAAP applicable to enterprises in general.
  - c. The method defers the rates intended to recover allowable costs beyond the period in which those rates would have been ordered under ratemaking methods routinely used prior to 1982 by that regulator for similar allowable costs of that regulated enterprise.
4. If a phase-in plan is ordered by a regulator in connection with a plant on which no substantial physical construction had been performed before January 1, 1988, none of the allowable costs that are deferred for future recovery by the regulator under the plan<sup>2</sup> for rate-making purposes shall be capitalized for general-purpose financial reporting purposes (hereinafter referred to as "financial reporting").

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

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

Phase-in plans do not include the deferral of costs between the commercial operation date of a major new plant and a change in rates to reflect commercial operation of that plant. Such incurred costs can be deferred provided they meet the requirements of SFAS No. 71 paragraph 9 and do not include an amount for AFUDC (borrowed and equity) greater than the equivalent interest cost. (See paragraphs 38-39 of SFAS No. 92)

#### 21. Property, Plant and Equipment

In accordance with the FERC Uniform System of Accounts ("USA"), Duke Energy uses composite depreciation to depreciate its utility plant for both FERC and GAAP purposes. Also, Duke capitalizes Contributions in Aid of Construction ("CIAC") as reductions in utility plant in accordance with the USA and prevalent industry practice for GAAP reporting purposes. Investment tax credits, for electric plant, are recorded as deferred credits instead of as reductions in PP&E (See section above entitled "Income Taxes and Investment Tax Credit for Regulated Entities"). Duke Energy does not record any regulatory assets or regulatory liabilities as PP&E. (See section above entitled "Allowance for Funds Used During Construction or 'AFUDC'".) The cost of removal component of depreciation is reported on the GAAP balance sheet as a regulatory liability although for regulatory purposes, this liability is credited to Accumulated Depreciation. (See section below on Removal Costs.)

The income statement effects of SFAS No. 143 "Accounting for Retirement Obligations", are deferred into a regulatory asset or liability.

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

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

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

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

#### 22. Rate Changes

Per SFAS No. 71;

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

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

Rate reductions for previously collected revenue (refunds) should be accrued as regulatory liabilities in accordance with SFAS No. 71, paragraph 11(a). Other rate reductions should likely not be accrued.

Rate changes for cost tracked items (such as a fuel or purchased power expense) are booked as revenue is billed (typically monthly), with offsetting impacts on unbilled fuel or unbilled purchased power expense.

#### 23. Reapplication of SFAS No. 71

Reapplication of SFAS No. 71 as a result of reregulation is the result of a change in accounting principle as a result of a changed circumstance. The effect of such a change is recognized in current earnings and is not a cumulative effect of a change in accounting principle. Caution should be applied to avoid the recognition of regulatory assets before they are considered probable of recovery. Reapplication of SFAS No. 71 may be considered an extraordinary item depending on facts and circumstances.

#### 24. Regulatory Accounting vs. U.S. GAAP

Per SFAS No. 111, "Rescission of FASB Statement No. 32 and Technical Corrections"

25. The chart below summarizes the GAAP hierarchy for financial statements of nongovernmental entities <sup>4</sup> under SAS 69.

#### **Established Accounting Principles**

Category (a)-FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins

Category (b)-FASB Technical Bulletins, cleared <sup>5</sup> AICPA Industry Audit and Accounting Guides, and cleared AICPA Statements of Position

Category (c)-Consensus positions of the FASB Emerging Issues Task Force and cleared AICPA AcSEC Practice Bulletins

Category (d)-AICPA Accounting Interpretations, FASB Implementation Guides (Q&As), and widely recognized and prevalent industry practices

### **Other Accounting Literature**

Other accounting literature, including FASB concepts Statements; APB Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles.

Regulatory accounting pronouncements (e.g., accounting from regulatory bodies such as FERC or state public utility commissions) should not be assumed to comply with U.S. GAAP reporting requirements (SFAS 71, paragraphs 4 & 54). However, per the excerpts from SFAS No. 111 above, pronouncements of regulatory agencies and prevalent industry practice represent lower level GAAP. Therefore, the

- FERC Uniform System of Accounts,
- FERC Accounting Interpretations, Releases and Rulemakings,
- State Commission Accounting Orders, Rate Orders or other pronouncements and
- prevalent industry practice

provide GAAP guidance as long as they are consistent with SFAS No. 71 and are not in conflict with any higher level GAAP.

#### 25. Regulatory Liabilities

Regulatory liabilities should be amortized over future periods consistent with the related decrease in customer revenues. Regulatory liabilities should not be netted against a corresponding GAAP asset unless the netting requirements of FIN 39 are met. Regulatory liabilities should not be included as a part of plant, property and equipment including nuclear fuel (PP&E) or inventory. (See the sections above entitled Allowance for Funds Used During Construction or "AFUDC", Intercompany Profit Elimination and Disallowances of Plant Costs for further guidance.)

Regulatory liabilities should be booked only if the criteria of paragraph 11 (a), (b) or (c) are met.

#### 26. Removal Costs

For certain regulated Duke entities, the depreciation component of rates includes an estimate for costs of removal. Costs of removal may include both the "non-legal" retirement obligations, such as estimated costs for non-nuclear facilities and the non-contaminated portion for decommissioning nuclear power plants as well as certain costs associated with retirement of gas pipeline systems. Under SFAS No. 143, these costs cannot be accrued as retirement obligations until incurred because

they do not represent legally-obligated costs. (The contaminated portion for decommissioning Duke Power's nuclear power facilities is an ARO liability as are certain other disposal costs for the DEGT and Duke Power.) Therefore, pursuant to SFAS No. 71, paragraph 11(b), the balance for these non-legal costs is recorded as a regulatory liability for GAAP reporting although regulated financial statements may be required, in some cases, to classify these credits within accumulated depreciation.

27. Reporting and Disclosure Requirements

Per SFAS No. 71;

19. For refunds that are recognized in a period other than the period in which the related revenue was recognized and that have a material effect on net income, the enterprise shall disclose the effect on net income and indicate the years in which the related revenue was recognized. Such effect may be disclosed by including it, net of related income taxes, as a line item in the income statement. However, that item shall not be presented as an extraordinary item.

Significant refunds that are recognized in a period other than the period in which the related revenue was recognized and that have a material effect on net income should be disclosed. The years for which the related revenue was recognized should be indicated. The effect may be disclosed, net of related income taxes, as a line item in the income statement. However, it should not be presented as an extraordinary item.

The amount of any revenue adjustments resulting from rate-making processes related to prior interim periods should be disclosed under the following circumstances. (From SFAS No. 16, "Prior Period Adjustments", paragraph 13)

- a. The effect of the adjustment or settlement is material in relation to income from continuing operations of the current fiscal year or in relation to the trend of income from continuing operations or is material by other appropriate criteria, and
- b. All or part of the adjustment or settlement can be specifically identified with and is directly related to business activities of specific prior interim periods of the current fiscal year, and
- c. The amount of the adjustment or settlement could not be reasonably estimated prior to the current interim period but becomes reasonably estimable in the current interim period.

If the revenue adjustment occurs in *other than the first quarter*, prior interim periods of the current year should be restated to include the portion of the revenue adjustment. The portion of the refund that is directly related to business activities during prior years will be included in the first quarter of the current year. Disclosures will be made of both a) the change in income and b) the income on

- continuing operations,
- net income and
- related per share amounts

See also, SFAS No. 16, paragraphs 14-15.

Losses recorded related to abandonments or disallowances should not be reported as extraordinary items.

Per SFAS No. 101;

6. When an enterprise discontinues application of Statement 71 to all or part of its operations, .... The net effect of the adjustments required by this Statement shall be included in income of the period in which the discontinuation occurs and shall be classified as an extraordinary item.

8. For the period in which an enterprise reflects the discontinuation of application of Statement 71 to all or a separable portion of its operations, the enterprise shall disclose the reasons for the discontinuation and identify the portion of its operations to which the application of Statement 71 is being discontinued.

If SFAS No. 71 is discontinued for any portion of the regulated business, the reason for the discontinuance and the portion of the operations for which SFAS No. 71 is discontinued should be disclosed. The discontinuance should be treated as an extraordinary item.

As part of Duke's significant accounting policies, Duke Energy discloses, in a separate footnote all regulatory assets and liabilities which would be written off if SFAS No. 71 were no longer applicable. Regulatory assets and liabilities exclude AFUDC (borrowed and equity) capitalized as part of plant, property and equipment including nuclear fuel, intercompany profit in PP&E or inventory or disallowances. Disclosures include:

- the nature of the cost deferred,
- the amount deferred,
- where each item is presented on the balance sheet,
- the recovery period and
- whether a return is being provided.

Unbilled Revenue (meters not read)

An amount for electricity or gas delivered but not yet billed is accrued each month based on estimates of the amounts delivered since the last meter reading date to the end of the reporting period. Revenue is recognized as the only activities before conversion into cash are meter reading, billing and cash collection. The revenue recognized is gross of meter reading, billing and cash collection costs due to the immateriality of such items.

## Accounting for Risk Management and Hedging Activities

|                        |                       |
|------------------------|-----------------------|
| <b>Applicability:</b>  | Applies to Enterprise |
| <b>Originator:</b>     | Corporate Controller  |
| <b>Approval:</b>       | Corporate Controller  |
| <b>Effective Date:</b> | 12/01/2004            |
| <b>Revision Date:</b>  | 12/15/2006            |
| <b>Reissue Date:</b>   | 12/15/2006            |

### **Statement of Purpose and Philosophy**

The purpose of this policy is to provide guidelines related to the accounting and disclosure of derivatives and other instruments or contracts related to risk management and hedging activities. Duke Energy is committed to preparing and providing financial information with the utmost integrity. To facilitate this corporate value, the Corporate Controller's Department will approve policies to ensure the accuracy of books and records (as detailed in the Code of Business Ethics).

### **Policy Expectations and Scope**

This policy is applicable to all business/corporate units of Duke Energy Corporation and its consolidated subsidiaries ("Duke Energy" or "the Company"). This policy contains a high-level summary of the key requirements of U. S. GAAP as it applies to Duke Energy, including any significant interpretations or policy elections made by Duke Energy, but is not intended to be a substitute for the detailed requirements of authoritative GAAP literature for specific issues or matters that may arise. This policy should help ensure consistent application of the accounting for derivative instruments and hedging activities across the consolidated Duke Energy group.

The scope of this policy is related to risk management functions surrounding derivative instruments and hedging activities, including any contracts whose terms and conditions qualify as derivative instruments even though the initial intent of the contract may not have been related to "risk management." This policy does not cover other risk management activities such as credit risk, allowances for bad debt, etc. This policy does not apply to equity investments or ownership of stock. In addition, this policy is intended to address matters of significance at the Duke Energy and Duke Capital LLC consolidated reporting levels. Additional details or procedural information may exist at the individual business or corporate unit level.

### **Materiality**

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

materiality should be directed to the Corporate Controller Department.

**Accountability: Roles and Responsibilities**

**Corporate Controller Department -**

- Maintain an accounting policy for risk management and hedging activities (primarily for derivative instruments) available on the Duke Energy portal to help ensure that business/corporate units are aware of the criteria in order to assess whether (1) a financial instrument or other contract is a derivative and (2) a derivative qualifies for the normal purchases and normal sales exception or hedge accounting.
- Accumulate the information reported by the business/corporate units for periodic reporting and disclosure purposes (e.g. Form 10-K, Form 10-Q, etc.), including SEC market risk disclosures, and ensure that GAAP, including SEC, disclosure requirements are met.
- Provide guidance/assistance to business/corporate units on the classification and disclosure of derivative instruments, derivative instrument transactions for which accrual accounting is available, trading and marketing activities, and other risk management activities.
- Establish and communicate the reporting timetable for risk management and hedging information needed for SEC filings.
- Provide guidance on the consideration of materiality as may be requested by the business/corporate units.

**Business/Corporate Unit -**

- Ensure all reporting requirements for derivative instruments, hedges, trading and risk management activities are reported to the Corporate Controller's Department in accordance with the established reporting timetable.
- Ensure proper support/documentation exists for the determination of whether: i) a financial instrument meets the definition of derivative, ii) a derivative instrument qualifies for the normal purchases and normal sales exception, and iii) hedge accounting is available for a hedging relationship.
- Ensure proper support/documentation exists for the determination of the fair value of derivative assets and liabilities at each reporting period.
- Ensure proper support/documentation exists for other risk management activities, such as hedge de-designation, reserve methodology, presentation, etc.
- Coordinate with the Corporate Controller department to ensure that all disclosure requirements are met in SEC filings.

**Standards/Requirements/Background Information**

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

**Standards**

The accounting for risk management activities evolved significantly from 1998-2006. Prior to 1998, accounting and disclosure for instruments used in risk management activities was primarily limited to



the following pronouncements:

- Statement of Financial Accounting Standard (SFAS) No. 52, Foreign Currency Translation
- SFAS No. 80, Accounting for Futures Contracts
- SFAS No. 105, Disclosure of Information about Derivative Financial Instruments and Fair Value of Financial Instruments
- SFAS No. 107, Disclosures about Fair Value of Financial Instruments
- AICPA Issues Paper, Accounting for Options (1986)

Since 1998, the Financial Accounting Standards Board ("FASB") and Emerging Issues Task Force ("EITF") issued various accounting standards that significantly changed the accounting recognition and disclosure of instruments used in trading and risk management activities. The significant pronouncements issued primarily included the following:

- EITF Issue 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities (superseded by Issue 02-03)
- SFAS No. 133 (as amended by SFAS Nos. 138, 149, 155, and 156), Accounting for Derivative Instruments and Hedging Activities
- EITF Issue 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent"
- EITF Issue 02-03, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities
- EITF Issue No. 03-11, Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not 'Held for Trading Purposes' as Defined in Issue No. 02-3
- Issue papers from the Derivatives Implementation Group ("DIG"), a committee formed by the FASB to address interpretation issues involving SFAS No. 133. Issue papers from the Derivatives Implementation Group (DIG) that are of the most relevance to Duke Energy include:
  - DIG Issue No. A6, Definition of a Derivative: Notional Amounts of Commodity Contracts
  - DIG Issue No. A10, Assets That Are Readily Convertible to Cash
  - DIG Issue No. A18, Application of Market Mechanism and Readily Convertible to Cash Subsequent to the Inception of Acquisition of a Contract
  - DIG Issue No. C15, Scope Exceptions: Normal Purchases and Normal Sales Exception for Option-Type Contracts and Forward Contracts in Electricity
  - DIG Issue No. C20, Scope Exceptions: Interpretation of the Meaning of Not Clearly and Closely Related in Paragraph 10(b) regarding Contracts with a Price Adjustment Feature
  - DIG Issue No. E7, Hedging-General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges
  - DIG Issue No. G7, Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut method Is Not Applied
  - DIG Issue No. G10, Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative
- SFAS No. 157, Fair Value Measurements

These accounting pronouncements provided material changes in the accounting recognition and disclosures included in Duke Energy's consolidated financial statements. SFAS No. 157 was issued in September 2006 and is effective for Duke Energy beginning in 2008. While this new guidance could have significant impact on Duke Energy's valuation of derivative and other risk management instruments, it is not addressed in this policy at this time since it is not yet effective.

Background:

**Types of Activities:**

The Company primarily operates in various facets of the electric and natural gas industries including, but not limited to, the ownership and operation of power plants and gathering, processing, transportation and storage of natural gas and natural gas liquids (NGLs) in the Americas. Duke Energy is exposed to market risks associated with changes in commodity prices, credit exposure, interest rates, and foreign currency exchange rates. The Company's historical risk management and trading operations can be grouped into two broad categories - economic hedging and proprietary trading. Currently, the Company does not engage in any significant proprietary trading activities, but references to this activity is being retained in this policy for historical and future potential reference purposes.

*Economic Hedging*

In connection with its operations, the Company has certain firm commitments and anticipated forecasted transactions that bear commodity price, interest rate and/or foreign currency exchange rate risk. To mitigate this exposure, the Company often enters into a forward type contract for the purpose of reducing the risk of price fluctuation upon settlement, delivery or execution of a particular transaction. Depending on the nature of the hedged transaction and the instrument used, the Company may or may not designate the instrument as a hedge in accordance with SFAS No. 133. The Company's economic hedging activities will be classified in the consolidated financial statements as either 1) "hedging" if they are designated and documented as such in accordance with SFAS No. 133 and meet all the hedge criteria in SFAS No. 133; 2) "other" or "undesignated" if they represent an economic hedge but are not formally designated and documented or do not qualify as a hedge for accounting purposes under SFAS No. 133; or 3) excluded from the consolidated financial statements until settlement occurs either because the forward type contracts used represent normal purchases and normal sales of the Company, as defined in SFAS No. 133 (as amended), or the contract does not qualify as a derivative (e.g., an operating lease or an executory contract).

*Proprietary trading*

Related, in part, to the Company's presence in the natural gas and electricity marketplace, the Company has historically entered into certain contracts to take a market view, capture market price or put capital at risk. This type of activity may use some of the same types of instruments as hedging activity described above and is generally short-term in nature. EITF Issue No. 02-3 clarified that classification of derivatives as held for "trading purposes" is based on the intent of the issuer or holder and shall be consistent with paragraph 12(a) of SFAS No. 115 which characterizes trading as "active and frequent buying and selling . . . with the objective of generating profits on short-term differences in price." On an ongoing basis, reclassifications into and out of trading should be rare. The SFAS No. 115 definition of trading involves holding an instrument for a short period of time, such as hours or days rather than months or years. Designation of a contract as proprietary trading activity is performed at the business/corporate unit level by the appropriate personnel and

documented within the business/corporate unit's risk management system as such. Paragraph 16 of EITF 02-3 states that "A derivative held for trading purposes may be designated as a hedging instrument, prospectively, if all of the applicable criteria in Statement 133 have been met". As noted above, the Company currently does not engage in any significant proprietary trading activities.

### **Types of Instruments:**

#### *1. Derivative Instruments*

As provided in SFAS No. 133, a derivative instrument is a financial instrument\* or other contract with all three of the following characteristics:

- a. It has (1) one or more **underlyings** and (2) one or more **notional amounts** or payment provisions or both.
- b. It requires **no initial net investment** or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- c. Its terms require or **permit net settlement**, it can readily be settled by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

SFAS No. 133 contains the following additional information on the determination of a notional:

*7. Underlying, notional amount, and payment provision.* An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable including the *occurrence* or *nonoccurrence* of a specified event such as a scheduled payment under a contract. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

57. a. Underlying. An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative. An underlying usually is one or a combination of the following:

- (1) A security price or security price index
- (2) A commodity price or commodity price index
- (3) An interest rate or interest rate index
- (4) A credit rating or credit index
- (5) An exchange rate or exchange rate index
- (6) An insurance index or catastrophe loss index
- (7) A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index.

However, an underlying may be any variable whose changes are observable or otherwise objectively verifiable. Paragraph 10(e) specifically excludes a contract with settlement based on certain variables unless the contract is exchange-traded. A contract based on any variable that is not specifically excluded is subject to the requirements of this Statement if it has the other two characteristics identified in paragraph 6 (which also are discussed in paragraph 57(b) and paragraph 57(c))

below).

SFAS No. 133 contains the following additional information on the determination of whether a contract contains an initial net investment:

**8. Initial Net Investment.** Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus premium or minus a discount) or that is determined by applying the notional amount to the underlying.

**57. b. Initial net investment.** A derivative requires no initial net investment or a smaller initial net investment than other types of contracts that have a similar response to changes in market factors. For example, entering into a commodity futures contract generally requires no net investment, while purchasing the same commodity requires an initial net investment equal to its market price. However, both contracts reflect changes in the price of the commodity in the same way, (that is, similar gains or losses will be incurred). A swap or forward contract also generally does not require an initial net investment unless the terms favor one party over the other. An option generally requires that one party make an initial net investment (a premium) because that party has the rights under the contract and the other party has the obligations. The phrase initial net investment is stated from the perspective of only one party to the contract, but it determines the application of the Statement for both parties.

SFAS No. 133 contains the following additional information on the determination of whether a contract contains net settlement:

**9. Net settlement.** A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:

a. Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.

b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

c. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash<sup>5</sup> or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another

example is a swaption—an option to require delivery of a swap contract, which is a derivative.

<sup>5</sup> FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, states that assets that are readily convertible to cash "have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price" (paragraph 83(a)). For contracts that involve multiple deliveries of the asset, the phrase in an active market that can rapidly absorb the quantity held by the entity should be applied separately to the expected quantity in each delivery.

57. c. *Net settlement.* A contract that meets any one of the following criteria has the characteristic described as net settlement:

- (1) Its terms implicitly or explicitly require or permit net settlement. For example, a penalty for nonperformance in a purchase order is a net settlement provision if the amount of the penalty is based on changes in the price of the items that are the subject of the contract. Net settlement may be made in cash or by delivery of any other asset, whether or not it is readily convertible to cash. A fixed penalty for nonperformance is not a net settlement provision.
- (2) There is an established market mechanism that facilitates net settlement outside the contract. The term market mechanism is to be interpreted broadly. Any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement.
- (3) It requires delivery of an asset that is readily convertible to cash. The definition of readily convertible to cash in FASB Concepts Statement No. 5, Recognition and measurement in Financial Statements of Business Enterprises, includes, for example, a security or commodity traded in an active market.... A security that is publicly traded but for which the market is not very active is readily convertible to cash if the number of shares or other units of the security to be exchanged is small relative to the daily transaction volume.

The determination of the existence of the three characteristics identified above is often difficult to assess and requires judgment. Attachment A represents an inventory listing of the primary commodity contract types in existence and the analysis as to whether such contracts represent derivatives. As discussed further below, certain contracts that meet the requirements for a derivative can be excluded from the financial statements (not recorded at fair market value) until settlement occurs pursuant to the normal purchases and sales exception in SFAS No. 133 if certain criteria are met.

The following is a summary of the primary accounting categorization of derivative instruments as they apply to Duke Energy:

- *Normal purchases and normal sales* – An elective accounting treatment for contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. It must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery (except for "**capacity contracts**" for power sale and purchase agreements under paragraph 10(b)(4) of SFAS No. 133). If a derivative contract qualifies for the normal purchases and normal sales exception and is documented as such, it is not subject to the requirements of SFAS No. 133 and shall be accounted for under the accrual method of accounting (as defined in "Accounting for Types of Instruments by Activity")

below) and therefore is excluded from the consolidated financial statements until settlement occurs. Duke Energy also enters into power purchase or sales agreements that are also capacity contracts# and these contracts may qualify for the normal purchases and normal sales exception even if they are subject to unplanned netting or bookout. The discussion in the "Key Terms" section details how the "clearly and closely related" provisions of normal purchases and normal sales differ from the "clearly and closely related" provisions of embedded derivatives (paragraph 12 of SFAS No. 133).

- ***Commodity Cash Flow Hedges*** - Some Duke Energy subsidiaries are exposed to market fluctuations in the prices of various commodities related to their ongoing power generating and natural gas gathering, distribution, processing and marketing activities. Duke Energy closely monitors the potential impacts of commodity price changes and, where appropriate, may enter into contracts to protect margins for a portion of future sales and generation revenues and fuel expenses. Duke Energy uses commodity instruments, such as swaps, futures, forwards and options, as cash flow hedges for natural gas, electricity and natural gas liquid transactions.

- ***Commodity Fair Value Hedges*** - Some Duke Energy subsidiaries are exposed to changes in the fair value of some unrecognized firm commitments to sell or purchase generated power or natural gas due to market fluctuations in the underlying commodity prices or the changes in the fair value of recorded assets or liabilities, such as natural gas held in inventory. Duke Energy actively evaluates changes in the fair value of such unrecognized firm commitments due to commodity price changes and, where appropriate, may use various instruments to hedge its market risk. These commodity instruments, such as swaps, futures and forwards, serve as fair value hedges for the firm commitments associated with generated power, natural gas or related product inventories.

- ***Interest Rate (Fair Value or Cash Flow) Hedges*** - Changes in interest rates expose Duke Energy to risk as a result of its issuance of variable-rate debt and commercial paper. Duke Energy manages its interest rate exposure by limiting its variable-rate and fixed-rate exposures to percentages of total capitalization and by monitoring the effects of market changes in interest rates. Duke Energy also may enter into financial derivative instruments, including, but not limited to, interest rate swaps, swaptions and U.S. Treasury lock agreements to manage interest rate risk exposure.

- ***Foreign Currency (Fair Value, Net Investment or Cash Flow) Hedges*** - Duke Energy is exposed to foreign currency risk from investments in international affiliates and businesses owned and operated in foreign countries. To mitigate risks associated with foreign currency fluctuations, contracts may be denominated in or indexed to the U.S. dollar and/or local inflation rates, or investments may be hedged through debt denominated or issued in the foreign currency. Duke Energy may also use foreign currency derivatives, where possible, to manage its risk related to foreign currency fluctuations. Please refer to the discussion in paragraph 40A of SFAS No. 133 for guidance pursuant to Intercompany foreign currency derivatives.

- ***Other Derivative Contracts (Trading)*** - Duke Energy is exposed to the impact of market fluctuations in the prices of natural gas, electricity and other energy-related products marketed and purchased as a result of proprietary trading activities. Duke Energy's exposure to commodity price risk is influenced by a number of factors, including contract size, length, market liquidity, location and unique or specific contract terms. Currently, the Company does not engage in any significant trading activities.

- ***Undesignated*** - Duke Energy uses derivative contracts to manage the market risk exposures that arise from energy supply, structured origination, marketing, risk

management, and commercial optimization services to large energy customers, energy aggregators and other wholesale companies, and to manage interest rate and foreign currency exposures. Derivative contracts that are not properly documented and designated, do not qualify for the normal purchases and normal sale exception or do not qualify hedge accounting are automatically marked to market as undesignated derivatives. This category also includes derivatives which are 'offset' with FAS 71 regulatory assets or regulatory liabilities.

## *2. Lease Contracts*

Certain contracts may meet the requirements to be accounted for as leases. The accounting for these contracts is outside of the scope of this policy.

Leases can be either capital or operating leases. A lease is defined in accounting literature as any agreement that transfers the right to use an asset usually for a specified period. EITF Issue No. 01-8 has clarified that contracts which convey the right to use specific property, plant and equipment, as defined, may meet the definition of a lease and be subject to SFAS No. 13. This definition is applicable even though the legal owner of the asset still provides substantial services. It should be noted that the agreement does not have to be specifically identified as a lease to be treated as such. EITF Issue 01-8 clarified that "leases that are within the scope of Statement 13 are not derivative instruments subject to Statement 133, although a derivative embedded in a lease may be subject to the requirements of Statement 133". Therefore, if a contract is considered a lease, mark-to-market accounting as a derivative is not permitted except for any derivatives which are embedded in the contract (see embedded derivative discussion below).

## *3. Executory Contracts*

An executory contract generally involves a purchase/sale of an asset or the providing of services and is distinct in that it does not have all three characteristics of a derivative, as defined above. If a contract is not a lease or a derivative, it is considered an executory contract.

### **Accounting for Types of Instruments by Activity:**

Duke Energy uses two comprehensive accounting models for its risk management activities in reporting its consolidated financial position and results of operations as required by GAAP: a mark-to-market model and an accrual model. Non-derivative instruments are accounted for as executory contracts, which is normally consistent with the normal purchases and normal sales methodology discussed below.

#### *Mark-to-Market*

The fair value model incorporates the use of mark-to-market (MTM) accounting. Under the MTM accounting method, which is the default for accounting for derivative instruments under SFAS No. 133, an asset or liability is recognized at fair value on the Consolidated Balance Sheet and the change in the fair value of that asset or liability is immediately recognized in the Consolidated Statement of Operations. This accounting method is applied only to derivative contracts that are not subject to

hedge accounting or the normal purchases and normal sales exception (as described below). The guidance in EITF Issue No. 03-11, EITF Issue No. 02-03 and EITF Issue No. 99-19 should be considered for the appropriate income statement classification and presentation of derivative contracts. For entities subject to SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," any changes in the fair value of MTM derivatives should be recorded as a regulatory asset or liability, rather than in earnings, as long as the criteria in paragraphs 9 and 11 of SFAS No. 71, as applicable, are met.

#### *Accrual*

An accounting method whereby there is no recognition in the Consolidated Statements of Operations for changes in fair value of a contract until the service is provided or the associated delivery period occurs (settlement) except to the extent a cash flow or fair value hedge is ineffective. For a derivative instrument that is initially subject to MTM accounting, Duke Energy may apply either hedge accounting or the normal purchases and normal sales exception in accordance with SFAS No. 133. The use of hedge accounting (to the extent effective) and the normal purchases and normal sales exception provide effectively for the use of the accrual model from an income statement perspective. (Both hedge and MTM accounting require that the fair value of the derivative be reflected on the balance sheet.) The guidance in EITF Issue No. 03-11 and EITF Issue No. 99-19 should be considered for the appropriate income statement classification and presentation of derivative contracts. For entities subject to SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," any changes in the fair value of derivatives designated as cash flow hedges should be recorded as a regulatory asset or liability, rather than in Accumulated Other Comprehensive Income (AOCI) or net income, as long as the criteria in paragraphs 9 and 11 of SFAS No. 71, as applicable, are met.

Hedge accounting treatment may be used when Duke Energy contracts to buy or sell a commodity such as natural gas at a fixed price for future delivery corresponding with anticipated physical sales or purchase of natural gas (cash flow hedge). In addition, hedge accounting treatment may be used when Duke Energy holds firm commitments or asset positions and enters into transactions that "hedge" the risk that the price of natural gas or electricity may change between the contract's inception and the physical delivery date of the commodity (fair value hedge). To the extent that the fair value of the hedge instrument offsets the transaction being hedged, there is no impact to the Consolidated Statements of Operations prior to settlement of the hedge. However, if not all of Duke Energy's hedges relate to the exact location being hedged, a certain degree of hedge ineffectiveness may be recognized in the Consolidated Statements of Operations.

The normal purchases and normal sales exception, as provided in SFAS No. 133 as amended and interpreted by DIG Issue C15 as amended, indicates that no recognition of the contract's fair value in the Consolidated Financial Statements is required until settlement of the contract (in Duke Energy's case, the delivery of power or for capacity contracts, the availability of capacity). All criteria for obtaining the normal purchases and normal sales exclusion must be met initially and on an ongoing basis. Obtaining the normal purchases and normal sales exception is an election and is not automatic as the contract must be specifically designated and documented as meeting the normal purchases



and normal sales exception.

Leases and executory contracts are also accounted for using the accrual method.

**Accounting Policy**

Duke Energy shall evaluate each financial instrument or other contract to determine whether it is a *derivative instrument* based on the three characteristics as prescribed in paragraph 6 of SFAS No. 133 and as discussed above. Financial instruments or other contracts meeting the definition of a derivative shall be accounted for under either the MTM or accrual method of accounting. As such, all derivative instruments not designated and qualifying for the normal purchases and normal sales exception under SFAS No. 133, shall be recorded on the Consolidated Balance Sheets at their fair value as "Unrealized Gains or Unrealized Losses on Mark-to-Market and Hedging Transactions." Duke Energy shall document, based on the three criteria that constitute a derivative instrument, whether each financial instrument or contract used in commodity risk management or trading activities meets the definition of a derivative.

The determination of whether a contract is a derivative under SFAS No. 133 is an ongoing process and should be periodically reassessed, especially when facts and circumstances change significantly. For example, a commodity purchase contract may not be a derivative due to the underlying commodity not being readily convertible to cash; however, if the commodity subsequently was considered to be readily convertible to cash, the contract would be considered a derivative and subject to the provisions of SFAS No. 133. Certain aspects of contracts, such as the level of transaction costs, are assessed only at inception of the contract.

Appendix A contains further interpretative guidance for use in determining whether a contract meets the definition of a derivative.

*Normal Purchases and Normal Sales Exception*

Contracts which meet the definition of a derivative may qualify for the normal purchases and normal sales exception if it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery, except as discussed below for 'capacity contracts.' If a contract qualifies for the normal purchases and normal sales exception, as defined in paragraphs 10(b) and 58(b) of SFAS No. 133, and the exemption is elected, the instrument shall be accounted for under the accrual method of accounting and shall be excluded from the consolidated financial statements until settlement occurs.

Power purchase or sales agreements which are not subject to bookout apply paragraph 10(b)(1) (for those contracts without optionality) or paragraph 10(b)(3) (for those contracts with optionality) in order to determine whether they can qualify for the normal purchases and normal sales exception. However, if a power purchase or sales agreement (whether a forward contract, an option contract, or a combination of both) for the purchase or sale of electricity is subject to unplanned netting (or being booked out or are scheduled to be booked out), they can qualify for the normal purchases and normal sales exception under paragraph 10(b)(4) if all of the following applicable criteria of paragraph 58(b)

are met and the contract meets the definition of a "capacity contract," as discussed below:  
[paragraph 58(b) of SFAS No. 133, amended by SFAS No. 149]

(1) For both parties to the contract:

(a) The terms of the contract require physical delivery of electricity. For an option contract, physical delivery is required if the option contract is exercised.

(b) The power purchase or sales agreement is a capacity contract.

(2) For the seller of electricity: The electricity that would be deliverable under the contract involves quantities that are expected to be sold by the reporting entity in the normal course of business.

(3) For the buyer of electricity:

(a) The electricity that would be deliverable under the contract involves quantities that are expected to be used or sold by the reporting entity in the normal course of business.

(b) The buyer of the electricity under the power purchase or sales agreement is an entity that is engaged in selling electricity to retail or wholesale customers and is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base.

(c) The contracts are entered into to meet the buyer's obligation to maintain a sufficient capacity, including a reasonable reserve margin established by or based on a regulatory commission, local standards, regional reliability councils, or regional transmission organizations.

For a power purchase or sale contract (whether a forward contract, an option contract, or a combination of both) that meets the definition of a "capacity contract" under paragraph 540, all of the above criteria (1-3 of paragraph 58(b)) must be evaluated by both parties in order to qualify for the normal purchases and normal sales exception under paragraph 10(b)(4). For a power purchase or sale contract that contains optionality, the characteristics of an option contract that is a capacity contract and a traditional option contract, which are set forth in the appendix of DIG Issue C15, should be considered in the evaluation of whether the contract meets the definition of a "capacity contract."

For power purchase or sale agreements that qualify for the normal purchases and normal sales exception as described above, the Company shall document the designation as normal purchases and normal sales and the basis for concluding that the agreement meets the requirements for the normal purchases and normal sales exception. The documentation must be in place at the time of application of the normal purchases and normal sales exclusion, which would normally be at inception of the contract. The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract. Failure to comply with the documentation requirements precludes the application of the normal purchases and normal sales exclusion to the contract, even if the contract would otherwise have qualified. For power purchase or sale agreements that qualify for the normal purchases and normal sales exclusion under either paragraph 10(b)(1) or 10(b)(3), the Company is required to document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. For power purchase or sale agreements that qualify for the normal purchases and normal sales exclusion under paragraph 10(b)(4), the Company is required to document the basis for how the contracts meet the criteria in paragraph 58(b).

For those contracts qualifying for the normal purchases and normal sales exception, if the underlying of the price adjustment feature is based on an index or other variable that is not "clearly and closely related" to the asset to be delivered under the contract, the normal purchases and normal sales exception cannot be obtained (refer to "Key Terms" and the guidance provided by DIG Issue C20). Contracts with inflation indexes should be documented that the index is clearly and closely related in order to meet the normal purchases and normal sales exception.

Consistent with the transition provisions in SFAS No. 149, contracts that were being accounted for under the normal purchases and normal sales exception under SFAS No. 133 as of June 30, 2003 shall continue to be accounted for under the normal purchase and normal sales exception as long as the requirements for applying the exception are met.

All criteria for obtaining the normal purchases and normal sales exception must be met initially and on an ongoing basis. Obtaining the normal purchases and normal sales exclusion is an election and is not automatic as the contract must be specifically designated and documented as meeting the normal purchases and normal sales exclusion. However, any derivative contract which is not initially designated as a normal purchases and normal sales may meet the exclusion on a prospective basis once all criteria for obtaining the exclusion, including documentation, is met. However, once a contract is documented and designated as a normal purchases and normal sales, it is the Company's policy that the contract may not be electively de-designated (the contract could be de-designated as a normal purchases and normal sales by failing to meet the criteria for such designation—see below under "De-designation of the Normal Purchases and Normal Sales Exception for Cause").

*De-designation of the Normal Purchases and Normal Sales Exception for Cause:*

If contracts cease to meet the normal purchases and normal sales exception, the fair value of the contracts shall be recognized on the Consolidated Balance Sheets and the contracts shall be accounted for using the MTM method unless immediately designated as a cash flow or fair value hedge (accrual method of accounting). Thus, once a normal purchases and normal sales contract has been de-designated for cause, the MTM of the derivative is immediately recorded to earnings and "hedge" accounting can be obtained on a prospective basis. The initial MTM of a contract coming off of the normal purchases and normal sales exception will always impact earnings, unless the entity holding the derivative is subject to SFAS No. 71.

*Hedge Accounting*

Qualifying energy commodity and other derivatives may be designated as either a hedge of a forecasted transaction or future cash flows (cash flow hedge) or a hedge of a recognized asset, liability or firm commitment (fair value hedge). For all hedge contracts, Duke Energy shall provide formal documentation of the hedge in accordance with SFAS No. 133. In addition, at inception and on a quarterly basis Duke Energy shall formally assess whether the hedge contract is highly effective in offsetting changes in cash flows or fair values of hedged items. Duke Energy shall document hedging activity by transaction type (futures/swaps) and risk management strategy (commodity price risk /interest rate risk).

The effective portion of changes in the fair value of a derivative designated and qualified as a cash flow hedge shall be included in the Consolidated Statements of Common Stockholders' Equity and Comprehensive Income (Loss) as AOCI until earnings are affected by the hedged item. Duke Energy shall discontinue hedge accounting prospectively when it has determined that a derivative no longer qualifies as an effective hedge, the Company electively removes the hedge designation, or when it is no longer probable that the hedged forecasted transaction will occur. When hedge accounting is discontinued because the derivative no longer qualifies as an effective hedge or the Company elects to discontinue hedge accounting, the derivative shall be subject to the MTM accounting method prospectively. Gains and losses related to discontinued hedges that were previously accumulated in AOCI shall remain in AOCI until the underlying hedged forecasted transaction is reflected in earnings, unless it is no longer probable that the hedged forecasted transaction will occur.

For derivatives designated as fair value hedges, Duke Energy shall recognize the gain or loss on the derivative instrument, including any hedge ineffectiveness, as well as the offsetting loss or gain on the hedged item in earnings in the current period.

All derivatives designated and accounted for as hedges shall be classified in the same category as the item being hedged in the Consolidated Statements of Cash Flows. However, if a derivative contains an other-than-insignificant financing element, other than a financing element inherently included in an at-the-market derivative with no prepayments (that is, the forward points in an at-the-money forward contract), then the borrower shall report all cash inflows and outflows associated with that derivative in a manner consistent with financing activities as described in paragraphs 18-20 of SFAS No. 95, *Statement of Cash Flows*. A derivative that at its inception includes off-market terms or requires an up-front cash payment, or both often contains a financing element. Identifying a financing element within a derivative is a matter of judgment that depends on the facts and circumstances.

In addition, all components of each derivative gain or loss shall be included in the assessment of hedge effectiveness, unless otherwise noted.

A derivative held for trading purposes may be designated as a hedging instrument, prospectively, if all of the applicable criteria in SFAS No. 133 have been met.

In order to obtain hedge accounting, at inception of the hedge, there shall be formal documentation of the hedging relationship and the risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value (fair value hedge) or in hedging the exposure to the hedged transaction's variability in cash flows (cash flow hedge) attributable to the hedged risk will be assessed.

Hedge accounting shall be discontinued prospectively for an existing hedge if any one of the following occurs: 1) the hedging relationship is no longer expected to be highly effective in achieving offsetting

cash flows (offsetting changes in fair value for a fair value hedge) attributable to the hedged risk during the period that the hedge is designated; ii) the derivative expires or is sold, terminated, or exercised; iii) if any of the criteria for cash flow or fair value hedge accounting are no longer met; or iv) the Company removes the designation of the hedge.

#### *Hedge Effectiveness*

Under SFAS No. 133, a derivative designated as a hedging instrument will qualify for cash flow or fair value hedge accounting so long as the hedging relationship can be shown to be "highly effective" (see discussion under "Initial Assessment" below) in offsetting cash flows (changes in fair value) attributable to the hedged risk. To demonstrate this relationship, an effectiveness assessment is required prior to the inception of the hedge and ongoing effectiveness shall be assessed at least every three months thereafter. There shall be a reasonable basis for how the business or corporate unit plans to assess the hedging instrument's effectiveness. The assessment of hedge effectiveness for a particular hedging relationship shall be consistent with the originally documented risk management strategy for that particular hedging relationship and clearly documented at the inception of the hedging relationship. At the inception of the hedge, the entity shall define and document the method it will use to assess hedge effectiveness, both prospectively and retrospectively. The methods for prospective considerations and retrospective considerations may be the same or different, but only one method may be used for evaluating each consideration. This method must be used consistently throughout the term of the hedging relationship. Methods shall not be changed from one period to the next unless the hedge designation is terminated and a new hedge is put in place.

If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, it could be concluded that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis (i.e., no ineffectiveness).

An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries (referred to as the shortcut method). No ineffectiveness in a hedging relationship of interest rate risk involving a recognized interest bearing asset or liability and an interest rate swap may be assumed if certain conditions are met. Please refer to paragraph 68 of SFAS No. 133 for a discussion of the conditions that are required to be met to apply the shortcut method and paragraphs 114 and 132 of SFAS No. 133 for guidance to apply the shortcut method to fair value hedges and cash flow hedges, respectively.

- **Initial Assessment:**

The initial assessment is a prospective consideration made prior to initiating a hedge relationship and its applicability shall be evaluated on an ongoing basis. This analysis shall be able to justify the expectation that the hedge will be highly effective over the period being hedged (the hedged period) in achieving offsetting changes in the cash flows or offsetting changes in fair value of the hedged item. For purposes of SFAS No. 133, the condition of "highly effective" is achieved when the change in the fair value or cash flows of the hedging instrument offsets 80% - 120% of the change in the fair

value or cash flows of the hedged item. It is common practice at Duke Energy to elect to use regression for the initial assessment of hedge effectiveness. In order to conclude that the hedging relationship is highly effective using a regression analysis, at least 30 data points should be used in the analysis,  $R^2$  should be equal to or greater than 0.8, the slope should be between a negative 0.8 and 1.25, and the t and F statistics should be evaluated at a 95 percent confidence level in accordance with guidance provided by the SEC staff.  $R^2$  measures the ability of the independent variable to explain the variation in the dependent variable.  $R^2$  can vary between 0 and 1. The higher the value the higher the indication that the independent variable can explain variation in the dependent variable. The t and F statistics are used to indicate correlation or a linear relationship between independent and dependent variables. A high t statistic generally indicates that correlation or a linear relationship exists between the independent and dependent variables. To achieve a 95% confidence level, the significance of F should be less than 5%. If the significance of F is less than 5% there is less than 5% probability that no linear relationship is present. The initial assessment need not be performed for each and every hedge but only when a new hedge strategy is proposed. However, the data used in the regression shall be updated at least on a quarterly basis (as new hedges are entered into). In addition, the initial assessment of effectiveness for a particular hedge strategy shall be evaluated if the ongoing assessment for a particular relationship, as discussed below, repeatedly indicates an ineffective hedge. Certain contracts may have a high correlation for a particular forward month while similar contracts for other forward months may not have a high correlation. The assessment both initially and ongoing should be undertaken on a forward month by forward month basis.

- Ongoing Assessment

Ongoing assessment is a retrospective assessment made at least on a quarterly basis to determine if a specific hedge relationship has been highly effective in having achieved offsetting changes in cash flows or the hedged item's fair value throughout the particular period being assessed (on a historical basis). The assessment may be based on cumulative dollar offset, regression or other statistical analysis of past changes in cash flows or fair value or other relevant information. If the relationship does not fall within the overall change effective range ( $R^2 \geq 0.8$ ), then hedge accounting for the period shall not be applied (all changes in fair value of the derivative during the period are recorded immediately in earnings). Failure of the 'ongoing assessment' test does not necessarily prevent the derivative in question from being considered as an ongoing hedge so long as the initial assessment continues to indicate a highly effective relationship. For cash flow hedges, if in subsequent periods, the relationship comes back into the highly effective range, by virtue of the ongoing regression analysis, the "ineffective" portion of gain or loss recorded in earnings in prior periods (or some part thereof) may be recaptured and recorded in current period OCI. For fair value hedges, if the relationship returns to the highly effective range, the hedged item (i.e., unrecognized firm commitment or recognized asset or liability) shall resume hedge accounting on a prospective basis along with the hedging instrument. For internal reporting, the ongoing assessment shall be performed at least quarterly.

Additionally, in assessing ineffectiveness, the likelihood of counterparty default should be considered. If the likelihood that the counterparty will not default ceases to be probable, the Company would be unable to conclude that the hedging relationship is expected to be highly effective and hedge