BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Duke-Ohio Energy Ohio, Inc. for Approval of the Second Amended Corporate Separation Plan Under Section 4928.17, Revised Code, and Chapter 4901:1-37, Ohio Administrative Code.))))))	Case No. 09-495-EL-UNC

OPINION AND ORDER

The Public Utilities Commission of Ohio, having considered the record in this matter and the application for approval of the second amended corporate separation plan, hereby issues its opinion and order.

OPINION:

I. Background

Duke-Ohio Energy Ohio, Inc. (Duke-Ohio) is a public utility as defined under Section 4905.02, Revised Code, and, as such, is subject to the jurisdiction of this Commission.

By opinion and order issued December 17, 2008, in *In the Matter of the Application of Duke-Ohio Energy Ohio, Inc. for Approval of an Electric Security Plan*, Case No. 08-920-EL-SSO, et al., the Commission approved Duke-Ohio's continued operation under the original corporate separation plan (CSP) was approved by the Commission in *In the Matter of the Application of the Cincinnati Gas & Electric Company for Approval of its Electric Transition Plan*, Case No. 99-1658-ETP, and as amended in *In the Matter of the Application of the Cincinnati Gas & Electric Company to Modify its Nonresidential Generation Rates to Provide for Market-Based Standard Service Offer Pricing and to Establish and Alternative Competitive-Bid Service Rate Option, Subsequent to the Market Development Period*, Case No. 03-93-EL-ATA, et al.

Pursuant to a finding and order issued in *In the Matter of the Adoption of Rules for Standard Service Offer, Corporate Separation, Reasonable Arrangements, and Transmission Riders for Electric Utilities Pursuant to Sections 4928.14, 4928.17 and 4928.31, Revised Code, as Amended by Substitute Senate Bill No. 221*, Case No. 08-777-EL-ORD (December 17, 2008), the Commission adopted Chapter 4901:1-37, Ohio Administrative Code (O.A.C.). This Chapter became effective on April 2, 2009. In this Chapter, the Commission directed each electric utility to file, within 60 days of the effective date of the Chapter, an application for approval of its proposed CSP, as outlined in Rule 4901:1-37-05, O.A.C.

On June 11, 2009, Duke-Ohio filed its application for approval of its new CSP, in accordance with Rule 4901:1-37-05(A), O.A.C., along with a motion to file its CSP instanter. Duke-Ohio clarified this plan in a June 22, 2009, letter, which explained that this was a new application, and labeled as "Second Amended Corporate Separation Plan," to distinguish it from prior CSPs. On August 26, 2009, Duke-Ohio's motion to file its CSP instanter was granted. In this same entry, the Commission issued a request for proposal (RFP) for an auditor to assist the Commission in its evaluation of Duke-Ohio's CSP and directed Duke-Ohio to bear the cost of the consulting services of the contractor chosen by the Commission.

Silverpoint Consulting LLC and Vantage Consulting, Inc. (jointly referred to as Silverpoint-Vantage) were selected by the Commission on September 30, 2009, to assist the Commission with the evaluation of Duke-Ohio's CSP. As the auditor, Silverpoint-Vantage was directed to evaluate Duke-Ohio's CSP to determine if the methodologies used by Duke-Ohio that allocate, charge, or assign costs to the Ohio-regulated operating companies are appropriate. Further, Silverpoint-Vantage was to ascertain whether Duke-Ohio implemented its CSP in compliance with previous Commission orders and to determine whether the CSP complies with the rules set forth in Chapter 4901:1-37, O.A.C. Silverpoint-Vantage filed its report of investigation on March 29, 2010 (audit report).

By entry issued April 8, 2010, motions to intervene in this matter by Ohio Consumers' Counsel (OCC) and the Ohio Energy Group (OEG) were granted. Further, the April 8, 2010, entry directed interested persons to file comments to the auditor's report of investigation no later than April 29, 2010, and reply comments no later than May 13, 2010. On April 29, 2010, as clarified on June 28, 2010, Duke-Ohio filed comments on the audit report.

II. Applicable Law

Section 4928.17, Revised Code, provides that an electric utility that, either directly or through an affiliate, engages in the business of supplying a noncompetitive retail electric service and a competitive retail electric service (CRES) or a product or service other than retail electric service must operate under a CSP. Pursuant to the statute, the CSP must be consistent with the policy of the state set forth in Section 4928.02, Revised Code, and achieve all of the following:

(1) provide, at minimum, for the provision of the CRES or the nonelectric product or service through a fully separated affiliate of the utility, and include separate accounting requirements, the code of conduct, and such other measures as are necessary to effectuate the state policy;

(2) satisfy the public interest in preventing unfair competitive advantage and preventing the abuse of market power; and

(3) be sufficient to ensure that the utility will not extend any undue preference or advantage to any affiliate, division, or part of its own business engaged in the business of supplying the CRES or nonelectric product or service, without compensation based upon fully loaded embedded costs charged to the affiliate; and ensure that any such affiliate, division, or part will not receive undue preference or advantage from any affiliate, division, or part of the business engaged in business of supplying the noncompetitive retail electric service. No such utility, affiliate, division, or part shall extend such undue preference.

Chapter 4901:1-37, O.A.C., sets forth the requirements pertaining to corporate separation for electric utilities. Specifically, this chapter is applicable to the activities of the utility and its transactions or other arrangements with its affiliates, any shared services of the utility with any affiliates, and the sale or transfer of generating assets.

III. Audit Recommendations, Duke-Ohio's Comments, and Commission's Decision

As part of its evaluation of Duke-Ohio's CSP, Silverpoint-Vantage reviewed relevant orders, testimony, Staff reports, and other documents filed at the Commission. Silverpoint-Vantage also reviewed various internal documents relating to Duke-Ohio's compliance with its CSP and evaluated documents relating to Duke-Ohio's allocation policies, practices, and procedures. Silverpoint-Vantage documented the methods and allocation factors Duke-Ohio used to assign costs to Ohio-regulated operations and reviewed and tested affiliated costs assigned to Duke-Ohio. The audit covered an 18-month period from January 1, 2008 to June 30, 2009. (Audit Report at 2.)

Based on its audit, Silverpoint-Vantage concluded that, overall, Duke-Ohio is in compliance with: all areas of Chapter 4901:1-37, O.A.C., regarding structural separation, separate accounting, financial arrangements, code of conduct, and emergencies; and the requirements of Rule 4901:1-37-05, O.A.C., regarding the filing of a CSP. As for Rule 4901:1-37-09, O.A.C., pertaining to the sale or transfer of generating assets, the auditor noted that, while no activities occurred under this provision, the process for such activities is clearly spelled out in the cost allocation manual (CAM). Regarding overall compliance, Silverpoint-Vantage stated that Duke-Ohio provides appropriate training on relevant policies and procedures, as well as the regulations on corporate separation. Silverpoint-Vantage conducted a comparison of pre- and post-merger charges; however, they reached no specific conclusions. As discussed below, during the audit, Silverpoint-Vantage identified several issues and set forth six recommendations. (Audit Report at 4-5.)

A. Recommendation 1: Include all agreements that describe the allocation of costs among affiliates in future CAMs.

Silverpoint-Vantage found that Duke-Ohio complies with the requirements of Rule 4901:1-37-08, O.A.C., regarding the CAM, with the exception of one agreement that should have been included. Silverpoint-Vantage asserted that Duke-Ohio should include all documentation and agreements that describe cost allocations among its affiliates. During the audit process, Silverpoint-Vantage discovered an affiliate agreement that was not included in the CAM and determined that Duke-Ohio needs to be more diligent and thorough in its determination of what documents need to be included in the CAM. (Audit Report at 5, 20.)

Duke-Ohio admitted that the document in question had not been included in the CAM and represented that it has now been incorporated. Moreover, Duke-Ohio recommitted itself to assure that its CAM is maintained in accordance with Rule 4901:1-37-08, O.A.C. (Duke-Ohio Comments at 3; Duke-Ohio Supp. Comments at 1.)

Upon consideration of the auditor's first recommendation, the Commission finds that it is reasonable and should be adopted. Duke-Ohio's recommitment to assuring that its CAM is maintained in accordance with Rule 4901:1-37-08, O.A.C., is appropriate and addresses the auditor's findings and recommendation on this issue.

B. Recommendation 2: Develop and maintain a formal corporate-wide affiliate transaction accounting manual.

In its technical analysis, Silverpoint-Vantage concluded that: all affiliate transactions were subject to written agreements; affiliate transaction accounting systems and methods are sufficient to ensure the accuracy and reliability of affiliate transaction data; and there was no evidence of widespread problems that would call to question the overall integrity and reliability of the affiliate transaction data used in the audit. To insure transparency, Silverpoint-Vantage recommended that Duke-Ohio develop and maintain a formal corporate-wide affiliate transaction accounting manual. Specifically, Silverpoint-Vantage noted that Duke-Ohio does not maintain a formal affiliate transaction accounting manual and has no common set of guidelines for how to process individual affiliate transactions. It was further noted that various groups within Duke Energy Corporation (Duke-Ohio Energy) have developed specific guidelines and procedures for their own purposes, but no uniform set of policies and procedures exist to guide the broader audience. According to Silverpoint-Vantage, the fact that the Commission does not require a formal affiliate transaction accounting manual should not excuse Duke-Ohio from keeping one. (Audit Report at 5, 34-36.)

In response, Duke-Ohio stated that it disagrees with the recommendation. Duke-Ohio asserted that, because of the different jurisdictions Duke-Ohio's affiliates operate in, it would be impractical to implement a generic document to which all of the operating utility companies would be subject. In addition, Duke-Ohio further asserted that Silverpoint-Vantage found that the existing system and methods under which Duke-Ohio currently operates are sufficient to ensure proper accounting between Duke-Ohio and its affiliates. Therefore, Duke-Ohio argued it should not be compelled to adopt requirements that the Commission has not found to be necessary. (Duke-Ohio Comments at 3-4; Duke-Ohio Supp. Comments at 2.)

Initially, the Commission notes that the auditor confirmed that Duke-Ohio's affiliate transactions were subject to written agreements, that Duke-Ohio's affiliate transaction accounting systems and methods were sufficient to ensure the accuracy and reliability of affiliate transaction data, and that there was no evidence of widespread problems relating to the affiliate transaction data. While the Commission agrees with the auditor's second recommendation that a corporate-wide manual would be optimal, we do not find it necessary, at this time, to require Duke-Ohio to develop such a manual. The Commission emphasizes, however, that Duke-Ohio should continue its diligent efforts to be as consistent as possible in its accounting of affiliate transactions. Accordingly, at this time, the Commission will not adopt the auditor's second recommendation that Duke-Ohio develop and maintain a corporate-wide affiliate transaction accounting manual.

As a final matter, the Commission notes that it is not clear whether Duke's affiliate transaction accounting manual clearly addresses the processes utilized in the event of an emergency which requires mutual aid between affiliates. Therefore, the Commission finds that Duke should clarify in its affiliate transaction accounting manual what processes and procedures are to be followed when mutual aid is necessary in a time of emergency. Furthermore, when mutual aid is utilized, Duke-Ohio needs to clarify in its affiliate transaction accounting manual how it will account for mutual aid situations.

C. Recommendation 3: Develop a plan to determine if further insulation from ratepayers is appropriate or complete separation of risks associated with Duke-Ohio-owned generation assets is appropriate.

The auditor found that, in general, the separation of financial risks is being handled appropriately. However, Silverpoint-Vantage noted that Duke-Ohio's current electric security plan (ESP) is scheduled to end December 31, 2011. Therefore, the auditor questioned possible separation through ring fencing or other means. The auditor recommended that Duke-Ohio develop a plan, as part of its next ESP discussions, to determine if further insulation from Duke-Ohio's ratepayers, or complete separation of risks associated with Duke-Ohio-owned generation assets, is appropriate. Specifically, Silverpoint-Vantage advised that Duke-Ohio should:

(1) conduct a risk assessment of the generation system owned by Duke-Ohio, given current industry issues;

(2) identify means to either further insulate ratepayers, or to separate ownership in a manner that does not impair ratepayers; and

(3) develop proposed solutions and provide them to the Commission in order to complete any necessary hearings and transactions before the termination of the ESP.

(Audit Report at 5-6, 48.)

In response, Duke-Ohio asserted that this recommendation is outside of the standard process required by the Commission. Moreover, Duke-Ohio argued that the proposal recommending Duke-Ohio conduct a risk assessment is an effort to usurp Duke-Ohio's own decision making process, and, if appropriate, Duke-Ohio will include a proposal to insulate ratepayers in its next standard service offer (SSO) application. Duke-Ohio further stated that it will address this issue internally by conducting risk assessments that it deems necessary. (Duke-Ohio Comments at 4-5; Duke-Ohio Supp. Comments at 2.)

The Commission does not know at this time whether Duke's SSO will be an Electric Security Plan or a Market Rate Option; or the details of its rate plan within those options. An issue such as risk insulation for ratepayers, including whether risk insulation is appropriate, may vary depending on the outcome of the SSO proceeding. The Commission may better address those issues in the SSO proceeding or in an application to transfer generation assets under Section 4928.17(E), Revised Code. The Commission does not believe that Duke-Ohio needs to take any additional action at this time to be in compliance with Chapter 4901:1-37, O.A.C.

D. Recommendation 4: Clarify the appropriate treatment of transactions between regulated and nonregulated portions of Duke-Ohio.

According to Silverpoint-Vantage, its review of operational agreements addressed a broad range of technical issues and found them to be reasonable. The auditor noted that, during the audit period, Duke Energy changed its policy regarding the inclusion of overhead in labor costs between the regulated and nonregulated portions of Duke-Ohio. For example, the auditor stated that, while the commercial power segment of Duke-Ohio is not technically an affiliate of the franchised electric and gas segment of Duke-Ohio, until recently, Duke-Ohio had treated it as such for purposes of pricing transactions. The auditor explained that, for the first half of 2008, Duke-Ohio applied overhead to labor charges in such transactions; however, after its conversion to new software in mid-2008, the company did not apply the affiliate overhead loader in transactions between the regulated and nonregulated portions of Duke-Ohio because they occurred within a single entity. Silverpoint-Vantage pointed out, however, that Duke-Ohio continues to issue formal service requests for services between the two segments, consistent with the nonutility agreement but no longer follows the transfer pricing requirements of the agreement. Therefore, the auditor recommended that Duke-Ohio clarify its position regarding the appropriate treatment of transactions between the regulated and nonregulated portions of Duke-Ohio. (Audit Report at 5-6, 58.)

In its comments, Duke-Ohio took exception with the auditor's statement that the effect of applying or not applying an affiliate overhead loader was that Duke-Ohio was not following transfer pricing requirements with regard to labor transactions between regulated and nonregulated segments of Duke Energy. Duke-Ohio explained that, under its accounting system, each payroll company can only have one business unit associated with it; thus, all employees of Duke-Ohio are paid out of the same payroll company, regardless of whether they are serving regulated or nonregulated functions. After unproductive labor is recorded to the associated company, Duke-Ohio allocates those amounts to split the activity among regulated and nonregulated and between electric and gas. While this recording of unproductive and subsequent allocation appeared to the auditors as if the nonregulated segment of Duke-Ohio was charging the regulated segment for transactions, Duke claims that this was not the case. Moreover, Duke-Ohio emphasized that the regulated and nonregulated portions of its business are a single entity; therefore, transfers between those entities should be made at cost. (Duke-Ohio Comments at 4-7; Duke-Ohio Supp. Comments at 2.)

The Commission finds that Duke-Ohio's transition to a different accounting system in mid-2008 appears to have created some confusion; thus, the auditor's fourth recommendation that Duke-Ohio clarify its treatment of transactions between the regulated and nonregulated portions of its business was appropriate and should be adopted. In its comments, Duke-Ohio addressed the auditor's recommendation and adequately clarified how it treats such transactions. On a going forward basis, the Commission expects Duke-Ohio to adhere to this process, as clarified, regarding such transactions between the regulated and nonregulated segments of Duke-Ohio.

E. Recommendation 5: Inform Staff of changes to service company cost distribution methods.

According to the auditor, an analysis of cost distribution methods did not uncover any major problems; however, Silverpoint-Vantage recommended that Duke-Ohio keep Staff informed of future changes to service company cost distribution methods. Silverpoint-Vantage stated that prior audits of Duke Energy's affiliate transactions and cost distribution methods resulted in three recommendations related to the methods by which the service company distributes its costs, namely, Duke Energy should: narrow the use of the three-part formula general allocator; eliminate the effect of spreading overhead costs from the calculation of allocation percentages; and develop a method to fairly assign service company overhead costs. Silverpoint-Vantage pointed out that the prior audit reports for Duke Energy recommended that, if the service company decided to maintain its approach of spreading overhead charges in a way that is not linked to the use of services or cost causation in any way, it should be required to make a showing that its approach yields equitable results and that those results are comparable to more direct approaches. Similarly, Silverpoint-Vantage pointed out that the prior audit reports recommended that the service company be required to make a showing that its charging method results in fully allocated costs for each function that it provides. Silverpoint-Vantage submitted that these recommendations are still appropriate, stating that cost distribution methods should be adequately designed to prevent cross-subsidization and yield equitable results. The auditor noted that similar recommendations have been made to, and addressed by, some of Duke-Ohio's affiliates. According to the auditor, Duke-Ohio has implemented changes to address these concerns beginning in 2010. Silverpoint-Vantage recommended that Duke-Ohio make available, upon request, the final reports from any third-party audits of Duke-Ohio's affiliates that address these issues. (Audit Report at 5-7, 73-74.)

In its response, Duke-Ohio commits to respond to any inquiry or audit initiated by the Commission on this subject matter. However, Duke-Ohio objects to producing irrelevant audit reports in their entirety from other jurisdictions, as they cannot dictate Duke-Ohio's business practices. (Duke-Ohio Comments at 7; Duke-Ohio Supp. Comments at 2.)

The Commission agrees with the auditor that it is important for Duke-Ohio to keep Staff apprised of future changes to the cost distribution methods employed by the service company. Furthermore, should Staff find it necessary to review final reports from third-party audits of Duke-Ohio's affiliates that address any of the issues mentioned by the auditor in this case, the Commission is confident that Duke-Ohio will work with Staff and, upon request, provide Staff copies of such reports. With this in mind, the Commission finds that the auditor's fifth recommendation should be adopted and Duke-Ohio should continue to work with Staff.

F. Recommendation 6: Inform Staff of improvements to service company charging practices.

Silverpoint-Vantage noted the following two audit recommendations from prior audit reports related to the service company charging practices, which recommended that Duke Energy: increase the percentage of labor that the service company directly charges to business units; and encourage employees to do more positive time reporting. Silverpoint-Vantage stated that it believes these recommendations remain appropriate and that Duke-Ohio has committed to implementing changes to address these concerns, beginning in 2010. The auditor noted that the service company's charging practices have a direct bearing on the cost of providing service by Duke-Ohio. Therefore, Silverpoint-Vantage again recommends that any future audit reports from third-party audits of Duke-Ohio's affiliates which address these issues should be made available to Staff upon request. Silverpoint-Vantage recommended that Duke-Ohio keep Staff informed of future improvements to service company charging practices. (Audit Report at 89.)

In response, Duke-Ohio asserted that it regularly cooperates and communicates with Staff. However, Duke-Ohio stated that it does not believe that delivery of out-of-state audits are appropriate. (Duke-Ohio Comments at 8; Duke-Ohio Supp. Comments at 3.)

As we stated previously, the Commission is confident that Duke-Ohio will continue to work with Staff and provide whatever information is necessary to assist Staff in its responsibilities, including third-party audit reports. Accordingly, the Commission finds that Silverpoint-Vantage's sixth recommendation should be adopted.

CONCLUSION:

The Commission finds the audit recommendations set forth by Silverpoint-Vantage should be adopted to the extent stated herein. Based on Silverpoint-Vantage's review and audit, and the directives set forth in this order, we believe that Duke-Ohio's second amended CSP filed on June 11, 2009, as clarified on June 22, 2009, is in compliance with Section 4928.17, Revised Code, and the rules contained in Chapter 4901:1-37, O.A.C. Accordingly, the Commission concludes that Duke-Ohio's application for approval of its second amended CSP should be granted, contingent upon its compliance with our directives delineated in this order.

FINDINGS OF FACT AND CONCLUSIONS OF LAW:

(1) Duke-Ohio is a public utility as defined under Section 4905.02, Revised Code, and, as such, is subject to the jurisdiction of this Commission.

(2) Section 4928.17, Revised Code, governs CSPs for electric utilities.

(3) Chapter 4901:1-37, O.A.C., sets forth the requirements pertaining to corporate separation for electric utilities.

(4) On June 11, 2009, as clarified on June 22, 2009, Duke-Ohio filed an application for approval of its second amended CSP.

(5) Silverpoint-Vantage was selected by the Commission to assist with the evaluation of Duke-Ohio's CSP.

(6) Silverpoint-Vantage filed its audit report on March 29, 2010.

(7) On April 8, 2010, OCC and OEG were granted intervention in this case.

(8) On April 29, 2010, as clarified on June 28, 2010, Duke-Ohio filed comments on the audit report.

(9) The audit recommendations set forth by Silverpoint-Vantage should be adopted to the extent stated herein.

(10) Duke-Ohio's second amended CSP is in compliance with Section 4928.17, Revised Code, and the rules contained in Chapter 4901:1-37, O.A.C., and should be approved.

It is, therefore,

ORDERED, That the recommendations of the auditor, Silverpoint-Vantage, be adopted to the extent set forth herein. It is further,

ORDERED, That Duke-Ohio's application for approval of its second amended CSP filed on June 11, 2009, and clarified on June 22, 2009, be granted, contingent upon Duke-Ohio's compliance with our directives delineated in this order. It is, further,

ORDERED, That nothing in this opinion and order shall be binding upon this Commission in any subsequent investigation or proceeding involving the justness or reasonableness of any rate, charge, rule, or regulation. It is, further,

ORDERED, That a copy of this order be served upon all persons of record in this case.

THE PUBLIC UTILITIES COMMISSION OF OHIO

Todd A. Snitchler, Chairman

Paul A. Centolella

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Betty McCauley

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Secretary