Duke Energy®

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VIA OVERNIGHT DELIVERY

March 31, 2010

Mr. Jeff Derouen
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602-0615

Re: In the Matter of the Joint Application of Duke Energy Corporation, Duke Energy Holding Corp., Deer Acquisition Corp., Cougar Acquisition Corp., Cinergy Corp., The Cincinnati Gas & Electric Company and The Union Light, Heat and Power Company for Approval of a Transfer and Acquisition of Control, Case No. 2005-00228.

Dear Mr. Derouen:

In the Settlement Agreement in the above-referenced case, Duke Energy Kentucky, Inc. (Duke Energy Kentucky) made several merger commitments. Attached herein is an original and ten copies of the 'Final Report Compliance Audit of Duke Energy Kentucky' in response to Merger Commitment No. 12;

Please file stamp the two copies of this letter and the Final Report enclosed herein and return in the enclosed return-addressed envelope.

Very truly yours,

Dianne Kuhnell

Dianne B. Kuhnell
Senior Paralegal

cc: Hon. Dennis G. Howard, II
Hon. David E. Spenard
Hon. Michael L. Kurtz

Final Report

Compliance Audit

Of

Duke Energy Kentucky

March 15, 2011

Vantage Energy Consulting, LLC

Management Consulting and Energy Services

21460 Overseas Highway, Cudjoe Key, FL 33042 Office Tel 305.744.3440

Compliance Audit of Duke Energy – Kentucky

Table of Contents

I. EXECUTIVE SUMMARY

A. BACKGROUND

Duke Energy Kentucky (DE-Kentucky) is a Kentucky Corporation with its principal office and principal place of business at 139 East Fourth Street, Cincinnati, Ohio 45202. DE-Kentucky is a utility engaged in the gas and electric business. DE-Kentucky purchases, sells, and transports natural gas in Boone, Campbell, Gallatin, Grant, Kenton and Pendleton Counties, Kentucky. DE-Kentucky also generates electricity, which it distributes and sells in Boone, Campbell, Grant, Kenton and Pendleton Counties. DE-Kentucky owns and operates three generating stations - East Bend Unit 2, Miami Fort Unit 6 and six combustion turbines at the Woodsdale Station, representing a total of 1,141 megawatts of capacity (winter rating), and a 69 KV distribution and transmission system to serve its retail load.

In 2006, Cinergy Corp. (Cinergy), the parent company of Union Light, Heat and Power Company (ULH&P), subsequently renamed DE-Kentucky, merged with Duke Energy Corporation (Duke Energy). As part of its approval of the merger, the Kentucky Public Service Commission (KYPSC or Commission) established 46 merger commitments in Case No. 2005-00228. The following three commitments relate directly to this audit. Those commitments are 11, 12 and 13.

Commitment 11

Applicants commit that the accounting and reporting system used by ULH&P will be adequate to provide assurance that directly assignable and non-utility costs are accounted for properly and that reports on the utility and non-utility operations are accurately presented.

Commitment 12

Applicants commit to implement and maintain cost allocation procedures that will accomplish the objective of preventing cross subsidization, and be prepared to fully disclose all allocated costs, the portion allocated to ULH&P, complete details of the allocation methods, and justification for the amount and the method. Applicants commit to give the Commission 30 days' advance notice of any changes in cost allocation methods set forth in the Service Company Utility Services Agreements, the Operating Company/Nonutility Companies Services Agreements and the Operating Companies Service Agreement approved as part of the Duke/Cinergy merger proceeding. Such audits will be conducted no less often than every two years, and reports will be filed with the Commission and the Attorney General. ULH&P shall file the audit report, if possible, when ULH&P files its annual report. Applicants may request a change to the frequency of the audit reports in future years, subject to agreement by the Commission and the Attorney General.

Commitment 13

ULH&P commits to protect against cross-subsidization in transactions with affiliates.

B. PROJECT SCOPE AND METHODOLOGY

This audit provides the findings, conclusions and recommendations of Vantage Energy Consulting LLC (Vantage) concerning DE-Kentucky's compliance with Kentucky Revised Statute, KRS 278.2201 through 278.2219; the established KYPSC regulation Kentucky Administrative Regulation 807 KAR 5:080; Procedural and filing requirements and safeguards concerning non-regulated activities of utilities or utilities or utility affiliates; as well as the agreed merger commitments. The findings, conclusions and recommendations presented in this audit were developed by following the Work Plan for the audit as presented in the Vantage proposal and modified based on initial discovery and discussions with DE-Kentucky.

The scope of the audit also includes offering an opinion on DE-Kentucky's actions regarding the recommendations from the previous audit.

Vantage Energy Consulting LLC (Vantage) conducted this audit using Generally Accepted Auditing Standards (GAAS). The auditors conducted sampling in accordance with Section 350 of the Generally Accepted Auditing Standards (GAAS). The Audit Work Plan is provided in our Proposal that is part of the contract to conduct this project.

In conducting this Compliance Audit, 63 Data Requests were made and answered and 10 interviews were held. In addition, numerous phone calls and e-mails were used to clear up details. A verification meeting was held to review key factual issues. DE-Kentucky representatives reviewed the Draft Report. Vantage reflected their comments in the Final Report as appropriate.

C. REPORT ORGANIZATION

Chapter I - Executive Summary - This chapter describes the project and the Vantage approach. Our overall conclusions are provided as well as a summary of recommendations.

Chapter II - Compliance - This chapter provides an overview of each affiliate standard and indicates whether DE-Kentucky is in compliance with it.

Chapter III - Identification and Recording of Affiliate Transactions - This chapter addresses the actual treatment of affiliate transactions.

Chapter IV - Financial and Liability Separation - This chapter addresses the sections of the Kentucky regulation that address financial liability and separation.

Chapter V - Affiliate Separation - In this chapter, Vantage presents its analysis, findings and conclusions regarding DE-Kentucky's compliance with KYPSC regulations and merger

II. COMPLIANCE

A. INTRODUCTION

In 2006, Cinergy Corp. (Cinergy), the parent company of Union Light, Heat and Power Company (ULH&P), subsequently re-named DE-Kentucky, merged with Duke Energy Corporation (Duke Energy). As part of its approval of the merger, the Kentucky Public Service Commission (KYPSC) established forty-six merger commitments in Case No. 2005-00228. Three commitments relate directly to this audit. Those commitments are 11, 12 and 13.

B. COMPLIANCE WITH 807 KAR 5:080 AND MERGER COMMITMENTS

807 KAR 5:080

This administrative regulation effectively implements the relevant provisions of KRS 278.2201 through 278.2219 and prescribes procedures, filing requirements, and safeguards relating to non-regulated activities of a utility or a utility affiliate. More specifically, KRS 278.2201 prohibits a utility governed by KRS 278.2201 through 278.2219 from subsidizing non-regulated activities performed by the utility or an affiliate. KRS 278.2205(3) requires a utility governed by KRS 278.2201 through 278.2219 to file with the Commission a statement that its cost allocation manual has been prepared and adopted, together with the manual, as specified in 807 KAR 5:080 Section 3. KRS 278.2205(4) requires a utility governed by KRS 278.2201 through 278.2219 to amend its cost allocation manual to reflect any material changes as specified in 807 KAR 5:080 Section 3 (a). KRS 278.2207 prescribes pricing requirements for transactions between a utility governed by KRS 278.2201 through 278.2219 and its affiliate, and provides for deviations from those requirements. KRS 278.2213(13) requires the Commission to establish specifications for a disclaimer to be used by an affiliate using the name, trademark, brand or logo of a utility governed by KRS 278.2201 through 278.2219 and detailed in 807 KAR 5:080 Section 6. KRS 278.2213(15) requires a utility governed by KRS 278.2201 through 278.2219 to inform the Commission of any new non-regulated activity within the time specified by the Commission and specified in 807 KAR 5:080 Section 3(b)(2). KRS 278.2213(17) authorizes the Commission to require a utility to file annual reports relating to its transactions with affiliates and detailed in 807 KAR 5:080

807 KAR 5:080 SECTION 2 – ANNUAL REPORTS

This section of the regulation specifies the information to be included in the annual report to be filed no later than March 31 with the Commission. The report must provide a description of each change in the utility's cost allocation manual made during the preceding year that has not previously been reported. In the report the utility must also include any incidental non-regulated activity, the nature of the activity, an explanation of why the activity should be considered incidental and the revenue for the year for the incidental non-regulated

VII-R1 Establish a more formal approach for responding to the recommendations in the affiliate audits. (Refer to Finding VII-F3)

As discussed herein, there was a considerable time lag between Vantage's data request and DE-Kentucky's response to update the status of the implementation plans relative to the recommendations from the previous audit. Although most parts of the response were provided more quickly, Vantage found the updates to each of the recommendations were terse and lacking in providing a full understanding of the problem and how the problem was resolved.[iii]

To-date the Kentucky PSC has not demonstrated much interest in the previous audit. However, DE-Kentucky cannot rely on the Commission's posture to continue. For certain, subsequent audits will inquire as to the implementation of recommendations from previous audits. It would be prudent for DE-Kentucky to establish a more formal approach for responding to the affiliate audit recommendations. One would expect overall responsibility for this process to reside in the Compliance Department. A lead person should be assigned to each recommendation. A schedule for regular updates should be established. All supporting documentation for the response to the recommendation should also be provided. This would enable DE-Kentucky to provide timely and well-documented responses to the Kentucky PSC or future auditors requesting updates.

[iii] / DR 62

E. SUMMARY OF RECOMMENDATIONS

Vantage offers the following recommendations.

III-R1 Provide details on fourth quarter 2009 transformer transfers as part of the 2010 affiliate audit. (Refer to Finding III-F3.)

DE-Kentucky indicated that, due to a new system implementation, quantification of the transformers transferred for the period of October 2009 to December 2009 could not be provided until the next audit cycle.

III-R2 Provide details on changes related to the two internal audits conducted. (Refer to Finding III-F5.)

Provide the next auditors with details of the changes made in response to the two internal audit reports discussed in Finding III-F5 and the impact of the changes.

VI-R1 Enhance Affiliate Training with more realistic examples that encourage the employee to think through the affiliate issue presented. (Refer to Finding *VI-F1 and VI-F2*.)

The Code of Business Ethics training has established a standard to which DE-Kentucky should strive to reach with its Affiliate Training. The current Affiliate Training meets the minimum requirements through a mundane presentation of the affiliate standards and some trivial examples. The annual review of this material, as currently presented, is not at the desired or expected level of employee interaction. The training would be much more effective if it were enlivened with better examples and a more interactive presentation of the standards.

VI-R2 Implement a set of formal procedures surrounding the provision of its affiliate training. (Refer to Finding *VI-F3*.)

During an interview with compliance personnel Vantage learned that Duke Energy has plans to develop and implement a corporate training protocol.[i] Through a follow-up data request, a draft of the training protocol currently under development by the Ethics and Compliance Department, was provided.[ii] The draft protocol establishes who the intended audience for the training is, when and how the training is offered, when the training should be updated, when reminders should be sent including reminders to immediate supervisors, and the maintenance of training records. The response indicated that the current plan is to implement the training protocol by the first quarter of 2011. Vantage recommends that this protocol for the affiliate training be established no later than the planned date.

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[i] / Interview 13

[ii] / DR 63

commitments regarding the adequate separation of the utility from its non-utility regarding the use of the company name and logo.

Chapter VI - Controls and Training - Addresses results of analysis and review relative to the adequacy of the internal controls and training that DE-Kentucky has in place to ensure compliance with the Affiliate Standards.

Chapter VII - Filing Requirements and Implementation of Recommendations - This chapter will review how DE-Kentucky keeps the Kentucky Public Service Commission (KYPSC) advised of its compliance. In addition, Vantage reports on its review of DE-Kentucky's annual and other filings as required by regulation or merger commitments. Finally, Vantage reports on DE-Kentucky's actions regarding the recommendations from the previous audit of its compliance with the affiliate standards.

D. OVERALL CONCLUSIONS

DE-Kentucky is in compliance with the Affiliate Standards reviewed by Vantage. The four recommendations made in the audit clarify and improve compliance and do not indicate any serious problems. Some of the key findings are summarized below.

- DE-Kentucky is in compliance with Section 3 of the Commission's regulation and appropriately files annual reports.
- DE-Kentucky is in compliance with Section 3 of the Commission's regulation and appropriately files a cost allocation manual and amendments.
- DE-Kentucky is in compliance with Section 4 of the Commission's regulation which requires notice of establishment of new non-regulated activities.
- DE-Kentucky is in compliance with its merger commitment 11 which requires proper accounting of costs.
- DE-Kentucky is in compliance with its merger commitment 12 which requires that it maintain appropriate cost allocation procedures and commit to third-party audits.
- DE-Kentucky is in compliance with its merger commitment 13 which requires that it protect against cross-subsidization.
- Vantage finds that, where appropriate, DE-Kentucky has developed and implemented reasonable implementation plans with regard to each of the fourteen recommendations from the previous affiliate audit.

activity. The annual report must also provide a list of non-regulated affiliates and a brief description of the activities in which the affiliate is involved. Finally, the regulation requires the utility, in its initial filing, to provide a copy of each service agreement with an affiliate and then in subsequent filings the utility shall file new or amended service agreements.

Vantage finds DE-Kentucky is in compliance with making its required filings. Vantage's analysis, findings and conclusions supporting its finding of compliance is discussed further in Chapter VII.

807 KAR 5:080 SECTION 3 – FILING OF COST ALLOCATION MANUAL AND AMENDMENTS

Section 3 of the regulation requires the utility to file its Cost Allocation Manual (CAM) with the Commission. If the utility adopts a new CAM or if the CAM is amended, the utility must file the changes within 60 days of the changes or within 90 days of engaging in a new unregulated activity that is not considered incidental. The filing must include a cover letter that briefly describes the activity and the changes to the CAM.

Vantage finds DE-Kentucky is in compliance with Section 3 of the Commission's regulation. Vantage's analysis, findings and conclusions supporting its finding of compliance is discussed further in Chapter VII.

807 KAR 5:080 SECTION 4 – NOTICE OF ESTABLISHMENT OF NEW NON-REGULATED ACTIVITY

Section 4 of the regulation requires the utility to provide notice to the Commission within 10 days of the establishment of a new non-regulated activity. The notice must briefly describe the new activity and indicate whether the utility proposes to consider the activity incidental.

Vantage finds DE-Kentucky is in compliance with Section 4 of the Commission's regulation. Vantage's analysis, findings and conclusions supporting its finding of compliance is discussed further in Chapter VII.

C. MERGER COMMITMENTS

In 2006, the Commission approved the merger of Cinergy, the parent company of ULH&P, subsequently renamed DE-Kentucky, with Duke Energy. As part of its approval of the merger, the Kentucky Public Service Commission established 46 merger commitments in Case No. 2005-00228. Three of the commitments (11, 12 and 13) relate directly to this audit.

MERGER COMMITMENT 11 – PROPER ACCOUNTING OF COSTS

Commitment 11 requires DE-Kentucky to use an accounting and reporting system that properly accounts for and reports on DE-Kentucky's utility and non-utility operations accurately.

Vantage finds DE-Kentucky is in compliance with its merger commitment 11. Vantage's analysis, findings and conclusions supporting its finding of compliance is discussed further in Chapter III.

MERGER COMMITMENT 12 – MAINTAIN APPROPRIATE COST ALLOCATION PROCEDURES AND COMMIT TO THIRD PARTY AUDITS

Commitment 12 requires DE-Kentucky to implement and maintain cost allocation procedures that will accomplish the objective of preventing cross-subsidization. The procedures should fully disclose all allocated costs, the portion allocated to DE-Kentucky, complete details of the allocation procedures, and justification for the amount and method. In addition, DE-Kentucky must agree to participate in periodic comprehensive third-party independent audits of its affiliate transactions.

Vantage finds DE-Kentucky is in compliance with its merger commitment 12. Vantage's analysis, findings and conclusions supporting its finding of compliance is discussed further in Chapter III.

MERGER COMMITMENT 13 – PROTECT AGAINST CROSS-SUBSIDIZATION

Commitment 13 requires DE-Kentucky to protect against cross-subsidization in transactions with affiliates.

Vantage finds DE-Kentucky is in compliance with its merger commitment 13. Vantage's analysis, findings and conclusions supporting its finding of compliance is discussed further in Chapters III, IV and V.

D. IMPLEMENTATION OF PREVIOUS AUDIT RECOMMENDATIONS

An independent, third-party audit of DE-Kentucky's affiliate transactions for the year 2007 was performed and completed in May 2009. The audit included 14 recommendations. Although the Commission did not require DE-Kentucky to formally respond or implement the recommendations, DE-Kentucky, through responses to Vantage data requests, has provided a status report on the implementation of each of the recommendations.

Vantage finds that, where appropriate, DE-Kentucky has developed and implemented reasonable implementation plans with regard to each of the recommendations in the previous audit. Vantage's analysis, findings and conclusions supporting this finding are presented in Chapter VII.

III. IDENTIFICATION AND RECORDING OF AFFILIATE TRANSACTIONS

In this section, Vantage discusses its review of DE-Kentucky's compliance with the terms of its affiliate agreements and regulatory requirements, which address the identification and recording of affiliate transactions. Written contracts between DE-Kentucky and its affiliates are reviewed and a sample of transactions is tested for compliance with applicable contract provisions.

A. FINDINGS

III-F1 DE-Kentucky accurately accounts for affiliate transactions in accordance with regulatory requirements.

DE-Kentucky complies with the Kentucky Affiliate Transaction Regulations by following the service request form process for the service agreements (Operating Companies Service Agreement, Operating Company/Nonutility Companies Service Agreement and Service Company Agreement) and the Asset Transfer Agreements.

FERC Order 707 requires that transfers of non-power goods or services between regulated franchised public utilities and their non-regulated utility or non-utility affiliates be priced using asymmetrical pricing. Asymmetrical pricing requires that if the regulated utility transfers an asset or provides a service to a non-utility or non-regulated utility affiliate, the regulated utility must be paid the higher of cost or market. Conversely, if the non-regulated utility or non-utility transfers an asset or provides a service to the regulated utility, then the regulated utility pays the lower of cost or market. The asymmetrical pricing rules have not been applied to DE-Kentucky's transactions for services with certain non-utility affiliates under the Operating Company/Non-utility Companies Service Agreement which was first entered into in January 2007.[iv] For the non-utility affiliates which were *not* grandfathered by this agreement, the Asymmetrically Priced Duke Energy Kentucky, Inc./Non-utility Service Agreement effective October 1, 2009 provides for asymmetrical pricing.[v]

In addition to administrative and other services provided by the Service Company, DE-Kentucky receives the following services from affiliates: outage support; lab services; substation maintenance; heavy equipment work; storm restoration; boiler inspection and administrative services. DE-Kentucky provides: CT support services; strike stop equipment

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[iv] / DR 01-008 Attachment 1

[v] / DR 01-039 Attachment B

installation and warehousing; underground line protection support; project support; administrative services; and storm restoration.[vi]

In 2009, DE-Kentucky was provided services totaling approximately $10.2 million by affiliates.[vii] In addition, DE-Kentucky provided goods and services of approximately $5.3 million to affiliates in 2009 (both regulated and non-regulated affiliates).[viii] The Operating Agreement permits the regulated utility affiliates, DE-Carolinas, DE-Indiana, DE-Kentucky, DE-Ohio, and Miami Power, to provide services to each other in such areas as: engineering and construction; operation and maintenance; installation; equipment testing; generation technical support; procurement; environmental; health and safety services. A utility may also lend employees to another utility so long as the loans do not interfere with the lending utility's operations. The Non-utility Agreement permits DE-Kentucky to perform services such as engineering and equipment testing for non-utility affiliates. Non-utility affiliates may provide such services as information technology services, meter reading, materials management, vegetation management and marketing to DE-Kentucky. The affiliates may lend employees as long as utility operations are not adversely affected.

Vantage reviewed supporting documentation for randomly selected sample affiliate transactions including transactions from the Service Company to DE-Kentucky. The total monetary value of the transactions selected for review was approximately $3,447,800. All transactions were found to be adequately supported and priced in accordance with relevant agreements.[ix]

III-F2 <u>DE-Kentucky records all transactions with its affiliates in accordance with GAAP, and sufficient records are maintained to permit an audit of all transactions between DE-Kentucky and its affiliates.</u>

All affiliate transactions are processed in accordance with GAAP. A chart of accounts which is consistent with the FERC Uniform System of Accounts is utilized by DE-Kentucky and its affiliates to record transactions. The Duke Energy policy for accounting for inter-company transactions requires that all inter-company transactions be recorded, that inter-company account balances be reconciled, and that discrepancies be resolved.[x] All transactions incurred pursuant to the Operating Agreement, the Non-utility Agreement, and the Service Company Agreement are separately reflected as inter-company charges through each party's payables and receivables accounts.

[vi] / DR 01-003

[vii] / DR 01-010

[viii] / DR 01-009

[ix] / DR 01-060

[x] / DR 01-015 Attachment C

A service request form must be completed and approved whenever one of Duke Energy's regulated utilities provides to services to any affiliate or receives services from any affiliate other than the service company. The estimated costs and subsequent actual charges must conform to the various service agreements and depending upon the situation, may require fully embedded costs or market costs (as discussed in Finding III-F1).

DE-Kentucky retains supporting documentation for affiliate transactions. The Company provided copies of the relevant portions of the KYPSC record retention policy and its company record retention policy, respectively. The KYPSC requires that all records be preserved, and the company record retention policy requires that journal entries and supporting detail be retained for periods ranging from 6 years to 25 years.[xi]

III-F3 A process has been developed to record and track asset transfers between the utility and non-utility affiliates.

All capital asset transfers to or from a regulated utility affiliate and inventory transfers between regulated and non-utility affiliates or non-regulated utility affiliates must be documented and approved on an affiliate asset transfer form.[xii]

In 2009, the following capital assets were transferred (at net book value) between DE-Kentucky and utility affiliates.

Meters from DE-Indiana to DE-Kentucky	$8,009.19
Meters from DE-Ohio to DE-Kentucky	$214,985.91
Transformers from DEO-Ohio to DE-Kentucky	$281,615.94
Gas Meters from DE-Ohio to DE-Kentucky	$57,753.22
Electric Meters from De-Kentucky to DE-Indiana	$(308,204.65)
Electric Meters from DE-Kentucky to DE-Ohio	$(149,931.19)
Transformers from DE-Kentucky to De-Ohio	$(14,632.42)
Gas meters from DE-Kentucky to DE-Ohio	$(204,023.45)
Regulator from DE-Kentucky to DE-Ohio	$(4,679.17)

The data supplied does not reflect transformers which were transferred during the fourth quarter of 2009 but not recorded due to a new system implementation. These fourth quarter

[xi] / DR 01-014 Attachments A and B

[xii] / DR 01-053

transfers will be recorded in 2010 activity.[xiii] There were no transfers of capital assets between DE-Kentucky and non-utility affiliates during 2009.[xiv]

IIIII-F4 Services provided by DE-Kentucky to an affiliate and goods and services provided to DE-Kentucky by any affiliate are covered by written agreements and are itemized in separate accounting entries.

The Service Company provides services to DE-Kentucky under the Service Company Utility Service Agreement (Service Company Agreement). DE-Kentucky and its utility affiliates provide goods and services to each other under the Operating Agreement. DE-Kentucky provides utility-related goods and services to its non-utility affiliates under the Non-utility Agreements, and non-utility affiliates provide DE-Kentucky with small amounts of goods and services under the same agreements.

DE-Kentucky is also a party to certain other agreements filed as described in its Cost Allocation Manual.

- Facilities Operation agreement.
- Utility money pool agreement.
- Receivables agreement.
- Gas and propane services agreement.
- Agreement for gypsum waste material disposal services.

In 2009, the Service Company allocated approximately $33,719,000 in charges to DE-Kentucky and directly charged approximately $56,171,000.[xv] Through 2009, the Service Company's approach for distributing costs not directly charged to an entity was to allocate such costs based on a series of data calculations which were updated annually. Included in these calculations was the general three factor formula. In applying the three factor formula, overhead costs for the Service Company did not allocate on the same basis as labor allocations. To reduce reliance on the general three factor allocation formula, a new approach was developed in 2010 whereby Service Company overhead will be applied to all Service Company labor charges, both directly charged and allocated labor costs. These charges will be offset by a credit back to overhead allocation pools on the Service Company, such that total dollars from the Service Company will not change.[xvi] Vantage concurs with this new approach.

[xiii] / DR 01-055

[xiv] / DR 01-057

[xv] / DR 01-010

[xvi] / "Service Company Overhead Loader" training materials, December 14, 2009

III-F4 Recent Internal Audits associated with cost allocations and state affiliate standards provide recommendations for enhancements to the process.

Internal Audit #309015, dated October 30, 2009[xvii] addressed the allocations process. It evaluated the process and procedures for service companies and departmental allocations across Enterprise Transactions for the period of July 1, 2008 to June 30, 2009. The objectives were to determine whether:

- processes and procedures were fully defined and roles and responsibilities were understood;
- allocations were consistently applied in compliance with applicable requirements; and
- cost pools were clearly defined and monitored.

The overall conclusion was that the process effectively administers allocations for the Enterprise. However, the process is complex and not fully understood by key business areas. There are opportunities for process enhancements which will impact the roles and responsibilities of process owners at the Service Company and departmental levels. Enhancements should include defining and communicating roles and responsibilities, implementing consistent documentation and monitoring practices, and providing training.

This moderate priority recommendation is scheduled for completion by August 31, 2010.

Internal Audit #110007, dated March 24, 2010 - FE&G State Affiliate Standards – Indiana and Kentucky. The scope of this audit was to assess compliance with Indiana and Kentucky Affiliate Standards. The audit focused on systems access, and controls and processes governing transactions between Duke Energy Indiana, Duke Energy Kentucky and respective affiliates. The objectives of the audit were to determine whether processes effectively ensure:

- systems with market or confidential information had appropriate access;
- invoices for IT services were appropriately charged;
- company guidelines regarding charges covered by Service Requests were consistently applied;
- labor loader calculations were accurate.

The conclusion of this moderate finding was that opportunities exist to enhance access reviews of regulated and non-regulated application data and improve the timeliness of corrections identified in the affiliate transaction review process.

Implementation will require changes to the GenWeb and MicroGads Gold user access and the FERC System Access Review system. Completion is expected in mid 2010.

[xvii] / DR 051

Recommendations

III-R1 Provide details on fourth quarter 2009 transformer transfers as part of the 2010 affiliate audit. (Refer to Finding III-F3.)

DE-Kentucky indicated that, due to a new system implementation, quantification of the transformers transferred for the period of October 2009 to December 2009 could not be provided until the next audit cycle.

III-R2 Provide details on changes related to the two internal audits conducted. (Refer to Finding III-F5.)

Provide the next auditors with details of the changes made in response to the two internal audit reports discussed in Finding III-F5 and the impact of the changes.

IV. FINANCIAL AND LIABILITY SEPARATION

In this chapter, Vantage discusses its review of the sections of the Kentucky regulation that address financial liability and separation. This includes assignment of liabilities, tax sharing, money pool agreements, asset transfers, investments in affiliates and asset sales and pricing.

A. OBJECTIVE AND BACKGROUND

The objective is to verify that DE- Kentucky customers are adequately insulated from all existing and likely future liabilities of Duke Energy Corporation and its non-regulated subsidiaries. The purpose of the work in this area is to determine if the liabilities and financial obligations of Duke Energy Corporation and its affiliates remain separate from those of DE-Kentucky. The Work Plan includes a review of the adequacy of the Company's "ring fencing" policies and procedures, the purpose of which are to financially separate a regulated public utility business from the parent company's other businesses, (particularly those that are non-regulated) in order to protect utility consumers from any bankruptcy or financial instability resulting from losses due to other market activities. Core ring fencing principles include the following.

- Any indebtedness incurred by another affiliate should be non-recourse to the utility.
- The utility may not enter into an agreement where it is obligated to commit funds in order to maintain the financial viability of another affiliate.
- The utility may not make any investment in another affiliate such that it would be liable for the debts and liabilities of that entity.
- The utility cannot issue any security for the purposes of financing the acquisition, ownership or operation of another affiliate.
- The utility cannot assume any obligation or liability of an affiliate as a guarantor, endorser, surety, or otherwise.
- The utility cannot pledge, mortgage or otherwise use as collateral any utility assets for the benefit of another regulated affiliate.

The work in this task area also entails a review of legacy Cinergy and Duke Energy liabilities such as pension funding and environmental liabilities to ensure that the Company has in place policies and procedures for ensuring that liabilities that should remain separate actually do so.

Vantage verifies that DE- Kentucky customers are adequately insulated from all existing and likely future liabilities of Duke Energy Corporation and its non-regulated subsidiaries.

BACKGROUND

The purpose of the work in this area is to determine if the liabilities and financial obligations of Duke Energy Corporation and its affiliates remain separate from those of DE-Kentucky.

IV-F1 Duke Energy Kentucky does not support the liabilities and financial obligations any non-regulated entities.

DE-Kentucky has confirmed that it does not support the financial obligations of any non-regulated subsidiaries in response to Data Request 17.

IV-F2 The Operation Agreement related to Miami Fort Unit 6 Operation provides adequate separation and protection for DEK ratepayers.

The Miami Fort Unit 6 Operation Agreement between the Cincinnati Gas & Electric Company and the Union Light Heat and Power Company (ULH&P) was made on January 25, 2006. This agreement is divided into five sections identified as A. to E. Section A spells out basic obligations regarding operations and use. Section B addresses capability and output, specifying that all output be fed into the transmission lines that ULH&P is entitled to the full capability, as defined in the section. Section C addresses the operation of Miami Fort 6. It specifies that CG&E operate using good utility practices and keep ULH&P informed of operational issues. Section D defines the reimbursement of CG&E by ULH&P. The seven separate paragraphs provide specificity to responsibility and reporting of all costs associated with operation. Finally Section E provides details on general contractual issues.

IV-F3 DE-Kentucky has only two financial, operational, and other liability types (e.g., pension, environmental, energy trading), whose assignment among affiliates is possible.

Pension and OPEB

Both pension and OPEB liabilities are actuarially determined. For Duke Energy Kentucky, the liabilities reflected on the general ledger are calculated based on the plans that the Kentucky employees participate in.[xviii] In 2009, the Company made contribution to the Duke Energy qualified pension plans of approximately $800 million. The amount contributed to the plans in which DE-Kentucky employees participate was $20.8 million.

Environmental Liabilities and Trading

Duke Energy regulated affiliates in the Midwest and Carolinas (DE-Carolinas, DE-Indiana, DE-Kentucky) are active traders of electricity, coal, natural gas, and emission allowances.

[xviii]/ DR 19

DE- Carolinas, DE-Indiana and DE-Kentucky each have separate energy trading books for native and non-native sales revenues. Each uses the CXL system for tracking its trades and the PACE system to allocate generation and purchased power costs between native load and non-native sales. All trades for native load are identified, and trades exceeding the native load are classified as wholesale sales and purchases. There are no trading positions between Duke Energy Midwest (DE-Indiana, DE-Ohio, and DE-Kentucky) and DE-Carolinas. Additionally, there are no transfers or sales of positions between these entities. The trading positions of DE-Ohio including native, non-native, and merchant energy sales are managed by the Duke Energy Commercial Asset Management group completely separate and independent the regulated affiliates' positions managed by the Regulated Portfolio Operations Group.

Emissions allowances purchased but not yet used comprise common assets for power generators. These are maintained separately for DE-Carolina, DE-Indiana, and DE-Kentucky and managed by the Director of Portfolio Management in the Regulated Portfolio Optimization group. Emission allowances for DE-Ohio are managed separately and independently in the Commercial Asset Management Group.

Trading, selling, or transferring positions of any of the commodities managed by Regulated Portfolio Optimization with Commercial Asset Management is strictly prohibited by the FERC Code of Conduct.

IV-F4 <u>DE-Kentucky files a consolidated Federal Income Tax return and allocates in accordance with the Provisions of the Tax Sharing Agreement.</u>

Duke Energy and its subsidiaries agreed to join annually in the filing of a consolidated Federal income tax return and to allocate the consolidated Federal income tax liabilities and benefits among the members of the consolidated group allocates in accordance with the Provisions of the Tax Sharing Agreement. The Agreement provides generally that consolidated Federal, State and Local income tax liabilities and benefits will be allocated, where appropriate, among members by calculating each member's taxable income as if that member had filed a separate return on the same basis as used in the applicable consolidated return.[xix]

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

Duke Energy maintains an "Inter-company Funding Policy" that applies to DE-Kentucky and all other regulated affiliates.[xx] This policy was issued on April 1, 2006 and revised on

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[xix] / DR 20

[xx] / DR 21

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

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

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

IV-F6 A process has been developed to apportion responsibility for Federal income tax liabilities and benefits among members of the Duke Energy consolidated group.

DE-Kentucky participates in Duke Energy's Agreement for Filing Consolidated Income Tax Returns and for Allocation of Income Tax Liabilities and Benefits effective 2006 and for years following. This agreement generally provides that consolidated income tax liabilities and benefits are allocated to DE- Kentucky and the other Duke Energy subsidiaries on the same basis as if each company had filed a separate income tax return on the same basis as used in the consolidated income tax return. Under this method, there is no impact for taxes to DE- Kentucky customers from tax liabilities properly assignable to other affiliates.

V. AFFILIATE SEPARATION

A. BACKGROUND

In this chapter, Vantage presents its analysis, findings and conclusions regarding DE-Kentucky's compliance with KYPSC regulations and merger commitments regarding the adequate separation of the utility from its non-utility affiliates regarding the use of the company name and logo. The Commission's regulations do not specifically address dealings with affiliates in the areas of sharing physical space, information systems, employees, or marketing activities with non-utility or wholesale marketing affiliates. However, it should be noted that DE-Kentucky follows the relevant corporate policies governing these matters.[xxi] Vantage has also presented its determination as to whether DE-Kentucky has ensured comparable treatment of affiliates and third parties regarding access to customer information and availability of its goods and services.

V-F1 <u>DE-Kentucky is in compliance with 807 KAR 5:080 Section 6.</u>

Section 6 of the regulation pertains to an affiliate's use of the utility's name, trademark, brand or logo. During 2009, no non-utility affiliate used the DE-Kentucky name or logo.[xxii] Nevertheless, DE-Kentucky has established specifications regarding the use of the name or logo in the event there is a request to use the name or logo.

V-F2 <u>DE-Kentucky is in compliance with regulatory requirements which require that DE not share market information about its regulated customers with affiliated wholesale power marketers except for information that is also available to non-affiliated entities.</u>

To determine compliance with these requirements relevant information systems were identified, policies and procedures governing sharing of information were examined and internal controls were reviewed to determine if they prevented the sharing of customer information.

In response to data requests, DE-Kentucky provided a listing of shared information systems and the security measures used to ensure the continued confidentiality of the customer information.[xxiii] As a general rule, DE-Kentucky follows the guidance of the FERC Code of Conduct/Standards of Conduct in sharing customer information. The FERC Code of Conduct prohibits the sharing of market information that includes customer information

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[xxi] / DRs 25, 26, 27, 28, 29 and 30.

[xxii] / DR 24

[xxiii] / DR 30

with a non-regulated utility unless simultaneously disclosed to the public. DE-Kentucky's FERC Code of Conduct/Standards of Conduct computer-based training covers information sharing and is provided to targeted employees annually. The policies governing the sharing of customer information are also provided in the affiliate standards computer-based training. In addition to the training, DE-Kentucky was, during the course of the audit in the process of developing formal guidelines governing the release of confidential information. It is Vantage understanding that the guidelines have been completed and are available to employees via a share drive.

In addition to a list of shared information systems, DE-Kentucky included the names of the "gatekeepers" for each of the systems. Two of the "gatekeepers" were interviewed to discuss the process utilized to ensure the inadvertent sharing of confidential information. The interviews confirmed that the shared systems have firewall separation and that separate passwords are required for regulated users and non-regulated users. Employees requesting system access are required to submit a request for access via eform/email to the system administrator (gatekeeper) through the employee's manager. Both the manager and the system administrator must approve the request prior to granting access to the appropriate system. In order to maintain access on an on-going basis, DE- Kentucky relies on a compliance tool called Open Pages. This tool is used to remind the administrators to complete a review of system access on at least an annual basis or sometimes more frequently. The system also advises the administrator of employee transfers that require the change in the employee's access to the information in order to delete access on a timely basis.

Based on its analysis, review of responses to data requests and interviews, Vantage finds that DE-Kentucky is in compliance with regulatory requirements regarding the sharing of confidential information.

V-F3 <u>During 2009, no DE-Kentucky customer had entered a contract with an affiliated wholesale provider that included a tying arrangement.</u>

DE-Kentucky's response to data request confirmed that no DE-Kentucky customer has a contract with an affiliated wholesale provider that includes a tying arrangement.[xxiv] Based on the response, Vantage finds that DE-Kentucky is in compliance with relevant regulatory requirements.

V-F4 <u>During 2009, DE-Kentucky provided products or services to Duke Energy-Ohio under the terms of various approved service agreements and consistent with its filed Cost Allocation Manual.</u>

Based on DE-Kentucky's response to data requests and interviews with DE-Kentucky employees, it was confirmed that DE-Kentucky had not provided any products and services

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[xxiv] / DR 28

to any affiliated wholesale power marketer or other third party with the exception of DE-Ohio and those were provided consistent with approved service agreements.[xxv] Therefore, Vantage concludes that DE-Kentucky is in compliance with relevant regulatory requirements.

[xxv] / DR 30 and Interview 7

VI. CONTROLS AND TRAINING

A. BACKGROUND

In this chapter, Vantage presents the results of its analysis and review relative to the adequacy of the internal controls and training that DE-Kentucky has in place to ensure compliance with the affiliate standards. Compliance with the affiliate standards is actually achieved through DE-Kentucky's own self-enforcement of the standards. This self-enforcement is accomplished through internal controls and training programs. In Chapters III and V the internal controls and processes that DE-Kentucky has implemented to protect the confidentiality of consumer information, to prevent the unintended sharing of information with non-utility affiliates, as well as to appropriately allocate costs are discussed and DE-Kentucky is found to be in compliance. Accordingly, this chapter focuses on training.

B. FINDINGS AND RECOMMENDATIONS

Adequate and appropriate training is a crucial ingredient to DE-Kentucky's plan to comply with the affiliate standards. Since compliance relies heavily on an employee's ability to identify potential violations, the employees must be informed about the standards and the importance of compliance. To accomplish this DE-Kentucky relies on primarily two different training programs: Affiliate Training (both classroom and computer-based training) and 2009 FERC Code/Standards of Conduct Training (Condensed version and longer version).

VI-F1 <u>DE-Kentucky's Affiliate Training and 2009 FERC Code/Standards of Conduct Training adequately identify and explain the compliance standards.</u>

In response to data requests, DE-Kentucky provided copies of the Affiliate Training and the 2009 FERC Code/Standards of Conduct Training.[xxvi] The training packages were carefully reviewed and checked to make certain they adequately addressed all of the relevant standards. Presently, the training package used in Kentucky is the same training package used in Ohio and Indiana. As the regulatory requirements are more detailed in both Ohio and Indiana than those in Kentucky, DE-Kentucky has erred on the side of providing a more stringent set of regulatory requirements for the DE-Kentucky employees.

However, our review of these training programs found them to be very mundane and basically a straight-forward recitation of the standards with a few simplistic examples. This is a concern because this training will be repeated annually for the affected employees. It would be advisable to develop a more interesting and invigorating way to present these standards and keep the employees interested and informed.

[xxvi] / DR 32

VI-F2 The DE Code of Business Ethics training program is outstanding.

Every new employee at DE takes the Code of Business Ethics New Hire Training course. Employees then take a computer-based refresher course on an annual basis. During the audit, Vantage reviewed the New Hire Training course, the 2009 Code of Business Ethics Refresher course and the 2010 Code of Business Ethics Refresher course.[xxvii] Vantage found the courses to be outstanding. They were viable, interesting and thought provoking. The employees were presented with realistic examples that had to be carefully thought through in order to satisfactorily resolve the business ethics issue. Some of the examples involved affiliate standard issues. It would be most unlikely that an employee would be bored while taking this interactive, computer-based training.

VI-R1 Enhance Affiliate Training with more realistic examples that encourage the employee to think through the affiliate issue presented. (Refer to Finding *VI-F1 and VI-F2*.)

The Code of Business Ethics training has established a standard to which DE-Kentucky should strive to reach with its Affiliate Training. The current Affiliate Training meets the minimum requirements through a mundane presentation of the affiliate standards and some trivial examples. The annual review of this material, as currently presented, is not at the desired or expected level of employee interaction. The training would be much more effective if it were enlivened with better examples and a more interactive presentation of the standards.

VI-F3 DE-Kentucky's process to make certain that the appropriate employees take the necessary training is not as formal as it could be.

The selection of which employees were to receive the Affiliate Training was based on the role, responsibility and function of the employee. For the initial training, employees who have responsibility for affiliate standards requirements (merger conditions) as well as employees impacted by the affiliate standards, were selected.[xxviii] A compliance software tool called Open Pages is used to track which employees have taken the course and to send reminders to those employees that need to take the course.[xxix] Although DE-Kentucky's compliance with the regulatory requirements and merger commitments is an important issue for the Company, there are not written policies or procedures clearly stating which employees are required to take the affiliate training, setting deadlines for completing the course or detailing how to deal with those employees who delayed taking the training.

[xxvii] / DR 45

[xxviii] / DR 33

[xxix] /DR 35

VI-R2 Implement a set of formal procedures surrounding the provision of its affiliate training. (Refer to Finding *VI-F3*.)

During an interview with compliance personnel Vantage learned that DE has plans to develop and implement a corporate training protocol.[xxx] Through a follow-up data request, a draft of the training protocol currently under development by the Ethics and Compliance Department, was provided.[xxxi] The draft protocol establishes who the intended audience for the training is, when and how the training is offered, when the training should be updated, when reminders should be sent including reminders to immediate supervisors, and the maintenance of training records. The response indicated that the current plan is to implement the training protocol by the first quarter of 2011. Vantage recommends that this protocol for the affiliate training be established no later than the planned date.

[xxx] / Interview 13

[xxxi] / DR 63

VII. FILING REQUIREMENTS AND IMPLEMENTATION OF RECOMMENDATIONS

A. BACKGROUND

Another important component of compliance is demonstrating compliance to those directly involved in the regulation of the utility. In this case the interested regulators are the KYPSC. This chapter will review how DE-Kentucky keeps the KYPSC advised of its compliance. In addition, Vantage reports on its review of DE-Kentucky's annual and other filings as required by regulation or merger commitments. Finally, Vantage reports on DE-Kentucky's actions regarding the recommendations from the previous audit of its compliance with the affiliate standards.

B. FINDINGS

VII-F1 DE-Kentucky complies with 807 KAR 5:080 Section 2 - Annual Reports.

DE-Kentucky files various reports with the KYPSC on an annual basis.[xxxii] These reports include the following.

- Merger Compliance Report.
- Annual Report.
- Annual Update to Administrative Case No. 387.
- Vegetation Management Report.

The Annual Report meets the requirements of Section 2 of the Commission regulation. The other reports are responsive to other Commission orders and requirements. Accordingly, Vantage finds DE-Kentucky is in compliance with the Commission's regulation and other relevant filing requirements.

VII-F2 DE-Kentucky complies with 807 5:080 Section 3 - Cost Allocation Manual.

Section 3 of the Commission's regulation requires the utility to file its Cost Allocation Manual (CAM) and all changes and amendments to it. In response to a Vantage data request DE-Kentucky's CAM was provided.[xxxiii] The CAM provides: a list of regulated and non-regulated divisions within the utility; a list of affiliates that DE-Kentucky provides services and products; a list of the services provided to affiliates and the cost allocation method used; a list of incidental, non-regulated activities; a description of the transactions between the utility and the affiliate; and identification of costs that are joint costs and how

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[xxxii] / DR 39

[xxxiii] / DR 40

they are apportioned. In addition the CAM provides copies of the various agreements that govern the transactions between DE-Kentucky and its affiliates.

Based on a review of the CAM, the attached agreements, the statute, and the regulation, Vantage concludes that DE-Kentucky is in compliance with 807 KAR 5:080 Section 3.

VII-F3 In response to the first audit, DE-Kentucky has prepared responses to either implement, clarify or reject each of the 14 recommendations made in the audit.

The following is a list of the 14 recommendations from the previous audit and a summary of DE-Kentucky's response to each of the recommendations.[xxxiv]

It should be noted that Vantage made its request for DE-Kentucky's status with regards to the recommendations from the Liberty audit on August 25, 2010. The final response was not received until September 18, 2010. Although there were some administrative reasons for the delay in getting this response completed, it does indicate the lack of a formal approach to responding to the audit recommendations.

Liberty Recommendation 1: **Conform billing and settlement procedures to the language of the Service Agreements.**

DE-Kentucky Response: The language in the Service Agreements has been changed to conform.

Liberty Recommendation 2: **Develop and maintain a formal affiliate transaction accounting manual.**

DE-Kentucky Response: The Company has not developed a separate affiliate transaction accounting manual. However, the most recent update of the Kentucky Cost Allocation Manual was revised to include much of the information recommended by Liberty. The revised CAM includes a listing of all service company allocations by function as well as other data.

Liberty Recommendation 3: **Complete time reporting training for all relevant employees by the end of the year.**

DE-Kentucky Response: Although the implementation of the time reporting changes has been delayed, it is planned to be implemented between September 2010 and March 2011.

Liberty Recommendation 4: **Identify and implement a program that DE and stakeholders consider appropriate for assessing whether the Service Company complies with Article I, Section 1.4 of the Service Company Utility Service Agreement.**

[xxxiv] / DR 62

<u>DE-Kentucky Response:</u> The Company has taken exception to this recommendation. The recommendation relates to Section 1.4 of the Service Company Utility Service Agreement. This section states that: "The Service Company shall maintain a staff trained and experienced in the design, construction, operation, maintenance and management of public utility properties." A careful review of the Liberty audit report does not indicate that there was any concern regarding the experience and capability of the Service Company personnel. It appears that Liberty had two concerns. First, the Service Company failed to somehow demonstrate compliance with this provision of the Agreement. Second, the audit report makes the observation that due to restructurings and downsizings there would be some excess costs to be shared by each of the Duke affiliates - non-regulated as well as regulated - until a more optimal staff sizing is attained. However, the report indicates that this is to be expected and presumes these costs will eventually work their way out of the cost structure of the common service organizations. Based on our independent audit, Vantage has no reason to believe that the Service Company's staff is not well-trained and experienced in the design, construction, operation, maintenance and management of public utility properties. We find DE-Kentucky's response that each department maintains hiring standards and requirements for all positions is reasonable. These standards and requirements may include minimum levels of education, advanced degrees, relevant industry training and experience. Vantage finds DE-Kentucky's rejection of this recommendation is appropriate.

<u>Liberty Recommendation 5:</u> Narrow the use of the three-part formula allocator.

<u>DE-Kentucky Response:</u> In January 2010, DE-Kentucky implemented a new overhead loader which will reduce the reliance on the three-part formula allocator. Also, when the time reporting system is completely implemented, it is expected employees may directly assign more cost and thus reduce the expenditures that are allocated based on the three-part formula.

<u>Liberty Recommendation 6:</u> Eliminate the effect of spreading overhead costs from the calculation of allocation percentages.

<u>DE-Kentucky Response:</u> The new overhead loader implemented in January 2010 will mitigate the effect of spreading overhead costs through the allocation percentage calculations. In addition, the elimination of DEBS from the allocation bases reduces the overhead costs spread through the allocation percentage calculations.

<u>Liberty Recommendation 7:</u> Develop a method to fairly assign Service Company overhead costs.

<u>DE-Kentucky Response:</u> The new overhead loader implemented in January 2010 more fairly assigns Service Company overhead costs.

<u>Liberty Recommendation 8:</u> Limit Service Company charges, to the extent possible, to those covered by the Service Company Utility Service Agreement.

DE-Kentucky Response: The types of pass-through costs that the Service Company was imposing on each group were identified and then the Service Company Utility Service Agreement was updated to allow the pass-through of these costs.

Liberty Recommendation 9: Increase the percentage of labor that the Service Company directly charges to business units.

DE-Kentucky Response: Through various forms of communication including emails and meetings, Service Company employees have been informed of the importance of direct charging for their time and encouraged to directly charge when possible.

Liberty Recommendation 10: Routinely review the appropriateness of Service Company employee default labor distributions and encourage employees to do more positive time reporting.

DE-Kentucky Response: Employee default labor distributions are now reviewed quarterly and the lines of business have been strongly encouraged to direct charge for labor whenever possible.

Liberty Recommendation 11: Develop formal written guidelines to describe into which of the twelve Service Company IT allocation pools the various types of IT invoices should be charged.

KE-Kentucky Response: IT management is responsible for training its employees and managers to properly charge to the correct IT pool. No formal guidelines have been developed as there does not appear to be a significant problem. In fact, Internal Audit performed a review of 2009 IT invoices in the first quarter of 2010 and the review found that no items had been improperly classified.

Liberty Recommendation 12: Develop a method to precisely identify charges associated with individual Service Requests.

DE-Kentucky Response: The Company has developed a new report to provide totals of charges that link back to specific Service Requests. In addition, there has been an increased focus on reviewing Service Request Forms for more details in the accounting so that charges can be more easily tracked.

Liberty Recommendation 13: Clarify the guidelines for the types of charges that are appropriate to Service Requests covered by the Operating Agreement and Non-utility Agreement and implement training for all relevant personnel.

DE-Kentucky Response: The service agreements clearly state that they only cover services and those services could include applicable equipment, facilities, properties or other resources. Service Requests are utilized only for the provision of services. The transfer of assets, goods, commodities, etc. is specifically excluded from the service agreements.

Employees are informed of these distinctions through the affiliate training conducted by the Company.

Liberty Recommendation 14: **Implement a more rigorous quality control review process for the calculation of loaded labor changes in FMIS.**

DE-Kentucky Response: Additional reviews have been added to the Responsibility Center change request process to reduce improper setup and resulting allocation processing errors. In addition subsequent audits have included reviews of labor loads. In regards to the overhead loader a consistent rate is being applied in the system to utility charges now that all jurisdictions are on the same accounting system beginning July 2008.

VII-R1 Establish a more formal approach for responding to the recommendations in the affiliate audits. (Refer to Finding VII-F3)

As discussed herein, there was a considerable time lag between Vantage's data request and DE-Kentucky's response to update the status of the implementation plans relative to the recommendations from the previous audit. Although most parts of the response were provided more quickly, Vantage found the updates to each of the recommendations were terse and lacking in providing a full understanding of the problem and how the problem was resolved.[xxxv]

To-date the Kentucky PSC has not demonstrated much interest in the previous audit. However, DE-Kentucky cannot rely on the Commission's posture to continue. For certain, subsequent audits will inquire as to the implementation of recommendations from previous audits. It would be prudent for DE-Kentucky to establish a more formal approach for responding to the affiliate audit recommendations. One would expect overall responsibility for this process to reside in the Compliance Department. A lead person should be assigned to each recommendation. A schedule for regular updates should be established. All supporting documentation for the response to the recommendation should also be provided. This would enable DE-Kentucky to provide timely and well-documented responses to the Kentucky PSC or future auditors requesting updates.

[xxxv] / DR 62