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Dianne B. Kuhnell.
Senior Paralegal

VIA OVERNIGHT DELIVERY

May 22, 2009

RECEIVED

MAY 26 2009

PUBLIC SERVICE
COMMISSION

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 are:

1. An original and ten copies of the Public version of the Final Report Audit of Merger-Related Agreements-Duke Energy Kentucky in response to Merger Commitment No. 12;
2. A Confidential version of the Report is enclosed under seal with an original and ten copies of the *Petition Of Duke Energy Kentucky, Inc. For Confidential Treatment Of Information Contained In The Liberty Consulting Group's Final Report Audit Of Merger-Related Agreements Dated May 19, 2009.*

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

Very truly yours,

Dianne B. Kuhnell

Dianne B. Kuhnell
Senior Paralegal

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

RECEIVED

MAY 26 2009

PUBLIC SERVICE
COMMISSION

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

PETITION OF DUKE ENERGY KENTUCKY, INC.
FOR CONFIDENTIAL TREATMENT OF INFORMATION
CONTAINED IN THE LIBERTY CONSULTING GROUP'S FINAL REPORT AUDIT
OF MERGER-RELATED AGREEMENTS DATED MAY 19, 2009.

Duke Energy Kentucky, Inc. (Duke Energy Kentucky or Company), pursuant to 807 KAR 5:001, Section 7, respectfully requests the Commission to classify and protect certain information provided in Liberty Consulting Group's Final Report Audit of Merger Related Agreements Duke Energy Kentucky (Audit Report). The Audit Report was required by Merger Commitment No. 12 as set forth in the Order issued by the Commission in Case No. 2005-00228. The information Duke Energy Kentucky seeks confidential treatment (Confidential Information) includes but is not limited to: (1) a summary of 2007 affiliate transactions across the Duke Energy Corporation holding Company structure (Duke Energy); (2) overall governance and labor charges, including labor to and from affiliates across Duke Energy; (3) Corporate allocation percentages from various departments to Duke Energy Kentucky; (4) inter-company charges to affiliates and detailed requests for service to affiliates. All of the above-described Confidential Information contains sensitive business and financial information, the disclosure of which would injure Duke Energy Kentucky, and its affiliates, and compromise the companies' respective competitive positions and business interests.

In support of this Petition, Duke Energy Kentucky states:

1. The Kentucky Open Records Act exempts from disclosure certain commercial information. KRS 61.878 (1)(c). To qualify for this exemption and, therefore, maintain the confidentiality of the information, a party must establish that disclosure of the commercial information would permit an unfair advantage to competitors of that party. Public disclosure of the information identified herein would, in fact, prompt such a result for the reasons set forth below.

2. The Commission approved the merger of Duke Energy and Cinergy Corp. in Case No. 2005-00228. As part of its merger commitments, Duke Energy Kentucky agreed to have an independent audit of the various service agreements approved as part of the merger. The first Audit Report was recently completed by Liberty Consulting Group and the Audit Report was developed. The Audit Report details a comprehensive audit of the various agreements and by necessity the Audit Report describes sensitive financial information and other business operations of Duke Energy Kentucky as well as the other parties to the various agreements. Duke Energy Kentucky on its own behalf, as well as on behalf of the other entities whose financial and business operation information is described in the Audit Report, respectfully request that certain limited information described in this petition be withheld from public disclosure and be maintained under seal.

3. The Confidential Information contained in pages 7-8 and 24 depicts summaries of affiliate transactions including costs. Disclosure would make public the operating costs of

not only Duke Energy Kentucky, but also of its affiliated regulated utilities and affiliated non-regulated companies under the Duke Energy Holding Company structure, which are permitted to provide one another goods and services under Commission- approved agreements. Disclosing this information would provide Duke Energy Kentucky's competitors, as well as competitors of its sister utilities and non-regulated affiliated companies with insight into how the utilities in the Duke Energy Holding Company structure operate. This information could provide a distinct competitive advantage to vendors in bidding for and securing new contracts for services to Duke Energy Kentucky, not to mention its affiliates. It could also provide a competitive advantage to a competitor of Duke Energy Kentucky, its sister utilities mentioned in the Audit Report, and the affiliated non-regulated companies listed.

3. Pages 49, 51-64 and 72-73, 102 of the Audit Report list and describe information regarding overall charges from Duke Energy Business Services (DEBS) to Duke Energy Kentucky, its sister utilities, and its non-regulated affiliates. The information includes, but is not limited to, labor charges for the individual business units, corporate governance allocations, Duke Energy Kentucky's allocated costs for various departments, and costs for the various utility operating companies and non-utility affiliates in Duke Energy. Public disclosure would afford vendors a distinct competitive advantage in bidding for and securing new contracts for services provided to Duke Energy Kentucky and its affiliates. Disclosure would also afford an obvious advantage to competitors of Duke Energy Kentucky or any of its listed affiliates, in any contractual negotiations and would necessarily impair Duke Energy Kentucky's or its affiliates ability to negotiate with prospective contractors and vendors.

4. The Confidential Information contained in tables and charts on pages 80-99 details the charges, for loaded labor, materials, vehicle expense, outside services, and journal entries by and between the regulated utilities and non regulated affiliates in Duke Energy. The information also includes descriptions and estimated and actual costs of specific services that were requested during the audit period by and between the various companies in Duke Energy. These services were performed according to the various Commission –approved service agreements. The information would afford competitors of any of the named companies, a distinct competitive advantage in bidding for and securing new contracts for services. It would give competitors keen insight on how the various named entities operate and what the exact costs include. Further, public disclosure would afford an obvious advantage to competitors in any contractual negotiations and would necessarily impair Duke Energy Kentucky's ability to negotiate with prospective contractors and vendors.

5. The Confidential Information contained in pages 105-106 pertains to the Commission-approved Utility Money Pool Agreement. The Money Pool Agreement allows the parties to more efficiently use cash by pooling daily excess and deficits of funds. The Confidential Information details the participation levels of all of the parties to the agreement, including Duke Energy Kentucky. It also includes Duke Energy Kentucky's monthly borrowing under this agreement. This information is maintained internally by Duke Energy Kentucky personnel, is not on file with any public agency, and is not available from any commercial or other source outside Duke Energy Kentucky. Releasing the information will give potential creditors and lendors insight into sensitive and confidential financial operations of Duke Energy Kentucky.

6. The aforementioned Confidential Information in all pages listed is distributed within Duke Energy and Duke Energy Kentucky only to those employees who must have access for business reasons, and is generally recognized as confidential and proprietary in the energy industry.

7. The information for which Duke Energy Kentucky is seeking confidential treatment is not known outside of Duke Energy.

8. Duke Energy Kentucky does not object to limited disclosure of the confidential information described herein, pursuant to an acceptable protective agreement, to the Attorney General or other stakeholders with a legitimate interest in reviewing the same.

9. In accordance with the provisions of 807 KAR 5:001 Section 7, the Company is providing the Commission one copy of the Confidential Material highlighted and ten copies without the confidential information. Duke Energy Kentucky has taken steps to only seek confidential treatment of the sensitive information contained in the responses, and in the interest of disclosure is only seeking confidential treatment of specifically identified information.

WHEREFORE, Duke Energy Kentucky, Inc. respectfully requests that the Commission classify and protect as confidential the specific information described herein.

Respectfully submitted,

DUKE ENERGY KENTUCKY

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of Duke Energy Kentucky, Inc.'s Petition for Confidential Treatment of Information Contained in The Liberty Consulting Group's Final Report Audit of Merger-Related Agreements dated May 19, 2009 was served on the following by overnight mail, this 22d day of May 2009.

Amy B. Spiller

Honorable Dennis G. Howard, II
Honorable David E. Spenard
Assistant Attorneys General
1024 Capital Center Drive, Suite 200
Frankfort, Kentucky 40601

Final Report
Audit of Merger-Related Agreements
Duke Energy Kentucky

Public Version

Presented to:

The
Kentucky Public Service Commission

THE LIBERTY CONSULTING GROUP

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May 19, 2009

Table of Contents

I. Introduction

A. Purpose of This Report

On November 29, 2005, the Kentucky Public Service Commission (KyPSC) issued its Order in Case No. 2005-0028 approving the acquisition and transfer of controls of Union Light, Heat and Power Company (ULH&P), later renamed Duke Energy Kentucky, Inc. (DE-Kentucky), as part of the merger between Cinergy Corp. (Cinergy) and Duke Energy Corporation (Duke Energy). The KPSC approved five merger-related agreements among UHL&P and affiliates:

- Service Company Utility Service Agreement
- Operating Companies Service Agreement
- Operating Company/Non-utility Companies Service Agreement
- Utility Money Pool Agreement
- Agreement for Filing Consolidated Income Tax Returns and for Allocation of Consolidated Income Tax Liabilities and Benefits.

The KPSC also approved an Agreed Stipulation that contains 46 merger commitments. Merger Condition No. 12 has particular relevance to this audit. This condition states as follows:

> *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.*

Under the Condition, DE-Kentucky committed to periodic comprehensive independent third-party audits, conducted no less often than every two years, of affiliate transactions under the agreements.

Duke Energy selected The Liberty Consulting Group (Liberty) to perform the audit work. This report addresses the results of Liberty's audit of the five merger-related agreements affecting DE-Kentucky.

B. Scope

The scope of the audit includes a review of:

- Determining DE-Kentucky's compliance with the five merger-related affiliate agreements
- Examining DE-Kentucky's affiliate transactions between January 1, 2007 and December 31, 2007 undertaken pursuant to the merger-related agreements
- Reviewing cost allocation factors in the Service Company Utility Service Agreement
- Assessing the adequacy of cost allocation manuals, policies, procedures, and activities associated with affiliate transactions and cost allocation and assignment
- Verifying through sampling that affiliate transactions are conducted in compliance with applicable requirements and that they are supported by the required documentation.

C. Report Structure

This report has nine chapters. Chapter I provides an introduction. Chapter II provides a brief overview of the three merger-related agreements that apply to services provided among affiliates: the Service Company Utility Service Agreement, the Operating Companies Service Agreement, and the Operating Company/Non-utility Companies Service Agreement. The second chapter also outlines commission reporting requirements for affiliate transactions. Chapter III addresses the accounting-related issues relevant to the service agreements.

The Service Company Utility Service Agreement is complex. This report addresses the issues it raises in two separate chapters. Chapter IV addresses service company cost allocation methods; Chapter V addresses service company charges.

Chapter VI presents the results of Liberty's review of the Operating Companies Service Agreement and the Operating Company/Non-utility Companies Service Agreement. Chapter VII describes the results of Liberty's testing to determine how effectively the company has implemented its methods to price, account for, and report affiliate transactions.

Two merger-related agreements address financial matters. First is the Utility Money Pool Agreement, which Chapter VIII of this report addresses. Second is the Agreement for Filing Consolidated Income Tax Returns and for Allocation of Consolidated Income Tax Liabilities and Benefits, which Chapter IX of this report addresses.

II. Service Agreements and Commission Reporting Requirements

A. Background

Three of the merger-related agreements are service agreements that cover certain transactions between DE-Kentucky and its affiliates. These agreements are:

- Service Company Utility Service Agreement
- Operating Companies Service Agreement
- Operating Company/Non-utility Companies Service Agreement.

The parties to these agreements include, among others, the following subsidiaries, for which Duke Energy Corporation is the ultimate parent:

- The former Cinergy utilities
  - The Cincinnati Gas & Electric Company (CG&E), later renamed Duke Energy Ohio, Inc. (DE-Ohio)
  - PSI Energy, Inc. (PSI), later renamed Duke Energy Indiana, Inc. (DE-Indiana)
  - Union Light, Heat and Power Company (ULH&P), later renamed Duke Energy Kentucky, Inc. (DE-Kentucky)
  - Miami Power Corporation (Miami Power)
- The former Duke Power utility, later renamed Duke Energy Carolinas, LLC (DE-Carolinas).

DE-Ohio provides electric and gas service in southwestern Ohio, and also owns and operates non-regulated generation assets. DE-Kentucky is a wholly-owned subsidiary of DE-Ohio; DE-Kentucky purchases, sells, stores, and transports natural gas, and generates, sells, and distributes electricity, in several counties in Kentucky. DE-Indiana generates, sells, and distributes electricity in portions of Indiana.

DE-Kentucky filed final versions of the agreements dated April 3, 2006 with the KyPSC in early 2006. The company filed agreement amendments dated January 2, 2007 as part of its recent Annual Report and Cost Allocation Manual filings. The revisions reflected party name and other administrative changes.

The following portions of this report chapter: (a) discuss the results of Liberty's examination of the reasonableness of the language and terms of these three agreements, and (b) provide an overview of commission reporting requirements relevant to this audit.

B. Findings

1. Service Agreements

There are two main categories of services provided among DE-Kentucky and its affiliates under the three service agreements:

- Shared services provided to DE-Kentucky and other affiliates by Duke Energy Business Services (DEBS) and Duke Energy Shared Services (DESS)

- Utility-related services provided among DE-Kentucky and its utility and non-utility affiliates.

a. Service Company Utility Service Agreement

The parties on the one side of the Service Company Utility Service Agreement (Service Company Agreement) are DE-Carolinas, DE-Indiana, DE-Kentucky, DE-Ohio, and Miami Power. The parties on the other side are DEBS and DESS, which collectively form the Service Company. The agreement addresses the Service Company's provision of the 23 business functions listed in the following table.

Service Company Functions

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

Appendix A to the Service Company Agreement describes the services and the methods for determining charges for these services. There is a separate agreement between the Service Company and non-utility affiliates. The terms, *i.e.*, services, cost assignment, and allocation methods, are essentially the same in both agreements. Appendix A briefly describes each of the functions, and indicates the method of cost allocation applicable for each function. Fully embedded costs form the basis for the pricing of services under the agreement. The agreement defines these costs as the sum of direct costs, indirect costs, and costs of capital. The Appendix to the Service Company Agreement sets forth certain accounting requirements. The Service Company must maintain records of employee-related expenses and other indirect costs for each functional group within the Service Company. Charges for salaries are to be based on time records, computed on the basis of employee labor costs plus fringe benefits, indirect labor costs, and payroll taxes. Indirect costs for each functional group are to be directly assigned when identifiable to a particular activity, process, project, responsibility center, or work order. When not specifically identifiable, the indirect costs of a functional group are to be distributed "in relationship to the directly assigned costs of the Function."

The Service Company should directly assign charges for services that it performed for a single company. Work often applies to two or more companies, a class of companies, or all companies, however. In those cases, the Service Company may allocate the charges among the companies. Appendix A specifies which allocation ratio is used for each Service Company function; the next table lists these ratios.

Service Company Allocation Ratios

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

Appendix A provides a brief definition for each of these allocation ratios. The Appendix also defines a general allocator; *i.e.*, the "three-factor formula" ratio. This allocator is the weighted average of three other defined ratios; *i.e.*, the gross margin ratio, labor dollars ratio, and plant, property, and equipment (PP&E) ratio. The Service Company Agreement defines gross margin as revenues as defined by Generally Accepted Accounting Principles (GAAP), less cost of sales, including but not limited to fuel, purchased power, emission allowances, and other cost of sales.

The Service Company Agreement obligates the Service Company to render to each client company served a monthly statement containing the billing information necessary to identify the costs charged for that month. The client company must remit all charges to the Service Company by the end of the month in which it received the bill.

The agreement requires the Service Company to allow access to its accounts and records, including the computation of allocations, necessary for a state commission or consumer representative to review a utility's operating results. The Service Company received no such requests for such a review during the audit period.

b. Operating Companies Service Agreement

Duke Energy's operating public utilities (DE-Carolinas, DE-Indiana, DE-Kentucky, DE-Ohio, and Miami Power) comprise the parties to the Operating Companies Service Agreement (Operating Agreement). The Operating Agreement authorizes the utility parties to perform services for one another in areas such as engineering and construction, operation and maintenance, installation, equipment testing, generation technical support, environmental, health and safety, and procurement. A utility party may also lend employees to another, provided that such loans do not interfere with the providing utility's business operations or utility responsibilities.

The parties should perform services in accordance with formal Service Requests. Utilities must directly charge for all provided services at fully embedded cost, which includes direct costs, indirect costs, and costs of capital.

The Operating Agreement obligates the service provider to render to each client company a monthly statement reflecting the billing information necessary to identify the costs charged for that month. The client company must remit all charges to the provider by the end of the month in which it received the bill.

The agreement contains language regarding amendments, termination, liability, and indemnification. It also incorporates by reference "DE-Carolinas Conditions, " which state that for transactions involving DE-Carolinas priced at anything other than fully embedded cost, DE-Kentucky must provide, 30 days prior to entering into the transactions, written notice to the state commission staff and consumer representative explaining the nature and benefits of the proposed transaction.

c. Operating Company/Non-utility Companies Service Agreement

The parties to the Operating Company/Non-utility Companies Service Agreement (Non-utility Agreement) comprise DE-Kentucky, on the one hand, and non-utility affiliates who execute the agreement, on the other hand. The terms of the Non-utility Agreement largely follow those in the agreement among the operating companies. The Non-utility Agreement, however, includes more detailed liability and indemnification language.

Parties must perform service in accordance with formal Service Requests, and pricing must be based on fully embedded costs. DE-Kentucky may perform the same services (*e.g.*, engineering and construction and equipment testing) for a non-utility affiliate as it does for other utilities. Non-utility affiliates may provide services in such areas as information technology (IT) services; monitoring, surveying, inspecting, constructing, locating, and marking of overhead and underground utility facilities; meter reading; materials management; vegetation management; and marketing and customer relations. The parties may also lend employees to one another, provided that such loans do not interfere with the utility's responsibilities or business operations.

The Non-utility Agreement obligates the service provider to render to each client company a monthly statement reflecting the billing information necessary to identify the costs charged for that month. The client company must remit all charges to the provider by the end of the month in which it received the bill.

2. Commission Reporting Requirements

Liberty reviewed the DE-Kentucky annual reporting requirements for affiliate transactions in general and transactions under the five merger-related agreements covered by this audit in particular.

Title 807 of the Kentucky Administrative Regulations sets forth the requirements for the Annual Report that DE-Kentucky must file with the KyPSC. The report contains, among other things, a description of incidental and non-regulated activities of DE-Kentucky, a list of non-regulated affiliates and a brief description of their activities, and copies of service agreements. It also contains a description of any changes to the Cost Allocation Manual and an updated manual as appropriate.

Kentucky Revised Statute (KRS) 278.2205 specifies that any utility engaging in a non-regulated activity whose revenue exceeds the amount provided for incidental non-regulated activities under KRS 278.2203(4)(a) must develop and maintain a Cost Allocation Manual. By this statute, the Cost Allocation Manual must include the following:

- A list of regulated and non-regulated divisions within the utility

- A list of all regulated and non-regulated affiliates to which the utility provides services or products and where the affiliates provide non-regulated activities
- A list of the services and products provided by the utility, an identification of each as regulated or non-regulated, and the cost allocation method generally applicable to each category
- A list of incidental, non-regulated activities subject to the statute provisions
- A description of the nature of transactions between the utility and the affiliate
- For each Uniform System of Accounts (USoA) account and sub-account, a report that identifies:
    - o Whether the account contains costs attributable to regulated operations and non-regulated operations
    - o Whether the costs are joint costs that cannot be directly identified
    - o A description of the method used to apportion each of these costs.

The statute requires the Cost Allocation Manual to be updated within sixty days of a material change. DE-Kentucky, in addition to this updating requirement, reviews its CAM and voluntarily provides a CAM update as part of its Annual Report. Overall responsibility for filing the Cost Allocation Manual lies with the Legal Group; however, various departments are responsible for maintaining and providing information, including:

- The Corporate Secretary: maintains the list of regulated and non-regulated affiliates
- The Products and Services Department: tracks services offered by DE-Kentucky in the service territory
- The Accounting Department: tracks affiliate transactions and incidental non-regulated activities
- The Legal Group/Corporate Secretary: maintain copies of affiliate service agreements
- The Rate Department: tracks USoA accounts.

Under KRS 278.2205, DE-Kentucky is not required to quantify and report its annual affiliate transactions. However, for informational purposes, DE-Kentucky includes as an attachment in its Cost Allocation Manual a summary level listing of "products and services provided by DE-Kentucky for its affiliates, and services provided by the affiliates to DE-Kentucky," excluding those with the Service Company. The listing groups the products and services in relatively broad categories for which it provides total dollar amounts. The following table summarizes that listing.

[redacted]	
[redacted]	
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

[redacted]	[redacted]
[redacted]	
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

The Cost Allocation Manual listing does not indicate which products and services relate specifically to the Operating Agreement and to the Non-utility Agreement. The largest volume of transactions involves services provided by DE-Ohio to DE-Kentucky, a large portion of which is governed by other agreements. Accounting personnel estimated that approximately $18 million of the $62 million of services provided by DE-Ohio related to agreements other than the Operating and Non-utility Agreements. DE-Kentucky receives certain products and services from DE-Ohio related to the transfer of Miami Fort Unit 6 and the Woodsdale and East Bend generation stations. For example, the Facilities Operating Agreement allows DE-Kentucky to use certain equipment owned and operated by DE-Ohio necessary to provide service. This equipment includes certain step-up transformer banks at the three generating stations. The Miami Fort 6 Operating Agreement requires DE-Ohio to operate Unit 6 on DE-Kentucky's behalf, and to provide materials, fuel, equipment, and services as needed.

Accounting personnel use data on inter-company charges, along with selected inter-company sub-ledger account data, to prepare the summary level listing of affiliate transactions. Liberty's testing work found that the dollar amounts include charges that are not truly affiliate transactions, such as inventory transfers or invoices paid on behalf of an affiliate. Accounting personnel include sub-ledger charges that it believes relate to affiliate transactions (such as transmission revenues), but the process for identifying such charges is not exhaustive. Liberty therefore observed that the listing includes some amounts that it should not, and may miss others.

C. Conclusions

1. The three merger-related service agreements contain sufficiently comprehensive and appropriate terms and conditions to provide baselines for measuring compliance effectiveness and to prevent inappropriate cross-subsidization.

The three merger-related service agreements provide information adequate to describe the relationships between the parties, the nature of the services provided, and the method of charging for services. The contract provisions that price corporate and utility-related services at fully embedded cost are reasonable, and consistent with practice within the industry. Such pricing provisions, if implemented appropriately, provide adequate protections against cross-subsidization. The Service Company Agreement also makes clear the preference for direct charging over less direct allocation methods. The use of direct charging should help to minimize the opportunities for one affiliate to subsidize another through the charges it pays for individual corporate services.

2. DE-Kentucky is not required to report to the Commission the quantity and dollar value of transactions under the merger-related agreements.

DE-Kentucky operates under general reporting requirements related to affiliate relationships, but is not required to identify and quantify its affiliate transactions in general and its transactions under the merger-related agreements in particular.

D. Recommendations

Liberty has no recommendations regarding the service agreements or reporting requirements.

III. Accounting Systems and Processes

A. Introduction

This chapter provides an overview of the accounting systems used to record affiliate transactions under the three merger-related service agreements. Liberty also discusses the company's approach to time reporting, payroll, and the calculation of labor charges.

The former Cinergy organization and former Duke Power organization had separate accounting systems during the audit period. This separation required common accounting procedures and programming to allow financial data to flow between the systems in a comprehensive, accurate, and reliable fashion. It was also important that the systems treat similarly the material components of fully allocated costs, which include labor expenses and labor loaders such as payroll taxes, fringe benefits, unproductive time, and incentives.

The methods for determining costs directly charged or allocated among affiliates under the three merger-related service agreements needed to be well defined and understood by relevant personnel. This chapter discusses Liberty's review of available documentation in this area, and addresses compliance with contract billing requirements.

B. Findings

1. Accounting Systems

The Business Data Management System (BDMS) operates as Cinergy's legacy accounting system. BDMS functions as the general ledger. Various feeder applications include accounts payable, fixed assets, transportation, and work management applications, plus a journal entry tool. These applications post to BDMS throughout the month. The BDMS system processes charges to and from DESS, DE-Kentucky, and other legacy Cinergy affiliates.

The Financial Management Information System (FMIS) operates as the legacy Duke Power accounting system. FMIS is a PeopleSoft system with general ledger, accounts receivable, accounts payable, asset management, project costing, contract, and billing applications. The FMIS system processes charges to and from DEBS, DE-Carolinas, and other legacy Duke Power affiliates.

Each legacy system has its own general ledger and account numbering approach. The parent uses Hyperion Financial Management (HFM) to report consolidated financial results. Data from the legacy Cinergy BDMS general ledger and the legacy Duke FMIS general ledger flow to a Finance Information Hub, which Duke Energy uses to generate certain financial reports. The corporation converted the entire company to PeopleSoft effective July 2008.

Each legacy system has its own terminology and method of operation, and each uses a code block (BDMS) or chart field (FMIS) that comprises a set of elements that classify financial information. The code block/chart field contains multiple elements that describe five aspects of a financial transaction:

- When: defines the timing of the work performed

- Who: identifies who performed the work on whose behalf
- What: defines the nature of the work performed
- How: defines the resource(s) used to perform the work
- Where: identifies the location(s) the work was performed or performed for.

The corporate organization consists of thousands of responsibility centers (RCs), which roll up into other higher level responsibility centers based on reporting responsibility. FMIS records an accounting entry for a direct charge transaction by designating: (a) an RC code representing the work group performing the service, and (b) an operating unit (OU) code representing the group for which the work was performed. The OU code can be specific or not; for example, it can designate a particular plant or just fossil/hydro plants in general. The business unit receiving the charge designates the OU code to which the amount should be charged. The accounting entry also includes an account/process/project number, resource type (*e.g.*, labor, materials, outside contractor), and amount; the FERC account number is usually embedded in the accounting code block numbering. For allocated charges, the OU code represents an allocation pool, such as governance or enterprise accounting. The FMIS system processes allocation pools at month-end, distributing the charges according to the appropriate allocation pool percentages.

Transactions that BDMS captures produce an accounting entry that typically includes a responsibility center similar to an RC code, a line of business (LOB) code that is similar to an OU code, resource type, account/work code, amount, and corporate/business unit designation. The LOB indicates whether the amount is to be directly charged or allocated. BDMS creates journal entries each time it records an event, *e.g.*, when it processes accounts payable, inventory, or payroll. For pool-type charges, BDMS charges the amount to an allocable LOB, and the BDMS system creates separate entries that automatically distribute the charge using the same percentages that FMIS uses to process the particular allocation pool. There exist therefore huge volumes of journal entries on the BDMS side, because, unlike FMIS, it does not accumulate charges in a pool and then allocate the pool at month-end. Instead, BDMS allocates them as they are incurred.

Prior to the merger (in the September to October 2005 timeframe), the companies started developing a method for putting together an ETL (extract, translate, and load) interface for the BDMS and FMIS systems. The purpose of the ETL is to translate data from FMIS to BDMS and from BDMS to FMIS. The ETL procedures translate one or more account numbers in one system into the corresponding account number in the other system. The companies were in the design-and-build stage through December 2005, and conducted eight to twelve weeks of system testing, beginning in January 2006. The companies started using the ETL logic to transfer actual data for April 2006.

The system executes the ETL logic daily. The ETL programs essentially comprise an account mapping logic. Teams from both the legacy Duke Power and Cinergy organizations worked together to establish the mapping structure and set up known, defined translations. There is not a one-to-one match between the account numbers in BDMS and those in FMIS. For example, BDMS may have ten separate accounts that all map to one account number on the FMIS side. In another case, FMIS may have an account number with no match on the BDMS side. In this last case, accounting personnel must create a new account number in BDMS. In the case of a new project or work order that is not already defined in the translation tables, the parties complete a form to set up specific accounting for both sides. Accounting chart fields include the Cinergy LOB, the Duke Power operating unit, and Cinergy and Duke Power RC codes, the Cinergy and Duke Power account numbers, the Cinergy work code, and the Duke Power project number.

Liberty asked for a description of any audits performed by either internal or external auditors of the ETL logic that the accounting systems use to transfer and translate accounting and transaction data. The internal auditing group performed an April and May 2006 integrated financial and IT audit of the processes and controls for translating accounting information between the FMIS and BDMS systems. The purpose of the audit was to evaluate the design and implementation of the detailed translation tables and the controls over financial data mapping. The audit also evaluated the IT infrastructure that supports these processes. The scope of the audit was sufficiently broad. Some of the topics of the audit included reviews of:

- Set-up phase of financial mapping
- Controls and processes for handling exceptions
- New project/activity set-up
- Translation table change process
- ETL access controls, change management, and version controls
- IT infrastructure associated with ETL
- Data processing, error management, backup, and recovery
- End user support.

There have been no subsequent audits of the ETL. Liberty did not perform any independent testing of the ETL logic.

2. Time Reporting, Payroll, and Labor Charges

Payrolls for the legacy Cinergy organization and the legacy Duke Power organization are processed separately. Legacy Cinergy's payroll was processed in house; Hewitt began processing legacy Cinergy payroll in January 2008. Non-exempt personnel are paid either on a weekly or bi-weekly basis. Generally such employees must submit a time sheet in order to get paid. Exempt employees are paid on a semi-monthly basis; they submit time sheets each pay period to record exceptions and additional pay.

Hewitt Associates processes payroll for the legacy Duke Power companies. Non-exempt personnel are paid on a bi-weekly basis; these employees must submit a time sheet in order to get paid. Exempt employees are paid on a monthly basis; some of them submit time monthly to record exceptions to their fixed labor distributions.

Legacy Cinergy uses the Labor Data Capture System (LDCS) as its time reporting tool. An LDCS manual provides general guidelines for reporting exception and non-exception time, and provides instructions about the on-line time reporting system. Employees submit time sheets weekly, or, if labor documents are system-generated, sign copies of the exception labor documents that are kept on file. Legacy Duke Power uses Workbrain as a time reporting tool. All bi-weekly time must be authorized either electronically or manually. Regardless of method, each Duke Energy employee is responsible for reporting time to a timekeeper, consistent with corporate policy and business unit requirements.

Overall, the Service Company has no formal written guidelines for where an employee should charge time, *i.e.*, direct charging or charging time into specific utility-, enterprise-, or governance-level allocation pools. The IT department, however, does maintain a brief document that provides assistance to its employees in determining which of the five main types of IT allocation pools (*e.g.*, mainframe services, PC support) cover specific work activities. When an employee performs work for affiliates, the business unit(s) requesting the charge indicates how and where the employee should charge time, *i.e.*, as direct charges to specific OU codes or into specific allocation pools. Charges from the same employee for the same type of service can therefore be handled in different ways in different circumstances.

Both legacy organizations set up a fixed salary distribution for each exempt employee. The fixed distribution can consist of any combination of business units or allocation pools. Some exempt employees use time sheets to record time charges to entities other than those on the fixed labor distribution, as well as to record any unproductive paid hours such as holidays, vacations, and sick days. In some cases, the companies also set up non-exempt or union employees with fixed labor distributions.

The Cinergy time reporting system, LDCS, distributes the labor, which is then posted to BDMS. The legacy Duke Power organization outsources its payroll to a provider that uses a PeopleSoft system to process payroll. The vendor provides summary-level information to the Duke Power Labor Distribution System (LDS), which sends the information on to FMIS. Both payroll systems maintain detailed information, which can be used by business units to trace data back to the individual employee level if needed.

The FMIS accounting system automatically applies labor loaders for fringe benefits, payroll taxes, unproductive time, and incentives. Accounting personnel enter into FMIS the percentage for each labor loader item each month. These rates typically remain constant for most of the year. Accounting personnel record actual costs for these four labor-related costs in separate accounts that they monitor to make sure that the rates it has been applying are staying in line with actual costs. Accounting personnel typically adjust loader rates in the fourth quarter to clear any residuals compared to actual costs.

For DE-Carolinas, the fringe benefit and payroll tax percentages are consistent, but the incentives and unproductive time percentages may differ by department. The percentages for unproductive time are consistent, however, across all employees in a given department and function. In some cases, a department may decide that it wants to apply to labor the costs associated with actual unproductive time in lieu of using a specific fixed rate, in which case the rate applied to labor charges for unproductive labor will fluctuate each month.

Accounting executes a separate procedure to true up exempt labor charges to actual time sheet data.[1] For example, assume that an employee's default labor distribution is 50 percent to entity A and 50 percent to entity B. Assume further that the total number of hours in a particular month is 160. After payroll has been processed, LDS creates journal entries to record the fully-loaded labor dollar amounts associated with 80 hours to both entities A and B. If the employee actually worked 10 hours for entity C during the pay period, and reports it on an exception time sheet, then LDS during the true-up process creates additional journal entries. The system will book the dollar amount associated with the 10 hours to entity C, and credit both entities A and B with the dollar amounts associated with five hours each. The system uses the default distribution to determine how to assign the credits. If in this example the employee actually worked the 10 hours for entity C in lieu of 10 hours for entity A, the employee would have to submit a more detailed exception time sheet to specify work of 70 hours for entity A, 80 hours for entity B, and 10 hours for entity C in order for FMIS to create the correct journal entries. Some employees find that they must submit an exception report every month because their labor distributions are so variable.

After the legacy Cinergy organization processes payroll, BDMS creates journal entries to record labor charges. BDMS applies to labor charges pre-determined loader rates for fringe benefits, payroll taxes, and unproductive time. The BDMS loader rates differ from those used in FMIS. Fringe benefit rates for the legacy Cinergy organization, for example, are significantly higher than those of the legacy Duke Power organization. Accounting personnel perform annual studies during the budgeting process to calculate the applicable loading rates for payroll taxes, unproductive labor, and fringe benefits.

Accounting monitors how closely the rates that BDMS applies for benefits, payroll taxes, and unproductive time follow actual costs during the year. Accounting personnel typically perform a true-up at year-end, using journal entries to make corrections. Accounting spreads correcting entries to business entities based on their share of direct and allocated labor costs. However, accounting personnel record any correcting entries at a high level, and as such the corrections are not traceable to specific transactions. The Cinergy organization does not allow its departments the option of using actual unproductive time in a given month versus a flat rate, as does DE-Carolinas, because BDMS cannot accommodate this approach.

Throughout 2007, the accounting group began making monthly entries to record incentives. Accounting records incentives at a high level; incentives are not directly associated with individual labor charges, and may even flow from a different responsibility center than labor. With the conversion of BDMS to PeopleSoft in July 2008, incentives are now loaded on individual labor charges.

On the legacy Cinergy side, there is no set rule for when it processes exception time reports. In some cases, an exception time report may get processed during the payroll process as actual time, depending upon when it was submitted in relation to when the payroll is processed. In other cases, the system processes exception time sheets after regular payroll has been run. Some groups require their employees to complete time sheets every week.

[1] No true-up is needed for non-exempt and union employees that submit time sheets with actual labor distributions.

During the prior audit of DE-Carolinas, Liberty reviewed examples of FMIS and BDMS exempt and non-exempt labor charge calculations. The personnel provided printouts from the time sheet reporting systems, showing default labor distributions, base salaries, and actual hours worked, and supporting time sheets. They also demonstrated how each system calculated hourly labor charges, as well as how it calculated the amounts for fringe benefits, taxes, unproductive time, and, in the case of DE-Carolinas, incentives. Liberty concluded that the processes for calculating labor charges were reliable. Liberty reviewed several additional examples during this audit and was satisfied that the process remained reliable.

DE-Carolinas has a cost allocation manual that contains guidelines for transactions between it and affiliates. The manual states that overtime worked by non-exempt employees should first be applied to work performed for affiliates, unless there is a documented reason not to do so. There is no official corporate policy to that affect, however. The treatment of overtime by DE-Kentucky and DE-Carolinas differs, in part driven by how each legacy utility calculates the labor charges in overtime situations.

BDMS calculates direct labor charges by using an average hourly rate method. FMIS, on the other hand, prices overtime and regular time hours separately. A simple example involving 80 hours of regular time and eight hours of overtime illustrates the result of this difference. The following table summarizes how each system would price labor, assuming a regular time hourly rate of $20 and an overtime rate of $30.

	FMIS	**BDMS**[2]
Regular hourly rate	$20.00	$20.91
Overtime hourly rate	$30.00	$20.91

FMIS would charge $30 per hour, or $240.00, in base labor costs to the affiliate for eight hours of work. This result conforms to DE-Carolina's policy of charging overtime by utility employees to affiliates. BDMS would charge $20.91 per hour, or $167.28. BDMS does not charge affiliates the full cost associated with the overtime. Instead, it spreads the cost of overtime over all hours worked. As a result, any overtime is averaged out so that it is spread across all work activities performed (and entities supported) by the employee during the pay period. During 2007, if a Cinergy utility employee worked regular hours for his or her home organization and overtime for an affiliate, the utility would subsidize the cost of overtime. If a DE-Carolinas utility employee worked regular hours at his or her home organization and overtime hours for an affiliate, the utility would not subsidize the cost of overtime. Accounting indicated that it ceased calculating overtime in BDMS this way beginning in 2008. BDMS now calculates separate regular and overtime rates, and charges the overtime rate to the business unit responsible for the overtime.

Labor rates for legacy exempt Duke Power employees are calculated by taking the monthly salary divided by 173.33 hours. On the FMIS side, the hourly rates remain constant over the year. Employees do not charge overtime, but normalize hours worked to represent the standard hours per pay period. The labor rates for legacy exempt Cinergy employees will fluctuate, because BDMS calculates an average hourly rate using semi-monthly salary divided by actual

[2] Derived by adding 80 hours @ $20 per hour and 8 hours @ $30 per hour, and dividing the total by 88.

hours charged, which would include overtime. The BDMS and FMIS approaches differ in how they calculate hourly rates for exempt employees; nevertheless, they should yield the same charges for time worked. The BDMS hourly rate will be lower, but the number of hours charged will be higher than would be the case under FMIS, because BDMS has not normalized hours worked to represent standard hours per pay period.

The process for calculating exempt labor rates changed beginning in January 2008. BDMS no longer calculates an average rate; it calculates rates in the same fashion as FMIS. The rates for all exempt employees are now calculated on a semi-monthly basis that uses 86.66 hours.

The BDMS and FMIS systems handle overtime by non-exempt Service Company employees in the same way that they handle overtime by utility employees. During 2007, overtime hours worked by DEBS non-exempt employees were charged at overtime rates; overtime hours worked by DESS non-exempt employees were charged at an average hourly rate.

Both accounting systems have the ability to track fully loaded labor charges. FMIS can track these charges down to the individual transaction level, because it fully loads individual labor charges to business units. BDMS can track loaded labor charges to the individual transaction level, but it cannot capture the actual incentive portion of these charges to the individual transaction level.

3. Billing

The Service Company Agreement, Operating Agreement, and Non-utility Agreement all require the service provider to render a monthly statement to each client company reflecting "the billing information necessary to identify the costs charged for that month." None of these agreements defines the informational requirements more fully. The agreements also state that the client company must remit all charges to the provider by the end of the month in which it receives the bill.

The Service Company does not issue inter-company bills or invoices for affiliate transactions. Business units can run system queries to view the charges allocated to them, but the Service Company provides no routine reports to the business units. Service Company monthly reports for the Treasury Group detail outstanding inter-company balances related to its services for the prior month. Charges between DESS and Midwest affiliates are settled monthly. There was no routine settlement for inter-company charges involving DEBS through the end of 2007 and the corporation did not move cash among companies on a monthly basis. Beginning in 2008, DEBS settled accounts payable charges with DE-Carolinas several times a month. Service Company governance charges to utilities are settled periodically at Treasury's discretion.

Affiliates other than the Service Company also do not issue inter-company bills or invoices. The Service Company provides monthly reports to the Treasury Group on outstanding inter-company balances involving these affiliates. The Treasury Group monitors the inter-company positions, and periodically settles the balances at its discretion or when the balances are outside certain parameters.

4. Documentation of Affiliate Transaction Accounting Methods

Corporations generally maintain documentation of their accounting, financial reporting, and related controls and policies; however, they are sometimes written at a relatively high level, and typically do not provide thorough guidance on how to process individual affiliate transactions. Affiliate transaction documentation should be sufficient to establish clear rules for pricing all services, should provide for clear and consistent methods for price determinations, and should be in accordance with requirements established by regulatory standards.

During the prior audit of DE-Carolinas, Liberty reviewed with accounting personnel the corporation's on-line documentation of accounting, financial reporting, and related controls and policies. Liberty found that internal controls and financial controls policies were written at a very high level. The corporation's written policy regarding accounting for affiliate transactions consisted of a few general statements, specifically: (a) all inter-company transactions will be recorded, (b) inter-company account balances will be reconciled, and (c) discrepancies will be resolved. The documentation set out roles and responsibilities in general terms, but provided no real detail on how to process individual affiliate transactions.

Utility corporations with a service company typically maintain a formal accounting manual that expresses the definitive statement of a company's policies and procedures on distributing costs among subsidiaries, provides a reference on the subject for employees, and serves as a repository of information as to why particular kinds of costs are distributed in specific ways. Liberty normally reviews a company's manual to determine if it is reasonably complete, and whether it would provide sufficient guidance in pricing services. In particular, the company's methods for directly charging, directly assigning, or allocating charges should be clear and adequately documented.

DE-Kentucky's affiliate utility DE-Carolinas maintains such a manual, which provides a description of the treatment of Service Company costs and defines "fully distributed cost." It also sets forth a priority for how Service Company costs should be distributed to business units, in decreasing order of preference:

- Direct charged to the extent possible
- Distributed to the applicable business units using specific percentages if known
- Allocated to the business units receiving the benefit using reasonable allocation methods.

The DE-Carolinas manual contains a listing of the allocation percentages used to distribute Service Company governance-, enterprise-, and utility-level pools during the audit period. It also contains guidelines for affiliate transactions other than those involving the Service Company, including cost allocation, overhead, and transfer pricing rules. Liberty was able to use the DE-Carolinas manual as a reference document regarding Service Company charges. DE-Kentucky is not required by the KyPSC to have a similar affiliate transaction accounting manual and does not have one.

5. Internal Audits

Company internal audits offer an opportunity to evaluate how effectively the corporation controls its affiliate transaction procedures and policies. Liberty requested copies of reports of audits conducted by Duke Energy's internal audit group during 2007 that addressed: (1) Service Company allocations, (2) services provided between DE-Kentucky and its utility affiliates, or (3) services provided between DE-Kentucky and its non-utility affiliates.

Internal auditing provided a May 18, 2007 report titled "U.S. Franchised Electric & Gas (FE&G) State Affiliate Code of Conduct (Kentucky) Audit." The audit reviewed compliance with Kentucky law related to transactions between DE-Kentucky and non-Service Company affiliates during 2006.

The internal audit group found that the roles and responsibilities for producing the annual Cost Allocation Manual portion of the Annual Report filing were not clearly defined, and recommended that DE-Kentucky find ways to improve by July 2007 the process for pulling together the information needed for the report. DE-Kentucky implemented a new process for the purposes of generating the 2007 report.

The corporation maintains a Service Request Database that keeps track of Service Request Forms. These forms are used to formalize the affiliate transaction approval and accounting processes. In 2007, the utility affiliates were not consistently using the forms. The internal audit report indicated that the process to monitor affiliate transactions was not fully defined. Specifically, responsibilities and procedures were not clear regarding: (1) verifying that direct charges had been authorized, and (2) verifying that services were priced at fully embedded cost. The report noted that DE-Kentucky rates, accounting, and similar groups would meet to discuss the procedures for ensuring that proper pricing was put in place, including the DE-Carolinas requirement for asymmetrical pricing. It also noted that regulatory accounting would develop a process and documentation, which would include confirming that transactions were authorized, and that these would be in place by the end of 2007. The latest version of this documentation, dated March 2008, sets forth a process for a review performed at least quarterly of Service Request Forms and affiliate transactions that includes:

- Confirming that a Service Request Form is in place, and if not, creating one
- Verifying that accounting information, such as responsibility center, is correct
- Reviewing charges above a given dollar threshold level, and spot checking others
- Confirming that pricing is consistent with the service agreements, affiliate guidelines, and codes of conduct, including DE-Carolinas asymmetrical pricing requirements
- Tracking charges to Service Request Forms and investigating charges not tied to a specific Service Request Form.

The sporadic use of Service Request Forms created a problem for DE-Kentucky, which uses the Service Request Database as the basis for generating the list of transactions it voluntarily includes in its Cost Allocation Manual filing. The audit group found that certain affiliate transactions had been recorded manually in the general ledger via journal entries, and had not undergone the formal Service Request Form process. Internal audit stated that, even if someone recorded an affiliate transaction directly in the general ledger, he or she still had to get formal approval before making the journal entries. The accounting system did not prevent the use of manual journal entries to record affiliate transactions, but the accounting group used training to educate personnel not to use this approach in the future.

The internal report also indicated that training programs were needed to educate personnel in how to charge time directly assignable to a utility or non-utility company, and that this finding applied to both utility personnel and Service Company personnel. The report indicated that a training program would be developed by year-end 2007. Liberty inquired about the current status of this effort. Accounting personnel indicated that, while a training plan and schedule had been developed by the end of 2007, development of the training program was suspending pending resolution of a system for time reporting. The delay was intended to allow the company to incorporate the conversion from BDMS to FMIS into the training program for legacy Cinergy employees.

The report also noted that billing statements were not being produced for affiliate transactions as required by the service agreements. It stated that management deemed appropriate the process by which the Treasury group managed inter-company balances. Liberty discussed this issue in a previous section of this chapter.

C. Conclusions

1. The legacy Duke organization and the legacy Cinergy organization maintain separate accounting systems, which complicates recordkeeping for affiliate transactions.

Both the FMIS and BDMS accounting systems have their own unique terminology and methods of operation. The organizations have put into place an ETL interface, which is essentially account number mapping logic, to translate data from FMIS to BDMS and from BDMS to FMIS. The ETL interface aggregates data. As a result, some of the transaction detail in BDMS does not carry over to the FMIS system, which the corporation uses to report consolidated financial results. The FMIS and BDMS systems also do not perform the accounting associated with affiliate transactions in the same way. For example, FMIS has the ability to accumulate charges into a particular cost pool and allocate the pool to business units at month's end. The BDMS system cannot accommodate cost pools and must distribute each pool-type cost as it is recorded. The system creates separate accounting entries to distribute the charge to business units in the same percentages that FMIS uses to process the corresponding allocation pool.

The corporation moved to one accounting system in July 2008, which should eliminate these complications.

2. The legacy Duke and Cinergy organizations process payroll separately and apply labor loaders in different but not inconsistent ways.

Both companies process their payrolls similarly, generally setting up default labor distributions and performing true-ups to actual time sheet data as needed. The methods by which the FMIS and BDMS systems record data after the payroll process are different, however. The FMIS system automatically applies to labor costs specific loader rates for payroll taxes, fringe benefits, and incentives; it also typically applies an unproductive time loader, although departments have the option to use actual costs rather than a set rate. Accounting personnel monitor the difference between the loader rates and actual costs, and adjust the rates as needed to eliminate any differences.

The BDMS system automatically applies to labor costs specific loader rates for payroll taxes, fringe benefits, and unproductive time. Departments do not have the option to use actual costs for unproductive time. Accounting monitors the difference between the loader rates and actual costs; it does not modify the rates but instead uses high level journal entries to routinely record adjustments. BDMS does not apply an incentive loader; accounting personnel use high level journal entries to record them.

Both companies apply the appropriate loaders to labor costs. However, Cinergy cannot trace fully loaded labor charges to the individual affiliate transaction level, as FMIS can, because it uses high level journal entries to record incentives and to record true-up adjustments. Company plans to consolidate payroll processing and accounting systems in 2008 would eliminate these differences.

3. **Labor directly charged to affiliates by legacy Cinergy companies, including DE-Kentucky, does not reflect fully embedded cost.**

BDMS does not use a specific labor loader for incentives, which are instead recorded by journal entry at a high level. As a result, labor directly charged from DE-Kentucky does not contain a cost component for incentives, which results in charges at less than fully distributed cost. Company plans to consolidate payroll processing and accounting systems in 2008 will eliminate this problem.

4. **The legacy Duke and Cinergy organizations calculated the hourly labor rates differently for employees working overtime in a given pay period.**

The FMIS and BDMS systems derive hourly labor charges for non-exempt or union labor differently for cases in which overtime is involved. BDMS derives one average hourly rate for both regular and overtime worked. FMIS derives two different rates, one for regular time and a higher one for overtime. During the audit period, BDMS charged an average rate for both regular and overtime hours, which means that overtime work is partially subsidized by regular work. The approach to pricing overtime should be the same across the organizations. The legacy Cinergy organization ceased calculating overtime in this fashion beginning in 2008, and now calculates separate regular and overtime rates, which corrects the problem.

It is not clear, however, that the policy regarding the entity to which overtime should be charged is the same for the legacy Duke Power and legacy Cinergy organizations. DE-Carolina's policy is that overtime worked by non-exempt employees should first be applied to work performed for affiliates, unless there is a documented reason not to do so. Its calculation and application of separate overtime rates is consistent with the policy. The current policy for DE-Kentucky is to charge overtime hours worked during a pay period to the business unit causing the need for overtime. The application of these two policies may or may not yield the same results in similar circumstances. The applicable method should be consistent across the corporation and it should be formally documented.

5. **Affiliates do not follow the procedures set out in the Service Agreements regarding monthly bills and payments.** *(Recommendation #1)*

The Service Company Agreement, Operating Agreement, and Non-utility Agreement all require that the service provider render a monthly statement to each client company reflecting the billing information necessary to identify the costs charged for that month. A client company must remit all charges to the provider by the end of the month in which it received the bill.

The corporation conducted no routine settlements for inter-company charges under the Operating Agreement and Non-utility Agreement. The Treasury Group monitors the inter-company positions and settles balances periodically at its discretion or when balances are outside certain parameters.

Charges between DESS and Midwest affiliates under the Service Company Agreement are settled monthly. Through the end of 2007, there was no routine settlement for inter-company charges under the Service Company Agreement involving DEBS, and the corporation did not move cash among companies on a monthly basis.

6. DE-Kentucky does not maintain a formal affiliate transaction accounting manual. *(Recommendation #2)*

Liberty considers it to be best practice for any utility with a service company, or with service agreements among utility and non-utility affiliates, to maintain a formal affiliate transaction accounting manual. Such a manual should provide a general description of Service Company functions and definitions of the allocation ratios used to distribute costs not otherwise directly charged or assigned, and should list the allocation percentages for each functional cost allocation pool. The manual should provide guidelines for transactions involving the utility to assist employees in implementing the accounting requirements regarding affiliate transactions. It should also describe the appropriate method to derive Service Company direct charge rates and to derive direct billing rates that reflect fully distributed cost for charges between utility and non-utility affiliates.

Best practice for a formal affiliate transaction accounting manual includes more than mere compilations of policies and procedures. Examples of supplemental material that is very useful include copies of memoranda, analyses, and invoices that serve as models, documentation, examples, and instructions on how to distribute costs among affiliated businesses, a meaningful introduction, and an explanation of its contents.

DE-Kentucky does not have a formal affiliate transaction accounting manual as described by Liberty. Its affiliate, DE-Carolinas, does have such a manual; it provides a description of the treatment of Service Company costs, defines "fully distributed cost," and sets forth a priority for how Service Company costs should be distributed to business units. The DE-Carolinas manual also contains guidelines for affiliate transactions other than those involving the Service Company, including cost allocation and transfer pricing rules.

7. Major recommendations of an internal audit report identifying shortcomings in the affiliate transaction approval and accounting process have been implemented, but the provision of training has been unduly delayed. *(Recommendation #3)*

The internal auditing group reported that utility affiliates were not consistently using Service Request Forms, which the company uses to formalize the affiliate transaction approval and accounting process under the Operating Agreement and Non-utility Agreement. The internal audit report indicates that responsibilities and procedures to verify that charges have been authorized, and that services are priced at fully embedded cost, are not clear. Regulatory accounting intended to develop a process and documentation to address these issues by the end of 2007. Liberty reviewed the latest version of this documentation, dated March 2008, and found it adequate.

Internal auditing found that certain affiliate transactions had been recorded manually in the general ledger via journal entries, and had not undergone the formal Service Request Form process, although accounting personnel did secure proper approvals before making the entries. BDMS does not block the use of manual journal entries to record affiliate transactions, but the accounting group used training to educate personnel not to use this approach in the future.

The internal audit group found that the roles and responsibilities for producing the annual Cost Allocation Manual portion of the Annual Report filing were not clearly defined, and DE-Kentucky subsequently implemented a new process for generating the 2007 report.

The internal report indicated that training programs were needed to educate utility and Service Company personnel in how to charge time directly assignable to a utility or non-utility company, and that such a training program would be developed by year-end 2007. The company developed a training plan and schedule, but suspended development of an actual training program, ostensibly because it had not yet decided upon a system for time reporting.

The report also states that management deemed the process whereby the Treasury group manages inter-company balances as appropriate to settle affiliate transactions. Liberty discusses this issue in a separate conclusion.

D. Recommendations

1. Conform billing and settlement procedures to the language of the Service Agreements. *(Conclusion #5)*

Liberty disagrees with management's opinion, as reflected in a recent internal audit report, that the Treasury Group's management of inter-company balances as needed is an appropriate method to settle affiliate transactions. Failure to settle inter-company balances in a timely fashion is equivalent to a "free loan" between affiliates. The parties to the Operating Agreement and Non-utility Agreement should render invoices and make settlements monthly.

During the audit period, DEBS did not settle charges monthly; however, starting in 2008 the corporation settles at least monthly both DEBS and DESS charges under the Service Company Agreement. The Service Company still does not render invoices, and the parties should do so or amend the wording in the agreement.

2. Develop and maintain a formal affiliate transaction accounting manual. *(Conclusion #6)*

While DE-Carolinas has a formal cost allocation manual, DE-Kentucky does not. The Midwest conversion to the FMIS accounting system in mid-2008 provides a good opportunity for the

Service Company and utilities to develop a new affiliate transactions accounting manual applicable to all affiliates, including DE-Kentucky.

3. Complete time reporting training for all relevant employees by the end of the year. *(Conclusion #7)*

The corporation's internal audit report indicated that training programs were needed to educate utility and Service Company personnel in how to charge time directly assignable to a utility or non-utility company. The corporation should finalize its choice of a time reporting system, develop an appropriate training program, and complete training of its employees by the end of this year.

IV. Service Company Overview and Cost Allocation Methods

A. Background

The Service Company is composed of two separate entities DEBS (Carolinas) and DESS (Midwest). Charging under the Service Company Agreement, however, essentially treats both DEBS and DESS as one. Duke Energy consolidated the two service companies into one entity as of July 1, 2008. The next table summarizes the direct, allocated, and total charges from DEBS and DESS to individual business units for the year 2007.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

B. Findings

1. Service Company Functions

The next table lists the 23 functions that the Service Company provides.[3]

Service Company Agreement Functions

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

Although not specified in the agreement, the Service Company separately distinguishes many of the business functions it provides into three service levels: governance-level, enterprise-level, and utility-level services. Governance-level service functions generally relate to the highest level activities necessary for an entity to exist and operate as a corporation, such as preparation of financial statements and U.S. Securities and Exchange Commission (SEC) reports. Enterprise-level services typically involve a business function that the Service Company performs for all entities. Utility-level services are those provided only to the operating utilities within the holding company structure. A specific Service Company cost allocation pool applies to each function and service level.

The following table identifies the service levels at which each function may be provided.

Service Company Functions

Function	Service Level		
	Governance	Enterprise	Utility
Information Systems		Y	Y
Finance	Y	Y	Y
Internal Auditing	Y		Y
Executive	Y	Y	Y
Human Resources	Y	Y	Y
Public Affairs	Y	Y	Y
Public Policy	Y		
Investor Relations	Y		
Corporate Development	Y		

[3] The Service Company has defined additional areas such as corporate development and public policy as sub-functions within these functions.

Accounting	Y	Y	Y
Legal	Y		Y
Planning	Y	Y	Y
Transportation	Y	Y	Y
Materials Management		Y	Y
Environmental, Health and Safety	Y	Y	Y
Facilities	Y	Y	Y

Some functions consist only of utility-level services specific to regulated utility companies; the next table lists them.

Utility-Only Functions

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

The Service Company accumulates the costs that it cannot directly charge or assign into various functional cost pools, and then allocates them to the business units. The DE-Carolinas affiliate transaction accounting manual contains a detailed cost distribution chart listing the applicable sub-functions of each Service Company function. For example, the information systems function contains five sub-functions: mainframe support, PC support, server support, communications systems, and management support. The chart also lists the service-level allocation pools for each function and sub-function. The Service Company has separate enterprise-level and utility-level allocation pools for its PC support sub-function, for example. The chart also lists for each pool the percentage of the pool that the Service Company allocates to each major business unit. For example, the human resources function uses separate governance, enterprise, and utility cost pools, of which DE-Kentucky receives 2.11 percent, 2.13 percent, and 2.42 percent, respectively. As noted earlier, DE-Kentucky does not have an affiliate transaction accounting manual, and Liberty used the allocation percentages shown in the DE-Carolinas manual for this audit.

The 2007 DE-Carolinas manual lists 75 separate functional cost allocation pools, although the Service Company does not necessarily use them all. There remain, however, about 50 additional allocation pools from before the merger of Cinergy and Duke Power. These additional allocation pools pertain specifically and are only charged to Midwest business units, including DE-Kentucky. The DE-Carolinas manual therefore does not list them. Although it has defined nearly 80 Midwest-only pools, DESS currently uses only 40-50 of them. These pools are a carryover from the legacy Cinergy organization, and reflect the way in which legacy DESS provided services to legacy Cinergy affiliates. Some of these pools pertain only to DE-Ohio and its subsidiary DE-Kentucky, and arise because of the organizational and staffing relationship between the two utilities. DESS has been working to reduce the number of Midwest-only allocation pools since the merger. The Service Company expects that the number will decrease to perhaps 20-25 pools as the legacy Cinergy organization converts its accounting system to FMIS in mid-2008.

Client companies are not required to utilize all Service Company functions. During the annual budget cycle, client companies have an opportunity to review projected costs from the Service Company. They may address any concerns or questions about charges for a particular service function at that time. There is otherwise no process in place to amend, alter, or rescind a service as discussed in Section 1.3 of the agreement.

2. Service Company Organization

DEBS provided traditional corporate support services (*e.g.*, accounting and human resources) to Duke Power and its affiliates prior to the merger. Cinergy's service company (renamed DESS), by contrast, provided a broader range of services. Cinergy centralized many utility support functions, such as engineering and construction, fuels, and power planning, in its service company in order to provide them commonly to its utilities, DE-Indiana, DE-Kentucky, and DE-Ohio. Duke Energy adopted a similar approach with DEBS after the merger, beginning a process of moving to DEBS utility-related functions previously performed in the Duke Power utility organization. It also decided to centralize other functions at DEBS. Those functions include human resources and IT, which had previously been performed on a decentralized basis. These changes required moving to DEBS many utility employees; DE-Carolinas officially transferred approximately 2,000-2,100 employees to DEBS as of January 1, 2007.

The following table indicates the number of employees in DEBS and DESS before and after the merger.

Service Company Employees

	DEBS	DESS
September 2005		
Corporate Governance	619	286
Shared Services	934	2,866
Total	1,553	3,152
March 2007		
Corporate Governance	n/a	161
Shared Services	n/a	2,399
Total	3,449	2,560

The figures for DESS for March 2007 reflect the movement of some corporate departments to DEBS and the acceptance by some DESS employees of early severance and retirement. In addition to the influx of DE-Carolinas employees, the figures for DEBS for 2007 reflect a net movement of approximately 70 employees to Spectra as part of the spin-off of the Duke Energy gas business in January 2007. Accounting personnel stated that this net movement resulted from the transfer of 92 DEBS employees to Spectra, and 21 Spectra employees to DEBS. Liberty asked in its prior audit of DE-Carolinas if and how headcount will be affected when the Service Company stops supporting the gas business. The Service Company indicated that it did not anticipate additional changes when it ceased supporting the gas business. Given the significant level of effort supplied by the Service Company to Duke Energy Field Services (Field Services) and Duke Energy Gas Transmission (DEGT), approximately $130 million in the last half of 2006, it is difficult to understand how Service Company resources would remain effective at the same level and composition.

The Service Company categorizes its employees as either corporate governance or shared service (*i.e.*, enterprise-level and utility-level service) employees. The distinction does not, however, relate to the type of work a given employee can perform. As a general matter, a Service Company employee can charge time into any type of cost pool. The distinction is important in the Service Company's calculation of allocation percentages, and in its calculation of employee non-labor overhead, which Liberty discusses in later sections of this report.

Under the terms of its agreement, the Service Company is required to maintain a suitably trained and experienced staff. Liberty discusses this issue in the next section of this chapter.

3. Training and Experience of Service Company Personnel

Article I, Section 1.4 of the Service Company Utility Service Agreement states: "The Service Company shall maintain a staff trained and experienced in the design, construction, operation, maintenance and management of public utility properties." Liberty used several broad and comprehensive data requests in an attempt to elicit information that would permit the formation of a judgment as to how the Service Company establishes its compliance with this part of the agreement.

Liberty asked for a full description of any significant organization and staffing changes made in 2007 involving the service companies DEBS and DESS or DE-Kentucky, and all studies performed in 2007 about any significant staffing, reorganization, function changes, and resizing involving any department or work group in DE-Kentucky and the service companies. The responses stated that there were no organization changes and no studies. Liberty also asked for business plans or documents describing the work programs of the service companies and their planned expenditures. The response was that there were none. There are reportedly some business plans at the department level.

To reduce the possibility of miscommunication, Liberty rephrased the questions. Liberty also inquired about discrete changes known to have occurred and potentially significant to organization and staff changes; *e.g.*, the transfer of DE-Carolinas employees to DEBS and the spin-off of Spectra. The response stated that no such studies were performed and confirmed that in 2007 none of Duke Energy's service companies or any of their segments prepared business plans or documents with other titles that described the work programs of the service companies or their components.

Company-provided information during Liberty's audit of DE-Carolinas indicated a transfer of about 2,000 employees from DE-Carolinas to DEBS in 2007. The response in this audit that there had been no significant staffing, reorganization, function changes, or resizing thus required reconciliation with the information gained in the North Carolina audit. Liberty asked for clarification of that apparent conflict: the response stated that "only 45 employees transferred between DEBS and the Carolinas." The Company has since reported that about 2,000 employees transferred from DEBS to DE Carolinas in 2006 (but effective in 2007).

Finally, Liberty asked the company to refer to the previous data requests and requested any other documents that show how Duke Energy complied with the requirement of Section 1.4 of the agreement. The response to that request indicated that there were none.

Liberty asked for the budgets and actual spending for all departments of the service companies for 2007. The company was unable to provide that information. It did provide expense budget and actual figures for a subset of the departments that make up the service companies, which were the "corporate center" groups that consisted of the Chief Executive Officer (CEO), chief strategy and policy officer, chief legal officer, and chief administrative officer. The budget and actual figures that the Service Company provided showed that actual spending was 98 percent of budgeted spending, excluding employee and executive benefits and rewards, for which actual spending exceeded the budgeted amount by 21 percent. The budget and actual figures provided excluded those Service Company units forming part of the U.S. Franchised Electric & Gas (FE&G) and non-utility businesses. The information provided to Liberty also excluded the budget and actual information for support provided to Spectra.

Liberty also asked for:

- Policies and procedures on hiring (including minimum experience/education requirements)
- New-hire orientation, continuing education, and training opportunities (both internally- and externally-offered materials/courses)
- Regular employee reviews and evaluations
- A list of Service Company positions filled (whether from internal or external sources) during the audit period
- How to undertake testing of each employee's educational background and past experience
- How the position/department was involved in the hiring decision
- Whether externally-hired employees completed new-hire orientation
- Whether these employees received regular evaluations in accordance with Duke Energy policy and training.

The response came too late to permit the contemplated testing. The response provided procedures for hires into internship and co-op programs and for pre-employment screening. It noted that "training is very diverse," and provided a brief narrative of the role of performance evaluation. The response also included data in spreadsheet format on "workforce activity." This data showed that in 2007 Duke Energy's hiring-activity rate was low. Excluding interns and co-op students, Duke Energy in total (not just the Service Company) in 2007 hired less than 80 employees, about half of whom were customer-service representatives.

4. Service Company Cost Allocation Ratios

The service agreement calls for the Service Company to charge or assign directly as much of its costs as possible. To the extent that it does not, the Service Company collects any residual costs in one of many functional cost allocation pools. A group of six accounting employees manages allocations from these pools for both DEBS and DESS. They have responsibility for calculating the allocation percentages that will apply each year. The group typically reviews allocations monthly to determine if the cost pools have cleared, and examines actual versus budgeted costs.

Accounting personnel review allocation ratios and percentages each year during the budgeting cycle, which typically runs from July to November. The Service Company considers allocation percentages to be final for the year when its budgets are finalized. However, any major organizational change (*e.g.*, resulting from a merger, acquisition, or divestiture) will generate a review of the allocation percentages. An adjustment to the pools affected will be made if the change is material.

Most Service Company functions use more than one cost allocation pool. For example, the finance function has separate governance, enterprise, and utility cost allocation pools. The service agreement calls for the use of one of a set of prescribed allocation ratios to distribute costs for each pool. The next table lists these ratios.

Service Company Allocation Ratios

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

5. Three-Factor Formula Ratio

The Service Company calculates the three-factor formula ratio as the weighted average of three other ratios: the gross margin ratio, labor dollar ratio, and net PP&E ratio. The Service Company has defined the underlying factors of these three ratios:

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

The ratio most frequently used by the Service Company is the three-factor formula ratio. The Service Company uses the three-factor formula ratio to allocate all governance pools, except human resources, and also uses it for a large portion of enterprise and utility functional cost pools. There was a significant change in the governance and enterprise three-factor formula percentages from 2006 to 2007, primarily resulting from the spin-off of Spectra. The next table summarizes the 2006 and 2007 allocations under the three-factor formula for each major business entity. These major business entities include Field Services, DEGT, Crescent

Resources, North American Non-regulated Generation (NANRG), and Duke Energy International.

Three-Factor Formula Percentages[4]

	DEO	DEK	DEI	DEC	NP&L	DEGT	Field	NANRG	Inter'l	Cres	Other
Governance 2006	6.50%	1.52%	11.01%	36.55%		24.94%	3.91%	9.11%	3.50%	2.46%	0.50%
Governance 2007	9.66%	2.81%	16.07%	52.86%	0.69%			11.67%	5.64%		0.60%
Enterprise 2006	8.12%	1.88%	13.71%	45.54%		15.40%		11.29%	0.29%	3.14%	0.63%
Enterprise 2007	10.25%	2.99%	17.09%	56.17%	0.74%			12.46%	0.19%		0.11%
Utility 2006	11.66%	2.76%	19.86%	65.72%							
Utility 2007	11.73%	3.44%	19.66%	64.32%	0.85%						

The Service Company's calculation of the three-factor formula ratio differs depending upon whether the functional cost pool is for governance-, enterprise-, or utility-level service costs. Calculation of the governance three-factor percentages includes both domestic and international assets, labor dollars, and gross margin. The enterprise three-factor formula percentage calculations, however, include only U.S.-based assets, labor, and gross margin. Consequently, the enterprise percentage calculations for 2006 excluded: (a) non-U.S Duke Energy International personnel, (b) DEGT Canada assets and personnel, and (c) gross margin associated with Duke Energy International and DEGT Canada. It also excluded Field Services. The Service Company justifies the exclusions on the basis that it does not support non-U.S. Duke Energy International personnel, and because it charged DEGT Canada and Field Services for enterprise-level services under a separate agreement in 2006. The Service Company deducted enterprise service revenues that it received under these agreements from its costs before allocating the remainder to the other business units.

When calculating the three-factor formula ratios for 2007, the Service Company removed DEGT (U.S. and Canada) and Field Services from all calculations, because these businesses were spun-off as of January 1, 2007. It also removed Crescent Resources, because that business is now accounted for as an equity investment, and effective January 1, 2007, does not use any governance or shared services. Such changes caused DE-Kentucky's governance and enterprise three-factor allocation percentages for 2007 to become notably higher than they were in 2006. The following table summarizes the components of DE-Kentucky's three-factor formula allocation percentages. Service Company personnel confirmed that the supporting documentation for the allocation percentages it provided in a prior audit were still valid.

DE-Kentucky Three-Factor Component Percentages

	Governance %		Enterprise %		Utility %	
	2006	2007	2006	2007	2006	2007
Gross margin	1.00	2.11	1.32	2.29	1.89	2.56

[4] In 2007, the Service Company began to calculate the allocation percentages for Nantahala Power & Light (NP&L) separately from those of DE-Carolinas.

Labor dollars	1.48	3.35	1.77	3.46	2.39	3.81
PP&E	2.07	2.98	2.55	3.20	3.95	3.93
Three-factor formula	1.52	2.81	1.88	2.99	2.76	3.44

Utility three-factor allocation percentages remained relatively constant, because their calculation is unaffected by the gas spin-off. There was, however, a more noticeable impact on the utility three-factor allocation percentage for DE-Kentucky, which experienced significant increases in gross margin and labor over the prior year. The increase in gross margin was mainly attributable to a gas rate increase that went into effect in late 2005 and to weather conditions that increased gas and electric revenues. The increase in labor was due to the transfer of generation units to DE-Kentucky from DE-Ohio effective January 1, 2006.

There were also other changes in the Service Company's method for calculating the three-factor formula percentages. The Service Company changed its approach to deriving the total labor dollars for three-factor percentage calculations from 2006 to 2007. Instead of using data for a prior twelve-month period, the Service Company annualized the labor dollars for a four-month period (April 30 to July 31, 2006). The Service Company's rationale was to provide a better reflection of relative labor dollars among the companies post-merger. This approach is atypical, but responsive to the change in baseline conditions brought about by the combination of Duke Power and Cinergy. The Service Company also began deducting Asset Retirement Obligation (ARO) Net Asset Balance, which is typically composed of environmental obligations, from net PP&E.

Liberty reviewed the Service Company's calculations of three-factor allocation percentages. The Service Company relied upon data from financial reports to derive net PP&E and gross margin figures and on accounting system reports to derive total labor dollars.

6. Extent of Three-Factor Ratio Use

Whenever practical, costs should be accounted for and charged on a direct basis. Indirect allocation should be limited to cases where it is necessary. In those cases, the allocation factor, *i.e.*, the unit upon which a ratio is based, should correspond as nearly as possible to the measurable benefits and beneficiaries of the service or, said another way, to the causer of the costs. The use of general allocators, such as the three-factor formula, should be minimized. The Service Company, however, uses the three-factor formula ratio to allocate all but one of its governance-level functional cost pools and a large number of its enterprise- and utility-level pools.

There is no universally accepted way to allocate governance-level costs, and no method is perfect. What is clear, however, is that a company should directly charge or directly assign as much of these costs as possible, in an effort to minimize the amounts that must be allocated. One possible alternative to using the three-factor formula ratio for allocating governance pools would be to charge functional governance pools to business units in proportion to their use of enterprise- and utility-level services for the same function. As an example, the Service Company could calculate the ratio of a business unit's monthly direct and allocated charges for enterprise and utility accounting services to the Service Company's total monthly charges for these services. The Service Company could then charge the business unit that same percentage of accounting governance costs. This approach would link a business unit's responsibility for accounting governance costs to its use of demand-driven accounting services, not its gross revenues, total labor, or net PP&E. This approach is appropriate for most governance functions; exceptions would include investor relations and internal auditing, which have no related enterprise- or utility-level cost pools. By adopting this approach, or one that accomplished the same result, the Service Company could limit its use of a general allocator for governance costs.

Similarly, there is no one correct way to allocate enterprise- and utility-level functional costs. However, using a general allocator for services that are "demand driven" is an oversimplification. Liberty has reviewed cost allocation methods and affiliate transactions at many utilities, and has found different approaches. What is atypical here, however, is the use of general allocators to distribute such a large proportion of service company demand-driven functional costs. DEBS and DESS allocate approximately $200 million of governance-level costs and $200 million of enterprise-level costs per year using the three-factor formula ratio. This is too large an amount to be distributed by generalized or imprecise methods.

7. Other Allocation Factors

Liberty examined a subset of allocation ratios that the Service Company uses for its cost pools for functions with both enterprise- and utility-level services. The next table summarizes this group of enterprise- and utility-level allocation factors.

Allocation Factors for Functions with Enterprise- and Utility-Level Services

Function	Enterprise	Utility
IT - Mainframe	CPU seconds	CPU seconds
IT - PC Support	# of PCs	# of PCs
IT - Server Support	# of Servers	# of Servers
IT - Communications	# of Employees	# of Employees
IT - Mgmt./Support	Three-factor	Three-factor
Finance	Three-factor	Three-factor
Internal Auditing	n/a	Three-factor
Executive	Three-factor	Three-factor
Human Resources	# of Employees	# of Employees
Public Affairs	Three-factor	Wt. avg. # of Customers and # of Employees
Accounting	Three-factor	Three-factor
Legal	n/a	Three-factor
Planning	Three-factor	Three-factor
Facilities Services	Three-factor	Three-factor
Facilities Locations	Square footage	Square footage
Environmental, Health and Safety *	Three-factor	Sales

Materials Mgmt - Procurement *	Procurement spending	Procurement spending
Transport. - Aviation	Three-factor	n/a
Transport. - Vehicles	n/a	# of Employees

* Denotes that the utility-level service is also provided to NANRG

With the exception of the three-factor formula, the factors listed above are specific. They also generally correlate more closely with cost causers and beneficiaries. Liberty's examination of them included a review of the methods for calculating the ratios that apply these factors. Liberty found many of them to be appropriate. Some raised questions that merited closer examination, as discussed in the next sections of this report.

8. Number-of-Employees Ratio Calculation

The Service Company uses the number-of-employees ratio to allocate the costs of several enterprise- and utility-level functional cost pools, and to allocate governance-level human resources costs. The next table summarizes the DE-Kentucky number-of-employees allocation percentages for 2006 and 2007.

DE-Kentucky Number-of-Employees Allocation Percentages

Governance %		Enterprise %		Utility %	
2006	**2007**	**2006**	**2007**	**2006**	**2007**
1.42	2.11	1.85	2.13	2.58	2.42

DE-Kentucky's governance and enterprise number-of-employee allocation percentages for 2007 were higher than those for 2006. In addition to the spin-off of the gas business, one reason for the change is the relatively large reduction in NANRG employees used for purposes of the 2007 allocation. The Service Company identified several factors that caused the reduction of NANRG employees from 2,574 to 1,439:

- Wind down of Duke Energy Americas and the sale of Duke Energy North America (DENA) plants
- Sale of the marketing and trading function
- Reduction of Duke Energy Generation Services employees
- Differences in how DEBS and DESS service company employees were allocated in 2007.

Liberty examined the general approach the Service Company used to develop its three separate governance, enterprise, and utility number-of-employees ratios. The Service Company derives for each business unit two different adjusted employee headcount numbers. One drives the calculation of allocation percentages for utility- and enterprise-level cost pools; the other does the same for governance-level cost pools. Essentially, the Service Company adds a prorated share of its employees to each business unit's headcount figures, in order to spread to other business units the costs that would otherwise be associated with Service Company employees.

The Service Company uses the enterprise-level number-of-employees ratio to spread certain demand-driven (*i.e.*, enterprise) costs to all business units except for DEBS and DESS shared services. In practice, the Service Company treats the corporate governance group like any other business unit, and allocates to it a portion of enterprise-level functional pool costs based on its adjusted number of employees. The Service Company uses the governance-level number-of-employees ratio to spread certain corporate governance costs to all business units except for DEBS and DESS shared service and governance.

To calculate the 2007 ratios, the Service Company first began with the base headcount of each business unit as of June 30, 2006. The Service Company used headcount figures as of September 30, 2005, to calculate the 2006 percentages. It then adjusted these figures by spreading its shared service employees over all other business units, including the corporate governance group. The Service Company examined where both DEBS and DESS shared service personnel charged their time during the prior period, and assigned them to a business unit headcount accordingly. It also examined where DE-Carolinas employees charged time, in order to recognize that some DE-Carolinas employees would be moving to DEBS in 2007. For DE-Kentucky, the Service Company adjusted the utility's base headcount number of 208 to 390, in order to reflect its "share" of shared service personnel. The Service Company then used this revised number to calculate enterprise- and utility-level allocation percentages.

To calculate the "utility" number-of-employees percentage, the Service Company divides DE-Kentucky's adjusted number of employees by the total adjusted employees for all utilities (16,159), to yield 2.42 percent. To calculate the "enterprise" number-of-employees percentage, the Service Company divided DE-Kentucky's adjusted number of employees by the total adjusted number of enterprise employees (18,289), to yield 2.13 percent. Total enterprise employees consist of all Duke Energy employees excluding non-U.S. Duke Energy International employees, as well as DEBS and DESS employees designated as shared service employees. The Service Company does not provide shared services to the non-U.S. portion of Duke Energy International, but it does provide governance services.

The Service Company calculates a second adjusted headcount figure for each business unit, whereby it also spreads its governance employees over all non-Service Company business units. The Service Company further adjusted the DE-Kentucky headcount figure to 405, which reflects the addition of its share of governance employees. To derive the governance allocation percentage, it divided this figure by the total adjusted employees (19,197), yielding 2.11 percent.

The Service Company's approach for calculating the number-of-employees percentages changed from 2006 to 2007. For the purposes of 2006 percentages, the Service Company simply spread DEBS employees in a prorated fashion to all legacy Duke Power business units. It allocated DESS employees based on how the respective centers had mainly charged their time in the prior year, which meant that many of the DESS employees had been allocated across only the legacy Cinergy enterprise. For 2007 percentages, the Service Company grouped DEBS and DESS employees based on function; accounting personnel reviewed how these functions charged their time, and then allocated employees to business units on that basis.

Liberty's review of the calculation of the 2006 number-of-employees percentages revealed that the Service Company did not include DESS governance employees in its corporate governance group headcount. It included only the DEBS governance employees. Under the 2006 allocation, therefore, the governance group received a slightly lower percentage of enterprise costs than it otherwise would have. The other business units received correspondingly more. Notably, the Service Company in turn allocates the governance group's costs to these same other business units. This second allocation causes the net effect of the error to be minimal. The Service Company indicated that it had not corrected the error for its 2007 calculations, and that the error in method may have affected other allocation ratios, such as number of PCs or servers.

The Service Company's "spreading" approach for determining the enterprise and governance number-of-employees ratios operates by adding a prorated share of its employees to business unit headcount figures, in order to spread costs that would otherwise be associated with Service Company employees. The approach involves a considerable degree of judgment and is at best an approximation. In simplest terms, the Service Company is attempting to assign each DEBS or DESS employee, or portion of each employee, to the business unit(s) he or she supports.

The Service Company indicated that it planned to eliminate the distinction between shared service and governance employees in the future, which means that it would have to develop a different approach for calculating this ratio.

9. Effect of the Service Company "Spreading" Approach on Other Ratios

Liberty examined the effects of the Service Company's "spreading" approach on the calculation of other allocation ratios. The next table summarizes the DE-Kentucky percentages for ratios used to allocate both enterprise- and utility-level costs.

DE-Kentucky Selected Allocation Percentages

Allocation Ratio	Enterprise %		Utility %	
	2006	2007	2006	2007
Number of CPU seconds	0.16	0.19	0.28	0.28
Number of PCs	1.43	1.78	1.81	1.97
Number of servers	2.24	3.50	5.18	6.91
Procurement spending	0.95	1.06	1.50	1.51
Wt. avg. # of customers/employees			3.87	3.82

The Service Company uses a spreading approach when calculating these five ratios similar to the one it used to calculate the number-of-employees percentages. The following example illustrates this approach. In order to calculate the number-of-servers allocation percentages, the Service Company had to first calculate adjusted server totals for each business unit. In the case of DESS, the Service Company conducted an analysis to determine which business units the DESS shared service employees supported, and spread the servers accordingly. In the case of DEBS, the Service Company simply prorated servers associated with DEBS shared service employees to the other legacy Duke Power business units, as well as to the DEBS corporate group, as summarized on the next table.

Reallocation of Servers
Associated with DEBS Shared Service Employees

Entity	# of Servers	% of Total	% of Total w/o DEBS	Adj. # of Servers
Corporate	121	14.85%	18.14%	148
International	13	1.60%	1.95%	16
DENA	280	34.36%	41.98%	342
DukeNet	4	0.49%	0.60%	5
DEC-Carolinas	249	30.55%	37.33%	304
DEBS	148	18.16%		
Total	815	100.00%	100.00%	815

The Service Company grossed up the number of servers for each supported business unit based on each unit's relative percentage of total servers. For example, DE-Carolinas had 249 servers, or 30.55 percent of the total of 815 servers, and had 37.33 percent of the 667 non-DEBS servers (815 less 148). DE-Carolinas was therefore assigned an allocation percentage for server support of 37.33 percent. DE-Carolinas, like the other business units, absorbs a portion of the cost of server support associated with DEBS employees. In this case, DE-Carolinas absorbs the cost for 55 of the 148 DEBS servers.

The Service Company used the adjusted total number of servers for each business unit, which included each unit's share of DEBS and DESS servers, to calculate the enterprise- and utility-level allocation percentages that it used to distribute, in this case, IT server support costs.

The Service Company made some modifications when it calculated some of these allocation percentages for 2007. For example, in some cases it used three-factor formula percentages to spread some enterprise allocation units (such as CPU seconds used by DESS), rather than conducting an analysis to determine which business units an employee supported (as it did for assigning PCs). As a general matter, DESS and DEBS each used slightly different methods to develop allocation factor units for 2006 allocation percentages, and have attempted to better align the methods for the 2007 calculations. Like the number-of-employees ratios, the Service Company's spreading approach for determining these percentages involves a certain degree of judgment and is at best an approximation.

The Service Company's approach to calculating these allocation percentages has implications for the cost of overhead. A portion of the cost for shared service functions that would otherwise be associated with providing that shared service, for example, a portion of human resource or IT costs, is not reflected in either the direct or allocated charges for a shared service function. As an example, the IT overhead costs associated with an employee performing enterprise-level accounting services are distributed to a business unit in proportion to how that business unit uses IT services, not how it uses accounting services. The business unit's allocation percentage for IT services incorporates the unit's share of the accounting group's IT costs.

10. Allocation Ratios for "Utility-Only" Costs

Liberty examined the allocation ratios that the Service Company uses to allocate functions that it provides only to the regulated utilities, or that it provides to regulated utilities and NANRG, *i.e.*, that have no corresponding enterprise pool. The next table summarizes the allocation factors that the Service Company uses for these functions.

Allocation Ratios for Utility-Only Service Company Functions

Utility Cost Allocation Pool	Allocation Factor
Meters	# of Customers
Rates	Sales
Fuels	Sales
Power Engineering/Construction *	Production plant construction expenditures
Rights of Way	Circuit miles of trans lines
Materials Mgmt. – inventory	Inventory
Electric System Maintenance	
Transmission System	Circuit miles of transmission lines
Distribution System	Circuit miles of distribution lines
Power Planning and Operations	
Generation Planning *	Electric peak load
Transmission Planning	Electric peak load
Distribution Planning	Wt. average of electric peak load and circuit miles of distribution lines
Generation Dispatch	Sales
Transmission Operations	Wt. average of electric peak load and circuit miles of transmission lines
Distribution Operations	Wt. average of electric peak load and circuit miles of distribution lines
Power Operations *	Generating unit MW capability
Wholesale power operations *	Sales
T&D Engineering/ Construction	
Transmission	Trans plant construction expenditures
Distribution	Dist plant construction expenditures
Marketing/Customer Relations	
Sales and DSM	Sales
Meter Read/Billing/Payment	# of Customers
Customer Service	# of Customers

* Denotes that the service is also provided to NANRG

The preceding allocation factors used for utility-only cost pools bear a reasonable relationship to cost causers, beneficiaries, and benefits. The Service Company uses a weighted average of two ratios (circuit miles and electric peak load) to allocate costs for certain power planning and operations functions. The Service Company stated that it adopted this approach to take into account the specific aspects of a system, and noted that using both circuit miles and peak load better represented the usage and physical aspects of the system. The next table summarizes DE-Kentucky's allocation percentages for the listed utility-specific ratios.

DE-Kentucky Utility-level Service Allocation Percentages

Allocation Ratio	2007 %
Number of employees	2.42
Sales (sales/DSM, rates, env.)	4.96
Sales (gen. dispatch, fuels)	4.04
Sales (wholesale power)	n/a
Inventory	0.56
Construction expend. - Trans.	0.58
Construction expend. - Dist.	2.80
Construction expend. - Power	1.00
Number of customers	5.23
Electric peak load - Gen.	3.08
Electric peak load - Trans.	2.34
Circuit miles - Trans.	0.52
Circuit miles - Dist.	1.99
Wt. avg. - peak load/circuit - T	1.43
Wt. avg. - peak load/circuit - D	2.17
Gen. unit MW capability - Utility	4.59
Gen. unit MW capability - Reg.	6.47

The 2007 utility-level service allocation percentages generally changed very little from those of the prior year. Liberty's examination of the supporting documentation confirmed the Service Company's calculation of these utility-specific allocation ratios. The spreading issue addressed earlier does not apply here.

The Service Company uses three different sales ratios to calculate allocation percentages, depending upon the functional costs it is allocating. The following table summarizes the sales ratios for utility-level functional cost pools. The percentages in 2006 and 2007 were the same.

Sales Ratio Allocation Percentages

Entity	Rates, Marketing, and Environmental	Generation Dispatch and Fuels	Wholesale Power Operations
DE-Indiana	19.46%	41.40%	28.72%
DE-Kentucky	4.95%	4.04%	n/a
DE-Ohio regulated	27.20%	n/a	n/a
DE-Ohio non-reg, (NANRG)	n/a	n/a	54.61%
DE-Carolinas	48.39%	54.56%	16.67%
Total	100.00%	100.00%	100.00%

The sales ratio that the Service Company uses for rates, marketing/sales/demand side management, and environmental affairs is based on Federal Energy Regulatory Commission (FERC) Form 1 data for megawatt hour sales; gas sales from the Midwest utilities are converted to equivalent kilowatt hours. The Service Company allocates costs for these functions to the former Cinergy utilities CG&E, ULH&P, and PSI, and to DE-Carolinas. The sales ratio that the Service Company uses for generation dispatch and fuels services is based on the same FERC Form 1 data, excluding DE-Ohio (because it has no regulated generation). Similarly, the sales ratio for wholesale power operations is based on FERC Form 1 data on non-requirements sales for resale for DE-Carolinas, DE-Ohio, and DE-Indiana (excluding DE-Kentucky because it has no sales for resale). Unlike the other two utilities, NANRG sales for resale are for the non-regulated generation business, although the relevant data still appear on DE-Ohio's FERC Form 1.

11. Service Company "Overhead"

The Service Company Utility Service Agreement does not explicitly discuss overhead costs; it states only that charges for services will be based on fully embedded costs. The DE-Carolinas affiliate transaction accounting manual mentions overhead, stating that Service Company charges will be based on fully distributed cost and include:[5]

- Labor and non-labor expenses
- Payroll taxes, fringe benefits, and incentives associated with labor expenses
- Overhead costs, such as management, administrative, facilities, telecommunications, computers, etc.
- Asset costs attributable to the Service Company, such as property tax, depreciation, property insurance, and cost of capital.

DEBS and DESS have significant overhead costs. The Service Company uses indirect approaches to account for and allocate these overhead costs. The Service Company spreads many of the overhead costs associated with shared service. *i.e.*, enterprise- and utility-level, functions to other business units by the way that it calculates certain allocation ratio percentages. Overhead costs associated with shared service employees are absorbed by other business units, not in proportion to the unit's actual use of the functional shared service, but in proportion to its own

[5] Duke Energy uses the term "fully distributed cost" and "fully embedded costs" interchangeably.

overhead costs of the same type, such as those related to IT. While the Service Company does assign some overhead costs to governance employees or functions, it allocates those out for the most part using the general three-factor formula ratio.

The Service Company does not include overhead costs in direct labor charges to a business unit. Consequently, direct charges to a business unit for work performed on its behalf by a functional area such as accounting or legal consist only of fully loaded labor, which is not, by definition, fully allocated cost. As a general matter, the Service Company distributes overhead costs indirectly through one of the numerous functional cost pools.[6] The amount of overhead costs that a given business unit receives for a shared service function, such as accounting, is based on how much of the cost pool that it receives using an allocation ratio, not on how much of the actual service it consumes. Stated differently, the business unit receives a portion of shared service accounting overhead costs for IT, for example, based on its own use of IT, not on its use of accountants.

Although most of the overhead costs for shared service employees have already been otherwise spread to the other business units, there are some relatively small overhead charges related to enterprise-level functions, such as office supplies or management costs. Typically, these nominal overhead costs are allocated in the same fashion as the allocation pool for the enterprise function. Even if a shared service employee directly charges all of his or her time, the employee's overhead would still be allocated via the cost pool. Direct charges for any enterprise-level functional services do not contain overhead.

The appendix to the Service Company Agreement states that the Service Company must maintain records of employee-related expenses and indirect costs for each functional group within the Service Company. It states that indirect costs should be directly assigned when identifiable to a particular activity, process, project, responsibility center, or work order. Liberty does not consider the allocation of all overhead costs using indirect methods to be appropriate.

The Service Company Agreement also states that charges under the contract "shall be at actual cost thereof, fairly and equitably assigned, distributed or allocated." The Service Company distributes overhead costs in such a way that it is extremely difficult to determine if the outcome is fair, *i.e.*, the cost of overhead is directly linked to cost causation or usage of services. In addition, the Service Company's method is not sufficiently transparent, and it is very difficult to verify through a document trail.

Under its approach, the Service Company does not know the all-in cost for any of the functions it performs. Liberty believes that the commitment by DE-Kentucky to maintain cost allocation procedures that accomplish the objective of preventing cross-subsidization imposes a requirement that the Service Company be able to do more than estimate the fully allocated cost of each of its services.

[6] BDMS does not actually accumulate costs in an overhead pool and distribute them at month-end, as does FMIS. Instead, the BDMS system distributes a charge that would otherwise go into a pool as soon as it is booked, using the same allocation percentages that would apply to the relevant pool.

The Service Company does assign to governance functions both its own overhead-type charges along with a portion of overhead costs such as IT or facilities costs that would otherwise be attributable to the DEBS and DESS shared service employees. In many cases, the Service Company can direct a share of these overhead costs to a specific governance pool, such as finance. If not, it essentially assigns the overhead costs into the Executive and Other governance pool. Therefore, all governance overhead costs, including the portion otherwise attributable to shared services, are allocated as if they had gone through a pool. Moreover, nearly all of the governance pools are allocated using the three-factor formula ratio. Direct charges for any governance-level functional services do not contain overhead. Previously, the Service Company distributed these overhead-type costs through the governance pools; it now allocates the overhead-type charges using the same percentage that would have been allocated from the governance pools.

The Service Company adopted its approach for handling overhead costs in order to "simplify" the process. It is hard to justify an overly simplistic approach to tracking and assigning overhead costs, much as it is difficult to justify an over-reliance on the use of general allocators to distribute Service Company costs. One cannot clearly correlate what a business unit like DE-Kentucky pays for a given service with how much it uses that service. Similarly, one cannot determine if DE-Kentucky is cross-subsidizing other business units through the charges that it pays for Service Company functions. If, as Liberty recommends below, the Service Company moves away from general allocators to a more sophisticated approach for pricing its functional services, such as activity prices, it will have to be more precise in tracking and assigning overhead costs.

C. Conclusions

1. Duke Energy does not maintain documentation sufficient to verify its compliance with Article I, Section 1.4 of the Service Company Utility Service Agreement. *(Recommendation #1)*

Within the context of an audit of this type, the only practical way to verify compliance is to determine that the company maintains documentation sufficient to give reasonable assurance of compliance. Otherwise, an independent and comprehensive organization and staffing study would be required. Liberty has undertaken reviews of that type, and therefore is familiar with the capability and resource requirements they impose. Such a study on a set of affiliates and work groups as large, dispersed, and complex as those here would require an undertaking significantly out of proportion to the resources devoted to this audit.

Duke Energy does not have documentation that provides a broad and deep enough basis for verifying that the Service Company was in compliance. Liberty's reading of the agreement is that the Service Company has an affirmative duty to comply, but given the state of documentation, that compliance cannot be verified.

Liberty believes that good utility practice does require a company to "maintain a staff trained and experienced in the design, construction, operation, maintenance and management of public utility properties." However, that standard does not require the maintenance of documentation that would on its face independently confirm the existence of such a staff. What makes such documentation material here is the question of how the Service Company should be obliged to demonstrate compliance with the agreement. One way to do that would be to maintain sufficient documentation. Absent such documentation, Liberty can only conclude that compliance is not verified, but cannot conclude that compliance does not exist.

Decisions that Duke Energy has made to curtail its non-utility businesses, through disposition or otherwise, may have a bearing on the value, from a regulatory perspective, that such a study would produce. Good practice in a utility holding and service company structure calls for the organization and staffing of common resources to meet both utility and other needs, subject to the standard that utility costs and service quality should not suffer as a result. If this standard is not met, then the utility experiences net detriments, rather than net benefits, from a common approach to providing goods and services to multiple affiliates. It should never be the case that customers bear more costs as a result of commonality, absent benefits (clear, tangible, and material to or for customers) in the qualities of the goods and services provided.

Having made common organization and staffing decisions and commitments on that basis, one must recognize that, as affiliate businesses come and go, the bases underlying those decisions and commitments change. Particularly in the case of reductions in business scale or scope (here, for example, in the case of the Spectra disposition) it would be extremely rare for the organization and staffing of common service organizations to respond immediately. As scope and scale are lost, the numbers of personnel in many areas can be expected to contract. Reducing personnel numbers is expensive and generally cannot occur at a rate commensurate with the loss of resource-consuming affiliates or businesses.

Accordingly, one should expect at times closely following dispositions of non-utility businesses that there will be temporarily suboptimal organization structure and staff sizing for the remaining needs. Such dispositions are a significant phenomenon of late in the utility industry, and are true particularly at Duke Energy in the recent past. Moreover, at Duke Energy the utility sector now comprises a notably larger part of remaining needs. Therefore, however quickly and effectively Duke Energy is moving to make changes, one should expect inefficiencies that will in the near term increase utility costs, but eventually work their way out of the cost structure of the common service organizations.

It is not typical to find, and Duke Energy did not do so here, an assignment of any of the residual inefficiency costs to the parent or to the non-utility sector, thus leaving the utilities, like the remaining non-utility businesses, to bear them all. The utilities typically derive no benefit from the proceeds of the disposition or restructuring (*e.g.*, taking on an outside partner and changing to equity accounting) of other businesses or companies. The utilities should not have to bear the costs of inefficiency resulting from suboptimal staffing as the groups who provide services get resized and restructured. While it is easy to conclude that there are such inefficiencies and the utilities should not bear them, it would take a comprehensive organization and staffing study well beyond the scope of this engagement to measure the impact of that inefficiency and to postulate when it will have worked its way out of the system through restructuring and resizing the groups providing common support.

In a ratemaking sense it is, however, true that the bearing of extra costs by the utility may not be of immediate consequence to customers. Whether customers bear any of those costs is a function of how recently rates were last reset or will be reset again.

2. The Service Company adopted generally appropriate conventions in its calculation of three-factor formula percentages.

The calculations of three-factor allocation percentages relied upon data from financial reports to derive net PP&E and gross margin figures and on accounting system reports to derive total labor dollars. The Service Company's calculations appeared reasonable in general, although there were slight differences in the time periods of the data it used for legacy Duke and legacy Cinergy companies.

3. The Service Company uses an effective set of allocation factors, but makes excessive use of general allocators. *(Recommendation #2)*

Liberty generally found the specific factors selected for enterprise and utility cost pools to correspond reasonably to cost causation, beneficiaries, and benefit levels. There is, however, a greater than necessary use of the three-factor formula ratio.

Whenever practical, costs should be accounted for and assigned on a direct basis; whenever indirect allocation is necessary, the allocation factor should correspond as nearly as possible to the cause of the costs or the beneficiaries of the services. The use of general allocators, such as the three-factor formula, should be minimized. Rather than using the three-factor formula to allocate most governance pools, the Service Company could charge functional governance pools to business units in proportion to their use of enterprise and utility-level services for the same function. This approach links a business unit's responsibility for governance-level function costs to its use of each function or service, not its gross revenues, total labor, or net PP&E. By adopting this approach, or one that accomplished the same purpose, the Service Company could limit its use of a general allocator for governance costs. The Service Company indicated that it found this alternative no more appropriate than the simpler three-factor allocation method.

One alternative approach that Liberty observed at another utility was to distinguish services, such as legal and IT, as "leveraged" services, which an affiliate can "buy." In this case, the holding company's service company accumulated costs in roughly 200 cost centers, which captured direct costs, employee overheads, vehicle costs, occupancy charges, and information system support costs. The service company calculated direct charges for specific activities using a standard rate, or activity-type price. The service company directly charged to the extent possible based on the activity price and usage, and allocated remaining costs in each cost center using one of the company's allocation ratios. The allocation ratios in this case were specific (*e.g.*, number of invoices, number of journal entries) because the activities were defined more precisely.

Liberty has observed much more robust approaches to assuring direct charging, including one that designated as many as 150 different services that a service company provided to itself, to affiliates, and to the parent. That company charged transactional services, such as invoice processing, on a per unit basis. It charged professional services, such as legal services, on a per hour basis. The service company used an activity-based costing process to identify the activities associated with each of its services and to set an activity price for each unit of the service based upon the planned cost of the service and the agreed-upon demand for it.

Another example would be the use of time sheet estimates to allocate service company costs for the month, applying budgeted time estimates to actual monthly costs. Each quarter, one could use actual time sheet data to perform a true-up. Labor hours can drive the assignment of other departmental costs such as fringe benefits and overhead, which included cross-charges for such services as human resources and IT. The cost of any given service company function would in that case more closely represent the true cost of that function. If residual costs are minimized, they can then be allocated in the same proportion as direct charges.

The Service Company could improve its allocation of enterprise- and utility-level functional costs in several ways. First, however, it is extremely important that it directly charge or directly assign as much of these costs as possible. Liberty discusses the issue of whether or not the Service Company directly charges as much costs as possible in Chapter V of this report.

There are certainly other possible approaches to improve the link between the cost that a business unit pays for a shared service function and that unit's actual usage of that service. The Service Company could use a much more imaginative approach to pricing its demand-driven services than a general allocator. As an example, the Service Company could further refine the shared service functions into activities, allocating such activities as accounts payable by number of invoices, and financial accounting by number of journal entries. In any case, the Service Company should implement a protocol to directly charge or directly assign as much as possible, so that the amounts in any enterprise or utility allocation pool are truly residuals. And if the allocation pools are truly residuals, then they arguably could follow the proportion of direct charges each month. Liberty recognizes that the Service Company would need to realign the way it captures costs in order to significantly change its approach. For example, the Service Company cannot specifically identify the purpose of most direct charges to its affiliates, and does not accurately capture the overhead costs associated with its shared service functions.

Liberty believes that a change in method would not involve seeking approvals in various jurisdictions, because the language of the Service Company Agreement regarding fully embedded cost would not change. A change in method would arguably improve the calculation of the fully embedded costs specified in the agreement. Given the large amount of costs involved, the various jurisdictions will likely be amenable to a method that improves the link between cost causation and benefits.

4. **The "spreading" approach used in calculating certain allocation percentages can cause charges for Service Company functions not to reflect fully embedded costs.** *(Recommendation #3)*

In simplest terms, the Service Company's spreading approach attempts to assign each DEBS or DESS employee and associated overhead items such as PCs, servers, and CPU usage to the business units he or she supports. Liberty found that the spreading approach for determining certain enterprise and governance ratios involves a considerable degree of judgment and is at best an approximation.

Because the Service Company does not assign any of certain enterprise-level costs to the Service Company shared service functions, the charges for a given function may not represent fully allocated costs. It is unclear why, for example, DEBS governance pools should receive a share of such costs as accounting, finance, and human resources, but the DEBS shared service functions should not. The costs of utilizing a Service Company employee should not depend upon whether the Service Company has labeled that employee as governance or shared services. In order to move away from over-use of the three-factor formula and significantly change its approach for charging demand-driven enterprise-level services, the Service Company may need to realign the way it captures costs. At present, the Service Company does not accurately distribute indirect, more specifically overhead, costs associated with its shared service functions in relationship to the directly assigned costs of the function, as specified in the Service Company Agreement.

5. **The Service Company's method for distributing its overhead costs is simplistic, and does not provide a good match between a business unit's use of a service function and the cost that it pays for that function.** (*Recommendation #4*)

The Service Company's treatment does not conform sufficiently to the intent of the Service Company Agreement, which states that indirect costs, which include overhead costs, should be directly assigned when identifiable to a particular activity, process, project, responsibility center, or work order. The Service Company uses an oversimplified approach to account for and allocate Service Company overhead costs by (a) spreading many of the overhead costs associated with enterprise-level functions to other business units by the way that it calculates allocation ratio percentages, and (b) failing to include overhead costs in direct labor charges to business units. The amount of overhead costs that a given business unit absorbs for a shared service function is based on how much of the cost pool that it receives using an allocation ratio, not on how much of the actual service it consumes. Similarly, all governance-level overhead costs flow to a pool, and the Service Company allocates nearly all of the governance pools to business units using the three-factor formula ratio.

An illustrative example may be helpful. If a DE-Carolinas engineer performed work for DE-Kentucky in 2006, DE-Carolinas charged the affiliate fully allocated cost, which in this case included labor, labor loaders, plus overhead loaders including administrative, facilities, supervisory, and corporate services costs. The fully loaded cost represents the opportunity cost of DE-Carolinas using the same engineer to perform work in-house. If that same engineer moved to DEBS in 2007 and performed the same work for DE-Kentucky, however, the Service Company would directly charge the affiliate labor plus labor loaders, but not overhead. It is not clear why the cost for the same engineer should be different. The overhead associated with that engineer is now spread over all business units through various allocation percentages for areas such as IT or human resources; the overhead is not linked directly to the affiliate's use of the engineer.

Liberty undertook in this and the prior audit considerable effort to fully understand the Service Company's approach to distributing its overhead costs. The information that Liberty was able to obtain from the Service Company was insufficient to fully uncover all of the potential issues with the approach. However Liberty believes that the Service Company's approach for handling overhead costs is far from transparent, and leaves one unable to determine whether DE-Kentucky is cross-subsidizing other business units in the charges it pays for individual services, or for Service Company charges combined.

D. Recommendations

1. **Identify and implement a program that Duke Energy and stakeholders consider appropriate for assessing whether the Service Company complies with Article I, Section 1.4 of the Service Company Utility Service Agreement.** *(Conclusion #1)*

The wording of the agreement is straightforward in describing the burden that the Service Company has assumed. Duke Energy does not, however, have a formal method for determining whether it is meeting that burden. The way to address this gap is to commence a formal program of studying the needs of the business units and whether the complements of the Service Company do in fact meet the needs of the entities they serve. Recognizing that compliance by means other than an agreed-to set of documentation will require independent study, Duke Energy should work with stakeholders to determine what degree of comfort about compliance with this agreement provision is to be obtained.

2. **Narrow the use of the three-part formula allocator.** *(Conclusion #3)*

The Service Company should establish an expedited program for identifying substantially more costs for direct charging and should create a layer of more specific allocation factors to address as many remaining costs as possible before applying its three-part formula allocator. It should also consider as an alternative converting its method to an activity-based costing approach, which is more in line with best practices used at other utilities. Oversimplified methods using general allocators do not allow the precision necessary to demonstrate that DE-Kentucky pays no more than fully embedded costs for each individual service.

3. **Eliminate the effect of spreading overhead costs from the calculation of allocation percentages.** (*Conclusion #4*)

The Service Company calculates many of its ratios in such a way that it spreads what would otherwise be overhead costs associated with shared service functions to the other business units. As a result, overhead costs associated with shared service employees are absorbed by other business units, not in proportion to the unit's actual use of the functional service, but in proportion to its own overhead costs. Service Company charges to business units therefore do not reflect fully embedded costs for individual functions or services. The effect of spreading overhead costs needs to be eliminated from the calculation of allocation percentages.

4. **Develop a method to fairly assign Service Company overhead costs.** *(Conclusion #5)*

The Service Company should develop a new method to track and assign Service Company overhead costs that result in a good match between a business unit's use of a service function and the cost that it pays for that function. In order to move away from an over-reliance on general allocators, the Service Company will need a more sophisticated approach for pricing its functional services, and will have to be more precise in tracking and assigning the overhead component of cost.

Many of the overhead-type costs that the Service Company currently spreads by way of its allocation percentage calculations or allocates by other methods could be converted into per-employee-hour rates and applied as a component of a Service Company overhead loader. The Service Company could more closely approximate the fully embedded cost for its services by converting certain IT, human resources, facilities, depreciation, and capital costs to overhead rate components. For example, the Service Company allocates approximately $14 million in capital costs associated with DEBS employee space in DE-Carolinas buildings to business units using the governance three-factor formula ratio. There is no clear relationship between a business unit's share of these costs and its consumption of Service Company functions. These capital costs are known in advance and could be converted into a per hour rate in a straightforward fashion. Each DEBS employee hour, whether directly charged to a business unit or charged into an allocation pool, could carry with it the appropriate share of this type of overhead cost.

If the Service Company does not pursue a new approach and were to continue its approach of spreading overhead charges in a fashion that is not linked to usage of services or cost causation in any discernible way, Liberty recommends that it be required to make a showing that its approach yields equitable results, and results comparable to more direct, less simplified approaches. Similarly, the Service Company should be required to make a showing that its charging method results in fully allocated costs for each function that it provides.

V. Service Company Charges

A. Introduction

Charges from the Service Company to the business units totaled $1.5 billion in 2007. The next table summarizes the charges from DEBS to the individual business units.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

The next table summarizes the charges from DESS to the individual business units during 2007.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Data on DEBS charges originate from FMIS, the legacy Duke Power accounting system, and data on DESS charges originate from BDMS, the legacy Cinergy accounting system. Service Company charges to DE-Kentucky totaled approximately $48 million, which is consistent with the amount reported in the company's Financial Statements and Auditor's Report for 2007.

B. Findings

1. Charges Not Addressed by the Service Agreement

Some charges for goods and services that flow through the Service Company are not expressly covered by the Service Company Utility Service Agreement, although they are reflected in the Service Company accounting data. Many may accurately be described as inter-company charges. As such, the dollar figures in the charts above may be misleading.

Most of these charges are between DEBS and DE-Carolinas. For example, in the first quarter of 2007, DEBS directly charged DE-Carolinas nearly $50 million for employee benefits and pension costs, including items such as "other post-employment benefits", which generally consist of retiree health benefits and are commonly termed "OPEB." Phantom stock and employee savings plans represent other benefit costs that comprise the $50 million. The service agreement defines the human resources function as one that, among other things, "processes payroll and employee benefits payments." It is not clear whether this language refers only to the mechanics of processing payments, or whether it is meant to imply that the human resources group should pay the bills and then subsequently charge the relevant business units. In either event, the $50 million in charges does not represent the costs incurred directly to process payments, but the pass through of the payments themselves.

As another example, DE-Carolinas was directly charged $1.5 million during the first quarter of 2007 for liability insurance by the DEBS Engineering and Construction–Power Production function. Processing liability insurance is not within the functional definition for this group in the service agreement. The Service Company merely selected this responsibility center to use as the source of the charges.

Midwest costs for similar items typically had been recorded directly on the books of the utilities, and did not pass through DESS. However, during 2007, the Service Company began to flow some of these costs through DEBS. For example, DEBS directly charged the legacy Cinergy companies approximately $400,000 per month for workers' compensation amortization expense. The consolidation of DEBS and DESS will cause this use of the Service Company as a conduit for such costs to continue. The Service Company plans to flow most employee benefits costs through DEBS; however, the associated obligation would remain on the utility's balance sheet.

2. Correlation between Functions and Responsibility Centers

Wherever practical, costs should be accounted for and assigned on a direct basis so that the beneficiary of the goods or services provided pays its costs. A company should make reasonable efforts to maximize the use of direct assignment over allocation.

Normally, Liberty examines how service company departments capture monthly costs associated with a specific shared service function, and then in turn how it charges these costs out to business units. Duke Energy Service Company departments do not precisely correspond to service functions as defined in the service agreement. The alignment is somewhat closer for more traditional support functions such as accounting or finance. Service Company responsibility centers do not, however, line up with those services that had traditionally been performed at the utility level but have now moved to the Service Company. Engineering and construction provide examples. Here, such services can be performed by a wide number of centers, and each center can perform more than one service *(e.g.*, distribution engineering and construction and distribution planning). In these cases, one cannot match up the departments on an organizational chart with the Service Company shared services on a one-for-one basis. Multiple responsibility centers may be involved, either directly or indirectly, in the provision of services. The Service Company indicated that the list of services in the agreement were not intended to reflect how it would be organized from an internal management perspective, but to describe in general the nature of the service being provided.

The Service Company analyzes and tracks charges by both the originating center and the business units receiving the charges. Business units typically keep track of the dollars charged to them. Direct charges show up on each unit's budget as a separate item, as would any other cost. The Service Company does not separately track or capture costs at a "departmental" level. Instead, it looks at the total costs charged out by a responsibility center during the month, which by default must be the same as the total costs that had been incurred by that center during the month.

Liberty generally can examine a company's department-level accounting information and determine, in a relatively straightforward fashion, how much a utility paid for legal services, finance, or other shared services in a given month. This ability conforms to the general view that functional collection of costs promotes efforts to manage the costs for services received, whether from internal, service-company, or third-party sources. Duke Energy's approach and structure do not operate in this fashion. The Service Company has assigned each responsibility center to one of the Service Company functions in order to derive estimates of services provided under each function. The Duke Energy approach does not, however, clearly identify the nature of a direct charge from a responsibility center. Direct charges from a legal responsibility center that reports to the general counsel could represent, for example, charges for legal services or for internal auditing. A direct charge from an employee in the engineering and technical services staff might be for transmission and distribution (T&D) planning, T&D operations, or T&D engineering and construction services. Similarly, one cannot predict how a given employee in a responsibility center will charge time. Theoretically, a Service Company employee may charge his or her time into any functional cost allocation pool or to any business unit.

3. DEBS Direct and Allocated Charges

Liberty examined DEBS direct charges and allocated charges for governance and shared services for the audit period of 2007. The next table summarizes the direct and allocated charges to each business unit.

	[redacted]			
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Viewed on an overall basis, DEBS directly charged to client companies approximately 40 percent of its total charges. Direct charges to DE-Kentucky for services totaled [redacted] in the audit period, or less than one percent of total DEBS direct charges. The bulk of the direct charges went to DE-Carolinas.

Liberty examined DEBS charges in more detail by major cost category for a sample month to test how well it performed in maximizing the direct charging of labor costs. The next table summarizes the labor and non-labor components of DEBS direct and allocated charges for October 2007.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]		[redacted]		[redacted]
[redacted]	[redacted]		[redacted]		[redacted]
[redacted]	[redacted]		[redacted]		[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

The table shows that DEBS directly charged approximately 38 percent of its total charges, and approximately 43 percent of its loaded labor. The next table shows that a much higher percentage of charges coming to DE-Kentucky were allocated rather than directly charged.

[redacted]

[redacted]	[redacted]		[redacted]	
	[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]		[redacted]	

Liberty examined allocated charges in more detail to confirm that DE-Kentucky received a percentage of charges consistent with established Service Company allocation percentages. The next table summarizes total DEBS allocated charges for October 2007.

[redacted]

[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

Of the total [redacted] in DEBS allocated charges in October 2007, [redacted] related to governance-level functions. Liberty recalculated DE-Kentucky's portion of DEBS allocated governance costs for the month to confirm that charges were consistent with its 2007 allocation percentages, which the next table summarizes.

[redacted]

	[redacted]	[redacted]	[redacted]
[redacted]			
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	

Liberty found that DE-Kentucky's total charges from pools allocated using the three-factor formula ratio and from the human resources governance pool, allocated using the number-of-employee ratio, were consistent with 2007 allocation percentages.

Of the total [redacted] in DEBS allocated charges in October 2007, [redacted] related to enterprise-level functions. Liberty recalculated DE-Kentucky's portion of DEBS allocated enterprise costs for the month to confirm that charges were consistent with DE-Kentucky's 2007 allocation percentages, as the next table summarizes.

[redacted]

	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	

Liberty's calculated figures were consistent with the amounts charged for the month to DE-Kentucky from enterprise-level allocation pools.

Allocated charges from utility-level pools totaled [redacted] in October 2007. Liberty recalculated DE-Kentucky's portion of DEBS allocated utility service costs for the month to confirm that charges were consistent with DE-Kentucky's 2007 allocation percentages, which the next table summarizes.

[redacted]

	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]

[redacted]	[redacted]	[redacted]	

Liberty's calculated figures were consistent with the amounts charged for the month to DE-Kentucky from utility-level allocation pools.

4. DESS Direct and Allocated Charges

Liberty examined DESS direct charges and allocated charges for governance and shared services for the audit period of 2007. The next table summarizes the direct and allocated charges to each business unit.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

DESS directly charged to client companies approximately 40 percent of its total charges. Direct charges to DE-Kentucky for services totaled [redacted] in the audit period, or approximately seven percent of total DESS direct charges.

Liberty examined DESS charges in more detail by major cost category for a sample month in order to assess performance in directly charging labor. The next table summarizes the labor and non-labor components of DESS direct and allocated charges for October 2007.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]		[redacted]		[redacted]
[redacted]	[redacted]		[redacted]		[redacted]
[redacted]	[redacted]		[redacted]		[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

In this month, DESS directly charged approximately 48 percent of its total charges, and approximately 59 percent of its loaded labor. The next table shows that DE-Kentucky received a higher percentage of total charges as direct rather than allocated charges.

[redacted]

[redacted]	[redacted]		[redacted]	
	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]		[redacted]	

Liberty examined DESS allocated charges in more detail to confirm that DE-Kentucky received a percentage of governance and shared service charges consistent with established Service Company allocation percentages. The next table summarizes total allocated charges for October 2007.

[redacted]

[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

Of the total [redacted] in DESS allocated charges in October 2007, [redacted] related to governance-level functions. Liberty recalculated DE-Kentucky's portion of DESS allocated governance costs for the sample month to confirm that charges were consistent with DE-Kentucky's 2007 allocation percentages for three-factor and number-of-employees governance ratios, which the next table summarizes.

[redacted]

	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
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Liberty's calculated figures were consistent with the amounts charged to DE-Kentucky for the month.

Of the total [redacted] in DESS allocated charges in October 2007, [redacted] related to shared service functions. Liberty recalculated DE-Kentucky's portion of DESS allocated shared service (*i.e.*, enterprise- and utility-level) costs for the sample month to confirm that charges were consistent with DE-Kentucky's 2007 allocation percentages, which the next table summarizes.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]
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Liberty's calculated figures were consistent with the amounts charged to DE-Kentucky for the month.

Of the [redacted] in allocated shared service charges, DESS charged [redacted] (nearly half) to Midwest-only allocation pools. DESS used well over 50 allocation pools. DESS structures these pools based on how the charges are allocated, rather than on the specific Service Company function or activities they may include. The reason for the large number of pools is threefold:

- DESS created specific pools that are allocated by a large number of factors (*e.g.*, number of employees, circuit miles) that mirror those of regular shared service pools
- DESS created specific pools that pertain to specific subsets of Midwest entities
- DESS created specific pools that are similar in all other aspects except the way in which the charges are ultimately allocated between a utility's gas and electric operations.

As examples, the Midwest-only pools designated by the LOB codes R20 and R21 are both allocated to DE-Indiana, DE-Kentucky, and DE-Ohio based on Midwest-only three-factor formula percentages; the further split between electric and gas for DE-Kentucky and for DE-Ohio are based on labor and number of customers, respectively. The Midwest-only allocation pool designated by the LOB code R30 is allocated to DE-Indiana, DE-Kentucky, and DE-Ohio, as well as NANRG.

Liberty recalculated DE-Kentucky's portion of the Midwest-only charges, using allocation percentages provided by the Service Company, which the next table summarizes.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]		[redacted]

Liberty's calculated figures were consistent with the amounts charged to DE-Kentucky for the month.

5. Direct and Allocated Charges for Traditional Business Functions

Liberty reviewed sample month's charges from individual business functions in order to evaluate Service Company performance in maximizing the percentage of costs directly charged. There is no clear alignment between Service Company functions and departments; therefore, a more straightforward departmental analysis was not practicable.

The next table summarizes October 2007 direct and allocated charges identified by the Service Company as related to the legal function.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]						
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[redacted]						
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[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

The October 2007 data indicate that the Service Company allocates significantly more legal loaded labor than it directly charges. Approximately 70 percent of loaded labor costs are allocated to business units. Charges for outside services and contract labor constitute the largest non-labor cost category for the legal function. The Service Company directly charged or directly assigned nearly 90 percent of those costs to client companies.

The next table summarizes October 2007 direct and allocated charges identified by the Service Company as related to the IT function.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]							
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]	[redacted]		[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]		[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

In October 2007, the Service Company allocated significantly more IT loaded labor than it directly charged. Approximately 84 percent of loaded labor costs are allocated to business units. Charges for outside services and contract labor constitute one of the largest non-labor cost categories for the IT function. The Service Company directly charged or directly assigned only 20 percent of those costs to client companies. Similarly, the Service Company directly charged or assigned about 40 percent of hardware and software purchase and maintenance expenses.

6. Direct and Allocated Charges for Utility-Related Shared Services

Liberty reviewed sample month's charges from individual utility-related functions, in order to test Service Company performance in maximizing the percentage of its costs directly charged. The next table summarizes October 2007 direct and allocated charges identified by the Service Company as related to the power engineering and construction function.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]						
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

The October 2007 data indicate that the Service Company directly charges the majority of loaded labor, allocating only approximately 10 percent to business units. Charges for outside services and contract labor constitute one of the larger non-labor cost categories for this function. The Service Company directly charged or directly assigned nearly 95 percent of those costs to client companies.

The next table summarizes October 2007 direct and allocated charges identified by the Service Company as related to the rates function.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]					
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]					
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

The Service Company directly charged approximately 60 percent of loaded labor. The Service Company directly charged or directly assigned approximately 90 percent of charges for outside services and contract labor to client companies.

7. Service Company Cost of Capital

The Service Company recovers from business units the depreciation expense associated with DEBS assets, most of it through an allocation pool that it distributes using the enterprise three-factor formula ratio. However, the Service Company separately identifies certain DEBS assets as related to achievement of the merger, and recovers the depreciation associated with those assets as part of a cost-to-achieve pool. It allocates this portion by using the governance three-factor formula ratio.

The Service Company added a considerable number of assets during 2007. DEBS assets net of depreciation at year-end 2007 were $254 million, compared to $121 million as of year-end 2006. DEBS depreciation expense for 2007 totaled $28.7 million. Liberty's review of Service Company inter-company charge data substantiated that DEBS monthly depreciation expense of approximately $2 million was accurately allocated to the business units, including DE-Kentucky.

As of year-end 2007, DESS capital assets had a value net of depreciation of $52 million; software comprises the majority of this value. During 2006, the Service Company had allocated all depreciation costs associated with DESS capital assets to Midwest business units only. The justification was that only one set of service company assets -- in particular financial systems -- was needed to run a corporation. Therefore, the reasoning went, the depreciation associated with the duplicate systems on the Cinergy side should not be spread to all business units. In 2007, the Service Company began to accelerate the depreciation on certain DESS financial systems identified for replacement in the transition to PeopleSoft, and re-categorized the depreciation associated with those assets as part of its merger cost-to-achieve. Of the $18.1 million in DESS depreciation expense during 2007, $4.3 million was treated as a cost-to-achieve. It was allocated to business units using the governance three-factor formula ratio. The remainder of the depreciation costs was charged exclusively to Midwest entities. Liberty's review of Service Company inter-company charge data substantiated that DESS monthly depreciation expense was allocated as described to the business units, including DE-Kentucky.

8. Facilities Rate of Return Allocation Pool

DE-Carolinas calculates capital charges associated with its owned facilities in North Carolina. It calculates the amount of depreciation, property tax, property insurance, and cost of capital (net book value times the allowed rate of return) associated with each of the buildings. DE-Carolinas directly charges its non-Service Company affiliates for their share of these costs based on occupied square footage in individual buildings. The amount of these capital costs that would otherwise be assignable to DEBS is placed into a Service Company Facilities Rate of Return

(Facilities ROR) governance pool. This pool is not specifically addressed in the Service Company Agreement, but is nonetheless an indirect cost of providing the service functions.

During 2007, DEBS allocated this pool to all business units, including DE-Kentucky, based on the governance three-factor formula. In 2006, it used the governance number-of-employees ratio. DE-Carolinas provided supporting documentation showing its calculation of 2007 capital costs per square foot for approximately 25 facilities. The analysis compared the annual cost per square foot for each facility to market-based rates for that facility. DE-Carolinas's cost was higher than market for all but one facility, *i.e.*, a small garage. The DE-Carolinas calculation of capital costs used the market rate for that one facility and its actual cost for the remainder. This approach is consistent with the requirement that DE-Carolinas charge the higher of cost or market. Arguably, DE-Kentucky is paying higher than fully embedded cost for its share of that one facility; the effect, however, is *de minimis*, as the total cost for this facility is extremely small (approximately $400 per year).

The DEBS share of the capital costs is $1.0 million per month. DEBS also is responsible for $0.15 million per month in depreciation associated with the alternative data center located at the McGuire nuclear station, which brings the monthly cost to $1.15 million. Of the total facilities ROR pool charges of $13.8 million in 2007, DE-Kentucky received 2.81 percent. Liberty's review of Service Company inter-company charge data substantiated that the monthly Facilities ROR expense of $1.15 million was accurately allocated to the business units, including DE-Kentucky.

Liberty sought to determine whether the Facilities ROR pool charges in 2007 reflect the movement of approximately 2,000-2,100 employees from DE-Carolinas to DEBS effective in January. Accounting personnel reported that the company performs routine studies to calculate ROR governance pool charges. The study to determine 2007 charges conducted in early 2007 used 2006 data. The 2007 charges therefore do not reflect the space occupied by the utility employees moved to DEBS; the additional space will not be incorporated into charges until the study for 2008, which will use 2007 data. Charges to DE-Kentucky in 2007 were lower than they otherwise would have been if DEBS had incurred the cost of the additional space.

The Service Company collects similar costs for legacy Cinergy buildings; however, it does not include property insurance (reportedly only $20-30 thousand per year) in its calculations. The Service Company provided a summary showing the derivation of capital costs of $9.43 million associated with the Cinergy Plainfield facilities and $9.72 million associated with the Cinergy Cincinnati facilities. DESS occupies 92.09 percent of the Plainfield facilities and 89.65 percent of the Cincinnati facilities, which translates into costs of $8.69 million and $8.71 million, respectively. Accounting personnel use journal entries each month to assign the relevant portion of these costs to the business units, based on square footage. The Service Company conducts an analysis of how DESS personnel support the various business units, and assigns square footage to business units accordingly. DE-Kentucky receives 5.4 percent of the charges associated with the Cincinnati facilities and 6.0 percent of the charges associated with the Plainfield facilities. Liberty's review of Service Company inter-company charge data with accounting personnel substantiated that the DESS monthly facilities expense of $1.5 million was accurately allocated to the business units.

9. Spectra Transition Agreement

The Service Company had separate service agreements with Duke Energy Field Services and with the Canadian portion of Duke Energy Gas Transmission for shared services in 2006. Charging costs across the U.S./Canadian border has tax implications. The Service Company identified the costs relevant to the Canadian portion of DEGT, and charged them to the U.S. portion of DEGT, which in turn billed them to DEGT Canada. Both affiliates comprised part of the Spectra gas portfolio spun off by Duke Energy in January 2007. The Service Company entered into a new, short-term agreement with Spectra for 2007, under which it typically priced individual services on a flat-fee rather than hourly basis. The Service Company sent Spectra an invoice for the work each month, and then credited back the charges to the appropriate responsibility center or cost allocation pool. Spectra also provided a small amount of services to the Service Company during 2007; the Service Company charged the costs to the appropriate business group or allocation pool. The Service Company billed Spectra $15.2 million during 2007. The transition agreement with Spectra ceased as of year-end 2007.

Liberty's audit of DE-Carolinas included a review with accounting personnel of the processing of charges to Spectra under its 2007 transition service agreement. Liberty was satisfied that the Service Company was appropriately billing Spectra for services under the contract, that it was being appropriately billed for services performed by Spectra, and that it was accounting for the charges paid by or to Spectra correctly.

10. Gas Company Spin-off Costs

During 2007, Duke Energy incurred costs of approximately $17.7 million in connection with the spin-off of the gas business.[7] Duke Energy recorded these costs in the Special Projects responsibility center at the Service Company level. The Service Company generally included these costs in the Executive and Other governance pool, which it allocated to all business units, including DE-Kentucky, by applying the three-factor formula ratio. DE-Kentucky received an allocation of 2.81 percent of these costs, or $0.5 million.

11. Examination of Senior Executive Labor Charge Distribution

Liberty's audit of DE-Carolinas examined time reporting data for the top executives of the corporation, the majority of which were part of the Service Company, to evaluate whether they charged their time in a reasonable fashion. Liberty had identified a number of errors; work in this audit sought to determine if and how the Service Company had corrected these errors.

The group of 64 executives that Liberty had originally reviewed in its audit of DE-Carolinas included the CEO, the executives that directly report to the CEO, and the direct reports of the CEO's direct reports. This group included positions such as group executive, president, senior vice president, and vice president. Accounting personnel provided data from FMIS covering the July 2006 to May 2007 period and data from BDMS covering the January to May 2007 period.

[7] Liberty's audit of DE-Carolinas found that Duke Energy's costs to achieve the spin-off during 2006 were approximately $58.0 million, plus $9.4 million in capitalized software

The accounting group sets up in its payroll system for each employee a default salary distribution, which specifies the percentage of salary that should be charged to specific business units or Service Company allocation pools. Unless the employee submits a time report specifying otherwise, salary is charged according to the default distribution. Two senior executives positively reported time during the period.

Liberty found that seven senior executives, including the DE-Carolinas President and six executives in nuclear-related areas, directly charged all of their time to DE-Carolinas in the time period. Unlike most other executives, they are not part of the Service Company for payroll purposes. Another ten senior executives directly charged their time to Midwest utilities or NANRG for the entire time period, consistent with their areas of responsibility. The senior executive in charge of new generation projects directly charged his time to DE-Carolinas, DE-Indiana, and NANRG. Liberty found the treatment for these 18 executives to be reasonable.

In all, 22 senior executives charged their time exclusively to one of the Service Company governance-level pools, such as human resources, accounting, and public affairs, throughout the time period. Liberty found this approach reasonable.

Of the remaining 24 senior executives originally reviewed by Liberty in its audit of DE-Carolinas, two charged their time to a single business entity; the rest charged into one or more pools in 2006. The Service Company uses an allocation method that is more accurately described as direct assignment to distribute the labor charges for three of the executives in the last group. The legacy Cinergy organization developed this approach in order to distribute salary costs for certain employees to both O&M and capital accounts, and distribution percentages were developed based on an analysis of the activities supported by these executives. Accounting personnel indicated that the direct assignment method will disappear when the legacy Cinergy organization is converted to FMIS in 2008. In roughly half the cases, the default salary distributions for this group of executives had changed from 2006 to 2007. Liberty had asked accounting personnel to determine why these executives' salary distributions had either changed or, in a few cases, did not appear to comport with the job title. They found that the salary distributions for nine senior Service Company executives contained errors, as summarized on the next table.

Executive Salary Distribution Errors

#	Salary Distribution - July 2006 to May 2007	Required Correction
1	50/50 Exec. Utility and Exec. Enterprise	All time to Exec Enterprise as of 1/07
2	100% DEC 2006; Mkt./Cust. Serv. Utility 2007	All time to Mkt. pools 2006 post-merger
3	Exec. Utility in 2006; Exec. Gov. 2007	All time to Exec. Utility in 2007
4	Mkt./Cust. Serv. Utility 2006; Exec. Gov. 2007	All time to Exec. Utility 2006 post-merger
5	Legal Utility 2006; 100% DEC 2007	All time to Legal Utility pool as of 1/07
6	Plan. Gov. 2006; Power Plan/Fuel Util. as of 2/07	All time to Utility pools 2006 post-merger
7	HR Gov. 2006; Exec. Enterprise as of 3/07	Time to Exec. Enterprise as of 1/07
8	HR Gov. 2006; Exec. Enterprise as of 3/07	Time to Exec. Enterprise as of 1/07
9	Cinergy holding company	Time to a legal pool as of 1/07

There was no one reason for the errors. In most cases, the executive's job function changed either after the merger with Cinergy, effective April 2006, or after the gas spin-off, effective January 2007, but the default distribution was not revised. In one case, a senior legal executive's time was charged to DE-Carolinas beginning in 2007 because of an inadvertent change.

Accounting personnel stated that the problems in time reporting due to the gas spin-off should have affected senior executives only, because they were the ones most affected by the divestiture. Liberty estimated that the net effect on charges to the business units would be relatively modest. The errors in most cases involved charges made into one allocation pool in lieu of another; the allocation percentages for the pools were similar. Liberty recommended in the DE-Carolinas audit revisions to the default salary distribution for the nine senior executives whose labor had been charged incorrectly, and the issuance of journal entries to correct the distribution of labor charges to the business units for the appropriate time period.

The Service Company subsequently corrected the salary distributions in the payroll system. In December 2007, accounting personnel also issued journal entries of approximately $1.5 million to correct seven of the executive pay errors. Accounting did not make journal entries associated with two of the errors that affected 2006 charges because the books had already been closed.

12. Examination of Service Company Employee Time Reporting

Liberty's audit of DE-Carolinas included a review of time reporting data for approximately 140 exempt management and non-management Service Company employees. Liberty undertook this review to evaluate whether their time charge appeared to correspond to work performed. The survey was intended to provide a check on Liberty's initial analysis about the extent to which Service Company employees directly charge their time. Liberty's analysis covered a significant portion of the period of this audit, and the findings from its analysis remain relevant and valid.

In that prior audit, Liberty selected approximately 60 employees performing Service Company utility-related functions, primarily engineering and technical services (*e.g.*, substation and transmission engineering), along with materials management, warehousing, and customer service. Many of these employees were still part of DE-Carolinas for payroll purposes during 2006. Liberty selected the balance of the employees from more traditional Service Company functions, such as human resources, accounting, finance, legal, and internal auditing. Accounting personnel provided eleven months of data from FMIS and BDMS for selected employees for the July 2006 to May 2007 period.

Liberty did not find examples of time reporting that appeared on their face to be wholly inconsistent with job titles. Liberty's overall observation after that review of time reporting data was consistent with the conclusion it reached earlier from analyzing Service Company charges. That conclusion is that the Service Company does not directly charge as much labor as one would expect.

In the traditional business functions, Liberty reviewed data for approximately 20 legal and auditing employees. All of the auditors charged to the internal audit governance pool. The employees in the legal groups, which covered such areas as commercial operations, regulatory, labor and employment, and litigation, did not follow a distinct pattern in charging their time.

Overall, roughly half were able to charge all or a majority of their time to specific business units, such as to the Midwest utilities or to DE-Carolinas. The other half charged all or a majority of their time to allocation pools. There was no obvious correlation between job responsibilities and time reporting. Two attorneys in the commercial operations area, for example, were able to directly charge only 10 to 30 percent of their time; the rest went to pools. One attorney in the labor and employment area was able to directly charge roughly 75 percent of his time, while another in that area charged nearly 70 percent to governance and enterprise pools.

In most cases, there was no obvious correlation between how a manager in the legal area and his or her direct reports charged time. For example, one senior management employee in the regulatory area charged time primarily to the legal utility pool. The manager's three direct reports charged nearly all of their time to the Midwest or to DE-Carolinas, consistent with their job responsibilities. In another case, a managing attorney in the FERC area charged the majority of his time to the legal utility pool; one of his direct reports charged all of his time to DE-Carolinas, and the other charged to various utility, enterprise, and governance pools.

Liberty reviewed time reporting data for approximately 40 employees at various levels in the organizations that perform human resources, finance, and accounting functions. With few exceptions (*e.g.*, employees responsible for DE-Indiana and non-regulatory accounting), these employees charged all time to allocation pools. Liberty expected that mid-level managers, such as those responsible for asset accounting revenue analysis or wholesale accounting, would have been able to distinguish at least some portion of their time as relevant to only one particular business unit.

In the IT area, Liberty reviewed time reporting data for approximately a dozen employees. The majority were management level employees, who charged nearly all of their time into one specific IT pool. In the case of employees in the areas of IT operations and data center management, this result appeared logical. Management level employees in the applications areas, as well as project managers and application developers, also charged the majority of their time into pools. Liberty expected that some employees would have been able to directly charge at least some portion of their time.

Liberty also sampled time data for a small number of employees in areas such as environmental affairs, strategy and business planning, and real estate. These employees charged into allocation pools in their respective areas. The commercial business employees that Liberty selected for review charged their time exclusively to Duke Energy Americas or the Midwest only, which appeared to be appropriate.

Liberty's test work disclosed a clear tendency for the time of Service Company employees in traditional functions to flow to allocation pools as the default labor distribution. Liberty did not observe an expected level of separate identification of the beneficiaries of specific assignments. Liberty did identify one error in time reporting in this area. Liberty questioned accounting personnel why the director of general accounting for the Midwest charged her time exclusively to the Midwest while the director for the Carolinas charged his time to the utility accounting services pool. Accounting personnel stated that the Carolinas director assumed the job at the beginning of 2007, but his default labor distribution had not been updated. They stated that the default distribution would be changed so that his time is charged exclusively to DE-Carolinas, and that accounting personnel would issue journal entries to correct the effects of the error. During this audit, accounting personnel provided a copy of the correcting journal entry, which resolved the issue.

The primary focus of Liberty's review of utility-related functions was the employees in the engineering and technical services functions. Liberty's general conclusion was that Service Company employees in the engineering and technical services functions directly charged or directly assigned a higher proportion of their time (as compared with some employees discussed below), and did not rely as much on allocation pools. A number of the selected engineering and technical services employees were legacy Cinergy employees whose time was distributed using a direct assignment method, which is based on an analysis of what efforts the employee supports. Three of these were higher level management, whose labor charges were spread based on capital projects, or between operations and maintenance (O&M) and capital. Another ten legacy Cinergy employees, engineers, and project managers had some or all of their time distributed using direct assignment, with the balance generally being directly charged to business units.

Liberty also surveyed some of the other utility-related functions. A large portion of the selected employees were those that moved from DE-Carolinas to DEBS in 2007. Liberty also selected legacy Cinergy employees for examination. This portion of Liberty's testing of time found that employees in the utility-type services make better use of direct charging than employees in the traditional business functions, but still overuse allocation pools in some areas.

Liberty selected two employees from the Midwest field operations (warehousing) organization. Both reported all or nearly all of their time exclusively to Midwest pools. One employee charged about five percent of his time to a materials management utility pool, which Liberty found appropriate. Liberty also reviewed time reporting data for a few materials management employees. One employee, a legacy Duke Power service technician, directly charged his time exclusively to DE-Carolinas, and another employee, a legacy Cinergy sourcing specialist, charged the majority of his time to the Midwest. This treatment appeared to be appropriate. Two employees, one of which was a buyer, charged their time exclusively to a materials management enterprise-level allocation pool.

Liberty also selected approximately two dozen management and non-management employees from various areas in the utility-level customer service and marketing function. The majority of employees, including those in the receivables, billing, customer support, revenue services, energy data management, and call center areas, charged their time exclusively to the utility-level meter reading and payment processing pool. Two legacy Duke Power employees charged the majority of their time to DE-Carolinas, with a small amount going to the pool.

Liberty identified a few errors in time reporting of employees in utility-related functions. In one instance, an employee moved from an engineering position to one in the customer service area during 2006, but his time distribution was not updated to reflect the change until the beginning of 2007. During 2006, the default time distribution for two employees in the power quality area of the power delivery organization had been to DE-Carolinas customer service. The distribution changed to a Service Company customer service pool in 2007. Accounting personnel confirmed that the change was made in error, and that the employees' time should have been charged to DE-Carolinas rather than the pool. Accounting indicated it would issue journal entries to correct the error. During this audit, accounting confirmed that it corrected the default time distributions for these employees in September 2007. It did not, however, correct the dollar impact of the error. Accounting personnel estimated that DE-Kentucky had been incorrectly charged $11,000 through the pool. The Service Company should have made the corrections in 2007; the books are, however, closed for the year.

13. Examination of Service Company Accounts Payable Charges

A significant portion of the charges that DE-Kentucky receives from the Service Company relates to invoices that represent accounts payable. In some cases, a utility is directly charged for an entire invoice amount; in other cases, it is directly assigned only a portion. Accounts payable also charges invoices into the Service Company functional allocation pools, of which DE-Kentucky receives a percentage. Liberty's prior audit of DE-Carolinas involved the selection of a number of vendors and invoices for a focused review in order to gain insight into the effectiveness of the Service Company's processing of invoices. The vendors that Liberty selected included primarily accounting and law firms, construction-related companies, computer equipment and service companies, outside programming firms, banking and financial firms, and consultants.

In most cases, Liberty identified no issues with the way that the Service Company had distributed the charges for these invoices, and encountered only a few relatively minor errors. Liberty did identify, however, a potential problem in the handling of some IT invoices. Liberty found that two invoices from a vendor had been charged to a pool allocated using enterprise three-factor formula percentages, although the invoices appeared to be related to IT server services, which are allocated on the basis of the number of servers. Two other invoices from another vendor had been charged to the utility-level IT server pool. They might have been more appropriately charged to the enterprise-level IT management and support services pool because the work related to application maintenance and support services rather than servers. Allocation percentages among the various IT pools can vary significantly; therefore, the selection of which pool to use can affect the portion of invoice charges ultimately allocated to the utility. For example, DE-Kentucky's share of the utility-level IT server pool in 2007 was 6.91 percent, compared to 2.99 percent for the enterprise-level management and support pool.

DEBS transaction testing in this audit involved the selection of an $89,000 charge into the IT management and support services pool, which is allocated using the enterprise three-factor formula ratio. Liberty substantiated that DE-Kentucky was allocated the correct portion of the charge. Liberty asked Service Company accounting personnel to investigate why the supporting invoices, which were for server maintenance, were charged to this pool, rather than, for example, the IT server pool. Accounting reported that the person who assigned the invoices believed they were charged to the appropriate pool, but agreed that the rationale was not apparent given the nature of the invoices.

C. Conclusions

1. A significant amount of costs that flow through the Service Company to business units do not relate to the costs of providing services under the Service Company Utility Service Agreement. *(Recommendation #1)*

Some charges that flow through the Service Company do not fit the categories expressly covered by the Service Company Utility Service Agreement. For example, the DEBS human resources group directly charged DE-Carolinas nearly $50 million for employee benefits costs such as OPEB, phantom stock, and employee savings plans in the first three months of 2007. These charges are not for services provided by the Service Company, and do not relate to Service Company labor. They simply comprise other costs passed through the Service Company. Similarly, the DEBS Engineering and Construction–Power Production function charged DE-Carolinas $1.5 million for liability insurance, which is not part of that group's defined purpose. A significant amount of Service Company charges to business units reflect similar pass-through costs.

During 2007, this issue primarily concerned DEBS and DE-Carolinas. Many pass-through costs were typically recorded directly on the books of the Midwest utilities, and did not flow through DESS. However, the Service Company more recently began to flow some otherwise pass-through costs for the Midwest business units through DEBS. For example, in 2007 DEBS directly charged the Midwest business units a total of approximately $5 million for workers' compensation amortization expense. After the consolidation of DEBS and DESS, the Service Company plans to flow more pass-through costs, including most of those related to employee benefits, through DEBS.

2. Liberty's test work verified correct calculation and charging of DE-Kentucky for its share of allocation pools.

Review of data for a sample month substantiated that DEBS and DESS correctly calculated the amounts charged to DE-Kentucky for governance-, enterprise-, and utility-level allocation pools, based on the predefined allocation percentages. Liberty also substantiated that DESS correctly calculated the amounts allocated to DE-Kentucky from the Midwest-only allocation pools.

3. Overall, the Service Company does not make sufficient use of direct charging for labor costs. *(Recommendation #2)*

Liberty examined how much loaded labor costs DEBS and DESS charged directly to business units rather than allocating them. Overall, DEBS directly charged approximately 40 percent of loaded labor charges to business units, and DESS directly charged approximately 60 percent. Thus, the Service Company as a whole directly charged as much governance and shared service labor as it allocated, as the next table summarizes.

[redacted]

[redacted]

[redacted]	[redacted]		[redacted]		[redacted]	
	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]		[redacted]		[redacted]	

Moreover, the Service Company's approach to tracking and charging Service Company costs does not result in a good match between a business unit's use of a service function and the cost that it pays for that function. Even when the Service Company directly charges a business unit for labor, these charges do not reflect fully allocated costs, in that they do not include applicable overhead. Therefore, even an increase in the amount of direct charging would not fully solve the overall problem.

Liberty discusses this issue in more detail in other sections of this report. Liberty has stated that the Service Company requires a more sophisticated approach for pricing its functional services. Liberty believes a sound approach should enable one to determine: (a) whether the Service Company is maximizing the effective use of direct charging, (b) whether the costs of individual functional services provided by the Service Company are lower than other alternatives, and (c) whether DE-Kentucky is cross-subsidizing other business units in the charges it pays for individual services.

4. **For the traditional, business-type shared services that it provides, the Service Company charges a reasonably sufficient portion of non-labor costs directly, but does not make sufficient use of direct charging for labor costs.** *(Recommendation #2)*

Traditional business-type shared services include such functions as accounting, finance, human resources, and IT. Liberty examined charges from DEBS and DESS that the Service Company identified as related to the legal function. In October 2007, the Service Company directly charged approximately 55 percent of its total overall costs to client companies. Liberty found that the Service Company was able to directly charge or assign a relatively large portion (90 percent) of charges for outside services and contract labor. It performed less well with labor charges. The Service Company directly charged only 30 percent of its loaded legal labor costs for the month.

Liberty also examined the charges from DEBS and DESS that the Service Company identified as related to the IT function. The Service Company directly charged to business units only 20 percent of general IT costs, and the same percentage of the loaded labor cost portion. It allocated approximately 80 percent of the costs for outside services and contract labor, and approximately 60 percent of hardware and software purchases and maintenance. Liberty recognizes that a considerable portion of IT costs relate to activities that are appropriately allocated to all companies or users, such as data center operation and maintenance of standard hardware and software. However, groups like legal and IT are generally able in service company contexts to directly charge employee time, because these groups generally tend more often to work on distinctly identifiable projects or activities.

5. **From the perspective of utility-type shared services that it provides, the Service Company has been effective in directly charging those total costs.**

Liberty examined charges from DEBS and DESS that the Service Company identified as related to the power engineering and construction function. In October, 2007, the Service Company directly charged approximately 90 percent of its total overall costs, and loaded labor cost in particular, to client companies. Liberty found that the Service Company was able to directly charge or assign a relatively large percentage, 95 percent, of charges for outside services and contract labor.

Liberty also examined the charges from DEBS and DESS that the Service Company identified as related to the rates function. The Service Company directly charged to business units approximately 60 percent of rates function costs in general, and loaded labor costs in particular. Liberty found that the Service Company was able to directly charge or assign a relatively large percentage, 90 percent, of charges for outside services and contract labor.

As might be expected, DEBS and DESS each provided these services to its associated legacy utility organization. All DEBS direct charges for these services were made to DE-Carolinas, and essentially all DESS direct charges were made to Midwest companies.

6. The Service Company does not charge business units, including DE-Kentucky, for all costs associated with DEBS assets on a per transaction/unit basis.

The Service Company Utility Service Agreement states that services will be priced at fully allocated costs, defined as direct costs, indirect costs, and costs of capital. The agreement specifically lists property insurance, depreciation, amortization, and compensation for the use of capital as examples of the cost of doing business. DEBS recorded a cost of debt for construction work in process throughout 2007, and beginning in May 2007 recorded both a debt and equity cost of capital. During 2007, the Service Company allocated to business units $28.7 million of depreciation costs. Costs of insurance, and property related taxes, unless specifically associated with a DEBS project, are not assigned to construction work in process, but are allocated to client companies as an operating expense using an approved allocation method.

7. The Service Company charges the majority of DESS capital costs to legacy Cinergy companies.

During 2006, the Service Company allocated all depreciation costs associated with DESS assets to Midwest business units only, having concluded that only one set of service company assets was needed to run a corporation and that the depreciation associated with duplicate systems should not be spread to all business units. In 2007, the Service Company began to accelerate the depreciation on DESS financial systems, and re-categorized the depreciation associated with those assets as part of its merger cost-to-achieve. Of the $18.1 million in DESS depreciation expense during 2007, the majority ($13.8 million) was allocated exclusively to Midwest entities. Depreciation associated with cost-to-achieve assets of $4.3 million was allocated to all business units, including legacy Duke Power companies, using the governance three-factor formula ratio.

8. The Service Company adequately recovers from client companies the cost of its occupancy in legacy Duke Power and Cinergy facilities.

DE-Carolinas calculates capital charges, including depreciation, property tax, property insurance, and cost of capital, associated with each of its facilities in North Carolina. The portion of these capital costs that DE-Carolinas would otherwise assign to DEBS are recovered through a "Facilities ROR" governance pool, which the Service Company allocates to all business units using the three-factor formula ratio. Similarly, the legacy Cinergy utilities calculate capital charges associated with the Plainfield and Cincinnati facilities. The portion of these capital costs associated with the space occupied by DESS personnel are allocated to business units based on an analysis of how DESS personnel support the various business units.

The calculation of the DEBS Facilities ROR charges for the year 2007 is based on year 2006 data, and does not reflect the movement of approximately 2,000 employees from DE-Carolinas to DEBS. DE-Carolinas will therefore not recover from the Service Company the capital costs associated with the incremental square footage occupied by these employees. This translates into a savings for DE-Kentucky.

9. The Service Company correctly applied the proceeds from the service contract with Spectra to offset costs that it allocates to DE-Kentucky and other business units.

In 2007, the Service Company billed Spectra $15.2 million under a short-term agreement that generally priced individual services on a flat-fee rather than hourly-charge basis. Spectra also provided a small amount of services to the Service Company.

During the prior audit of DE-Carolinas, Liberty reviewed the arrangement with accounting personnel, and determined that the Service Company was appropriately billing Spectra for services under the contract and crediting the charges to the appropriate responsibility center or cost allocation pool. Liberty was also satisfied that the Service Company was being appropriately billed for services performed by Spectra, and that it was charging the costs to the appropriate business function or allocation pool.

10. The original distribution of labor charges for several senior executives reviewed by Liberty in its audit of DE-Carolinas contained errors that were subsequently addressed appropriately.

During a prior audit of DE-Carolinas, Liberty found the distribution of labor charges for nine Service Company senior executives to contain errors. Typically, the job functions of these executives changed either after the merger or after the gas spin-off, and their fixed salary distributions were not updated in the payroll system. Accounting personnel corrected the salary distributions and subsequently issued journal entries to correct seven of the executive pay errors. Accounting personnel did not make journal entries associated with two of the errors that affected 2006 charges because the books had already been closed. Liberty believes the actions taken were reasonable and resolve the issue.

11. Service Company employees rely too heavily on the use of default time distributions to allocation pools rather than positive time reporting. *(Recommendation #3)*

Liberty's review during the previous audit of Service Company time reporting data reinforced its conclusion that the Service Company employees do not directly charge as much labor as they can. A large percentage of the employees that Liberty reviewed, particularly those associated with the more traditional Service Company functions such as accounting or auditing, charged all or nearly all of their time into allocation pools. Liberty found it remarkable that so many employees were unable to identify at least some amount of work during an entire 11-month period that applied to only one business entity. While it may be true that an employee's work benefits, for example, all utilities, it arguably does not do so every hour of every day.

12. Audit work disclosed a number of cases in which labor allocations were incorrect as a result of the Service Company failing to update default distributions to conform to organization, position, or job duty changes. *(Recommendation #3)*

Duke Energy and its subsidiaries have undergone major changes recently to combine operations as a result of the merger and as a result of non-utility business changes. It is understandable that gaps or errors will result in how time is allocated when organizations, positions, incumbents, and job descriptions change. Nevertheless, it is important to apply controls that are effective in minimizing the time that such gaps or errors remain. Liberty's examination of employee time reporting identified a number of examples where errors occurred due to a lack of updating.

13. There is not a sufficiently clear rationale for including certain IT invoices in a given Service Company allocation pool. *(Recommendation #4)*

During its prior audit of DE-Carolinas, Liberty examined a sample of Service Company invoices and found that four invoices for IT services may have been charged to the incorrect IT allocation pool. Because of the difference in allocation percentages among the twelve defined Service Company IT pools, DE-Kentucky received a higher percentage of the charges than it otherwise might for two invoices and received a lower percentage than it otherwise might for two other invoices. During its transaction testing in this audit, Liberty encountered two invoices charged to the IT management and support services pool that were allocated using the enterprise three-factor formula ratio, although the invoices indicated that they were for server maintenance. Service Company personnel involved in testing could not explain the rationale for this assignment; there is reason to question the consistency in handling of certain IT invoices.

14. The costs incurred to accomplish the spin-off of the gas business are not related to the costs to provide regulated utility service.

Any benefits associated with the spin-off of the gas business will accrue to shareholders of Spectra and Duke Energy, and not ratepayers. The costs that the company incurred to effectuate the spin-off are not part of the cost of providing utility service.

D. Recommendations

1. Limit Service Company charges, to the extent possible, to those covered by the Service Company Utility Service Agreement. *(Conclusion #1)*

Liberty believes that the Service Company should reduce the amount of charges that it processes as pass-through costs that have no relation to the functions it provides under its agreement with the business units. Liberty recognizes that the Service Company may want to flow some charges, such as those for outside legal and auditor bills, through the Service Company to better identify and manage the full cost of these functions. The process for handling any pass-through costs that are not directly related to the functions that the Service Company provides could be made clear as part of a company's affiliate transaction accounting manual.

Liberty has learned, however, that the company plans to file an amended Service Company Agreement that will make explicit areas in which it plans to treat specific pass-through costs as part of a given service function. For example, the definition of services performed by the human resources function will be expanded to include the payment of certain employee benefits expenses.

Liberty believes that amending the Service Company Agreement in such a way as to clearly define all pass-through costs covered by the agreement would be a positive step towards implementing its recommendation. There are downsides to this approach, however. The amount of direct charges flowing from the Service Company to the business units will significantly increase. These typically large pass-through costs cloud any assessment of whether the Service Company is truly maximizing the effective use of direct charging for the functions it has contracted to perform at fully distributed cost. It also makes it difficult to compare the cost of service company functions to the cost of third-party suppliers or self-provision. To that end, Liberty believes that the Service Company should separately identify its major categories of pass-through costs in any official reports of affiliate transactions.

2. **Increase the percentage of labor that the Service Company directly charges to business units.** *(Conclusions #3 and #4)*

Liberty's examination of shared services in general, and traditional business-type shared services in particular, disclosed that the Service Company did not make sufficient use of direct charging for its labor costs. It is not unreasonable to expect the Service Company to directly charge or directly assign from two-thirds to three-quarters of its labor costs. For groups like legal and IT, which tend to work on defined projects, the percentage can be higher. Liberty recognizes that the Service Company may not be able to attain these levels unless it moves to a more sophisticated approach for pricing its functional services, such as activity-based costing.

3. **Routinely review the appropriateness of Service Company employee default labor distributions and encourage employees to do more positive time reporting.** (*Conclusions #11 and 12*)

The Service Company should review on an annual basis the default labor distributions for Service Company employees to determine if they are still appropriate. Recent organization changes due to the shift of two thousand people from DE-Carolinas to the Service Company and the recent gas business spin-off underscore the need for the Service Company to ensure that each employee's default labor distribution accurately reflects the work assignments of the individual. The errors that Liberty identified during its limited review of employee time reporting during the prior audit indicate the merit in assuring timely correction.

As discussed in an earlier chapter of this report, a Duke Energy internal report indicated that training programs were needed to educate personnel in how to charge time directly assignable to a utility or non-utility company, and that this finding applied to both utility personnel and Service Company personnel. The internal auditor's recommendation lends support to Liberty's conclusion that Service Company employees in general did not directly charge labor as much as they could.

There should be a structured and comprehensive program for assuring that default time distributions have been made current in light of recent organization, position, and job duty changes. It should include instructions to managers and supervisors to be aware of the potential in their areas of responsibility and to examine likely sources of a lack of updating based on changes specific to their areas. It should also include sufficient testing by accounting personnel to identify the likely magnitude and principal locations of errors, and should incorporate methods for more detailed examinations of those errors including a means for the prompt correction of any problems found. After a baseline effort across the board, the program can be scaled back to periodic testing in areas of known significant change, accompanied by periodic communication to managers and supervisors of the need for attentiveness when changes occur in their areas of responsibility.

4. **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.** *(Conclusion #13)*

The dollar impact of misallocation of invoice charges for IT services can be significant. To provide consistency and clarity in the method by which IT-related invoices are charged into the various Service Company allocation pools, the Service Company should develop formal written guidelines.

To monitor how well invoices are being handled on an on-going basis, the company should include a review of invoices flowing through the Service Company in its next internal audit of affiliate transactions.

VI. Operating Agreements

A. Introduction

Liberty reviewed the two merger-related agreements covering services among utilities and affiliates, the Operating Companies Service Agreement and Operating Company/Non-utility Companies Service Agreement. Liberty sought to determine whether DE-Kentucky and its affiliates were following the terms of the agreements, including those regarding pricing. Liberty also sought to determine whether Duke Energy had established a defined Service Request process for all work performed under these agreements, and whether the process has been consistently followed.

Not surprisingly, the majority of transactions are among the utilities, with DE-Ohio as both the largest provider of services and the largest receiver of services. While DE-Kentucky performs work for non-utility affiliates, it is fairly unusual for a non-utility affiliate to provide services to the utility. In this chapter, Liberty provides an overview of charges among affiliates under the agreements. Liberty also discusses an additional component of fully embedded cost, *i.e.*, utility overhead, and examines transactions that fall under the DE-Carolinas Code of Conduct condition.

B. Findings

1. Inter-company Charges involving DE-Kentucky

Liberty asked for reports showing affiliate transactions between DE-Kentucky and its affiliates during the audit period. Accounting personnel provided inter-company charge data from BDMS, but the data were not limited specifically to work performed under the Operating Agreement and Non-utility Agreement. No other available reports focused specifically on transactions under the agreements. DE-Kentucky is not required to identify, quantify, and report to the KyPSC its transactions under the merger-related agreements.

The inter-company data reflect charges flowing through inter-company payables and receivables accounts that originated from the labor, accounts payable, inventory, and vehicle charge systems. The data cover more than affiliate transactions. For example, invoices for Midwest utilities are paid from the same location and therefore some portion of the accounts payable charges consist only of pass-through costs. In other words, beyond serving as a conduit for the pass-through of costs others incur for providing goods or services, the charging affiliate adds no other value. The data also include both system-generated and manual journal entries that were made for various purposes. For example, included in the journal entries are approximately $59,000 in interest received by DE-Kentucky from DE-Ohio and approximately $143,000 in interest paid to DE-Ohio and DE-Indiana. Accounting personnel indicated that as a general matter inventory and accounting entries are typically not parts of work performed under the two agreements.

Accounting procedure is to reflect all transactions under the two merger-related agreements as inter-company charges through the company payables and receivables accounts. Liberty was therefore satisfied that the data provided captured the transactions that are the subject of this audit.[8] Liberty was not able to adequately screen the data to remove charges that did not relate to affiliate transactions in general and to the two merger-related agreements in particular. This inability affected Liberty's transaction testing process, as the next chapter of this report discusses.

The following tables summarize inter-company charges involving DE-Kentucky. The first shows DE-Kentucky as the service provider or originator of the charges, and the second shows DE-Kentucky as the client or receiver of the charges.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]		[redacted]	[redacted]	[redacted]		[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

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[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]			[redacted]				[redacted]
[redacted]	[redacted]						[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Nearly all of the [redacted] in inter-company charges originating with (or "from") DE-Kentucky involved affiliated utilities. Loaded labor accounted for approximately 50 percent of DE-Kentucky's total charges to affiliates.

Nearly all of the [redacted] in inter-company charges to DE-Kentucky originated from utility affiliates (DE-Ohio in particular). Loaded labor accounted for less than 30 percent of the charges to DE-Kentucky from affiliates.

[8] Liberty later identified a journal entry charge by DE-Kentucky to DE-Carolinas, made to true up for an overhead loader, which was not included in the inter-company data.

The BDMS data includes charges to and from legacy Cinergy entities, and charges from DE-Kentucky to legacy Duke Power affiliates. Accounting personnel provided separate reports showing FMIS-originated charges to DE-Kentucky, *i.e.*, charged by DE-Carolinas or another legacy Duke Power affiliate. The next chart summarizes charges from DE-Carolinas to DE-Kentucky during the audit period.

[redacted]

Liberty asked the company to explain the nature of the negative journal entries. Accounting personnel explained that the contract labor charges of [redacted] were made by a DE-Carolinas responsibility center, but should have originated from a Service Company center. Accounting used journal entries to reverse the charges. While researching the journal entries, accounting personnel discovered that DE-Kentucky had been over-credited by $864.

DE-Carolinas was the only legacy Duke Power affiliate that charged DE-Kentucky during the audit period.

2. Service Request Process

The Operating Agreement and Non-utility Agreement state that all services should be performed in accordance with Service Requests issued by the client company and accepted by the service provider. Duke Energy developed a formal Service Request Form (SRF), which records the requestor, provider, description of service, approvals, estimated costs, accounting codes, and scheduled start and end dates for specific work performed subject to the agreements. The company also developed a Service Request Form Database to keep track of such requests.

Duke Energy found that its affiliates were not consistently using SRFs to document requests for service under the agreements. The absence of SRFs was notable in particular for work provided by DE-Ohio to DE-Kentucky. The sharing of employees between those affiliates occurred regularly well before the merger, with crews routinely being dispatched to both Ohio and Kentucky. Neither affiliate set up SRFs for this type of routine work. This issue was identified in an internal audit report, which Chapter III of this report discusses.

Duke Energy developed a process for institutionalizing the use of SRFs, conducted training for relevant personnel in early 2007, and formalized the process for administering SRFs. The Financial Planning and Reporting group now has the responsibility for FE&G-related transactions and for enforcing the use of SRFs. The group was responsible for manually reviewing reports of inter-company charges in 2007 to identify those charges that actually reflected affiliate transactions, as opposed to inter-company charges for other reasons. The group also had responsibility for tying those charges to SRFs. The group identified some SRFs that had to be created after the fact. Chapter III of this report describes this review process in the section discussing the corporation's internal audit report.

The Service Request Form application was part of a web-based system until November 2007, when the company moved it to the corporate IT electronic form system that all Duke Energy employees can now access through a common platform. The new electronic form now incorporates a box which can be checked "to confirm that this Service Request will not result in impairment of Service Provider's utility responsibilities or business operations."

An SRF cannot be cancelled or rescinded in the system after it has been finalized and approved. If the original estimate for the dollar value of work is too low, for example, the requestor must submit another SRF for the additional work, because one cannot change the dollar amount on an approved SRF. The process to rescind an SRF is manual. The client company must communicate that the SRF has been rescinded and then the administrator of the SRF system indicates on future reports that this SRF is no longer considered approved for future transactions. No SRFs were rescinded in 2007. [9]

Duke Energy affiliates created approximately 70 SRFs during 2007. Liberty requested a printout from the database of all 2007 SRFs that included DE-Indiana or DE-Kentucky as one of the parties. The following tables summarize these SRFs.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]			[redacted]
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[9] Several SRFs were rejected prior to approval, and in some cases replaced with new ones. As examples, SRF 232 was replaced with SRF 234, and SRF 244 was replaced with SRFs 245 and 246.

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[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]			[redacted]

Some of these 36 SRFs involving DE-Indiana and DE-Kentucky displayed no activity or had no charges associated with them. Given the relatively small number of SRFs, Liberty conducted its review of the service request process for both utilities combined. All but one of the SRFs involved the use of "loaned employees" as defined under the agreements. The remaining one, which did not include labor, consisted of DE-Indiana's receipt of surge protection equipment on behalf of Duke Energy One.

Liberty selected a sample of ten from these SRFs, and asked for a copy of the original request forms.[10] Liberty's review of the original forms found that they contained all required information. However, in some instances, the work, project, or activity codes were marked as "TBD" or "various." This convention appeared to be appropriate for these SRFs given the nature of the request, *e.g.*, as-needed O&M support or storm support. The Operating Agreement and Non-utility Agreement state that Service Requests should be as specific as practicable in defining the required services. Liberty found the work descriptions to be adequate.

Liberty used this same sample of ten SRFs to review other provisions of the agreements. Liberty confirmed that loaned employees performing work under these SRFs continued to be paid the same payroll and benefits by their home organization while on loan to a client company. In each case, the loaned employee(s) worked under the direction, supervision, and control of the client company as appropriate to complete the work requested. Management provided for each selected SRF an affirmative statement that acceptance and completion of the services did not result in the impairment of the service provider's utility responsibility or business operations. There was no necessity to withdraw loaned employees. None of the work resulted in claims nor involved any deficiencies. The work performed complied with the work as described in the SRF.

Liberty sought to compare the original cost estimate for work performed under an approved Service Request to actual charges. As noted earlier, Liberty cannot identify which inter-company charges pertain to work under the Operating Agreement and Non-utility Agreement. Similarly, Liberty was typically unable to identify the actual charges associated with a given Service Request.

The Financial Planning and Reporting accounting group is responsible for manually reviewing reports of inter-company charges to identify which were actually affiliate transactions and tying those charges to SRFs. Group personnel identify inter-company charges that are potentially associated with each SRF. These charges can originate from the labor, inventory, accounts payable, and vehicle systems, and from journal entries. In some cases, specific work codes were included on the original SRF, and accounting personnel can use these codes to trace charges associated with a specific SRF. The work codes are not specified beforehand for larger blanket-type SRFs. Such SRFs can ultimately involve a large number of codes. In such cases, the group must rely on other code block fields, such as LOB, to identify potential charges. The accounting group enlists the support of operating personnel to examine potential charges to identify those not associated with the SRF. This after-the-fact analysis is time consuming and involves a good deal of judgment. In essence, there is no way to precisely track charges associated with individual SRFs.

Liberty requested a copy of the company's analysis of charges associated with SRFs. Several SRFs (*e.g.*, SRF 229 and 231) had no charges associated with them. SRFs are often set up in advance to cover potential work, *i.e.*, the provision of storm support work by customer service, which ultimately proves not to be needed. This proactive approach to SRFs is appropriate. Liberty found that in several cases the dollars charged for work performed under an SRF exceeded the initial estimate. As examples, charges for support during an ice storm provided by

[10] Liberty selected ten SRFs from the web-based system: 226, 231, 238, 245, 247, 251, 259, 269, 270, and 281.

DE-Kentucky and DE-Indiana to DE-Carolinas (SRFs 241 and 242 respectively) totaled $579 thousand, although the estimated cost under the SRFs was $450 thousand. Charges from DE-Kentucky and DE-Indiana to DE-Carolinas for support during a wind storm (SRFs 269 and 270) totaled $1.67 million, although the estimated cost was $1.2 million.

Other cases were more extreme. The accounting group provided its estimate of charges for three specific SRFs that involved as-needed O&M work at East Bend, Miami Fort #6, and Woodsdale performed by DE-Ohio on behalf of DE-Kentucky. The following table summarizes the estimated cost authorized in each SRF and the actual charges.

[redacted]

	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
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Accounting personnel explained that some of the charges under work codes associated with these SRFs did not pertain to what it would consider actual work performed under the Operating Agreement. For example, charges to DE-Kentucky under SRF 245 included pass-through charges for DE-Kentucky's share of coal purchases for Miami Fort.

There are other examples. Liberty's transaction testing disclosed a $260 thousand charge from DE-Indiana to a non-utility affiliate that was part of charges under SRFs 259/283, but actually related to an asset transfer. Such asset transfers are not covered by the Non-utility Agreement. Article I, Section 1.1(c) explicitly states: "For the avoidance of doubt, affiliate transactions involving sales or other transfers of assets, goods, energy commodities (including electricity, natural gas, coal and other combustible fuels) or thermal energy products are outside the scope of this Agreement." Accounting personnel indicated that there were no clear guidelines regarding treatment of pass-through charges or for determining whether inventory transfers should be covered by SRFs or by other types of agreements.

As noted earlier, affiliates did not make consistent use of SRFs during 2007. Accounting reviewed inter-company charges and developed a list of work activities involving DE-Indiana and DE-Kentucky that should have been covered by SRFs but were not. This analysis produced an estimate of $13.7 million of charges incurred under the agreements that should have been covered by formal Service Request. All of the work identified fell under the Operating Agreement. Liberty summarized the types of activities into broad categories, as shown in the next table.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]
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	[redacted]	[redacted]	[redacted]
		[redacted]	[redacted]

As a general matter, work that involves a non-utility affiliate should be covered by an SRF. Liberty's review of inter-company charge data found that DE-Kentucky provided $125 thousand of work to KO Transmission; it appears that this work was not covered by an SRF.

3. Overhead

In principle, an inter-company billing rate should leave the billing company at least no worse off by having lost the benefit of an employee's time spent serving another entity. Meeting this test in the case of labor requires that the employing company secure reimbursement for the employee's direct salary, with adjustments to account for non-productive time, such as vacation, holiday, and sick time; payroll taxes; and employer costs for benefits, such as pensions and medical and dental coverage. It also means that billing rates should include an additional loader for overhead costs.

Chapter III of this report discusses Liberty's conclusion that the accounting systems were appropriately calculating labor rates and labor loaders, with one exception, *i.e.*, that BDMS does not include incentives in labor charges outside the home company. The Operating Agreement and Non-utility Agreement state that charges for utility-related work must be priced at fully embedded costs. The utility must apply some amount for overhead to its fully loaded labor charges to meet this standard.

During 2007, the FE&G Group developed a standard overhead labor cost multiplier rate for use by DE-Kentucky and the other utilities for work charged outside the utility. Because of the unique staffing arrangement between DE-Ohio and its subsidiary DE-Kentucky, whereby some overhead such as supervision is shared, the FE&G Group also developed somewhat lower overhead rates applicable only to work performed between these two utilities, with separate rates for electric and gas. The components of the FE&G overhead cost multipliers are summarized in the following table.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]

Liberty reviewed with accounting personnel the derivation of the components of the overhead loaders, and found the approach reasonable. The cost of capital portion of fully embedded cost, for example, is reflected in the facilities component. DE-Ohio and DE-Kentucky elected to staff some employee that provide service to both utilities on the DE-Ohio payroll; therefore, the FE&G Group determined it need apply only a portion of the cost of Service Company governance and shared services in overhead for electric work between the two utilities. The FE&G Group also conducted an analysis to develop a multiplier specific to gas work between DE-Ohio and DE-Kentucky. The group concluded that it could eliminate the supervisory component because supervisors directly charge their time to such work as needed.

To calculate a fully embedded labor rate for work charged to an affiliate, DE-Kentucky applies to base wage rate a labor cost multiplier, in order to reflect fringe benefits, payroll taxes, unproductive time, and incentives, and the overhead multiplier. For example, if a DE-Kentucky non-exempt employee had a base hourly labor rate of $30 per hour, the fully embedded cost for this employee (assuming the work was performed for an affiliate other than DE-Ohio) would be $97.05 per hour, *i.e.*, $30 multiplied by the sum of 1.2864 and 1.9487, which is DE-Kentucky's labor cost multiplier rate for 2007.

During much of 2007, the Midwest utilities did not apply overhead to direct charges in utility-to-utility transactions, although they typically did apply overhead to charges to non-regulated affiliates. Charges from DE-Kentucky to affiliated utilities were therefore consistently priced at less than fully allocated costs. The legacy Cinergy utilities started using the new FE&G overhead multiplier in the third quarter of 2007. The BDMS system cannot incorporate the overhead multiplier into its labor loadings; accounting must therefore use journal entries to record the overhead component of charges. Accounting personnel issued journal entries to charge overhead costs for the labor that DE-Kentucky had charged to affiliates up through November. They also issued journal entries to reflect the difference between the new FE&G rate and the one the utility had applied to labor charges to non-regulated affiliates, which had been 14.91 percent. Accounting personnel also used journal entries to record overhead for December.

Liberty reviewed the journal entries and found that Midwest accounting had correctly calculated and applied overhead for labor charges from DE-Kentucky to affiliates that went through the labor system. It did not, however, calculate and apply overhead to labor charges that were recorded as journal entries. Some labor and labor loaders were charged to DE-Carolinas using journal entries, because early in the year BDMS was not set up to bill DE-Carolinas directly through payroll charges. Accounting personnel had to use journal entries to move the correct amount of labor and loaders to DE-Carolinas, breaking charges into separate entries by resource type (union labor, fringe benefits, etc.). Accounting also used a journal entry to credit DE-Kentucky for labor charges from DE-Ohio, which should have had a credit for overhead applied.

Liberty calculated the overhead amount that otherwise should have been applied, as summarized on the following table.

[redacted]

[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]

Accounting personnel agreed that overhead should have been applied to the labor charged through journal entries. The shortfall to DE-Kentucky was [redacted] due to overhead not collected from DE-Carolinas plus [redacted] due to an overhead credit not received from DE-Ohio. The company indicated that it would likely not issue journal entries to fix the problem because the books were already closed for 2007.

Unlike BDMS, FMIS automatically applied an overhead loader to labor charges originating in DE-Carolinas but charged outside the utility. Until August 2007, DE-Carolinas applied a loader of 83.19 percent, which was based on a 2005 analysis that utilized 2004 data. Liberty inquired whether DE-Carolinas had made journal entries to correct the shortfall between the old and new overhead rates. Accounting personnel stated that the new rate was implemented in mid-year. The change in the overhead loader in FMIS to the new rate came in August 2007; journal entries were needed to true-up for the difference in rates for July. There were no labor charges to DE-Kentucky in July and therefore no true-up was needed.

The overhead multiplier rate used during the first half of the audit period is therefore different between BDMS and FMIS. DE-Carolinas charged DE-Kentucky a total of [redacted] in labor during the first half of 2007, so the shortfall due to the difference between the overhead rates of .8319 and 1.2864 is minimal.

The Non-utility Agreement states that labor charges from non-regulated affiliates providing services to DE-Kentucky must also reflect fully embedded cost. When non-utility affiliates charged labor to DE-Kentucky, they applied standard labor loaders, but no overhead. Accounting personnel acknowledged that DE-Kentucky was therefore charged less than fully embedded

All of the work performed by DE-Kentucky involved mutual assistance for two separate storms, and was covered by two separate SRFs.[11] Charges from DE-Kentucky for one of the storms were above $100,000, and as such this set of charges constitutes a transaction subject to the DE-Carolinas conditions.

The Code of Conduct requires that DE-Carolinas must pay the lower of fully distributed cost or market for goods and services it receives. DE-Kentucky charged, or intended to charge, fully embedded costs for these services.[12] Liberty asked if DE-Carolinas had determined that fully embedded cost was lower than market for this work. DE-Carolinas provided a copy of its analysis of market rates for utilities working an emergency event. The company calculated the cost per man-day of seven utilities, including Cinergy, for assistance during a December 2005 ice storm, the average of which was $1,501 per man-day. It escalated the rate by three percent to derive an estimated December 2006 rate of $1,554. It also calculated the average cost for support from the Cinergy utilities during a February 2007 ice storm at $1,316 per man-day. The company concluded that the affiliate's rate was the lower of cost or market. Based on its review of inter-company charge data, Liberty concluded that the total Midwest charges used in the analysis reflect the otherwise missing overhead discussed above.

DE-Carolinas also charged DE-Kentucky for services during the audit period. None of the transactions were large enough to trigger the provisions of the Code of Conduct and therefore could correctly be priced at fully embedded cost.

C. Conclusions

1. DE-Kentucky received an excess credit from DE-Carolinas due to a journal entry error.

Charges to DE-Kentucky for contract labor that should have originated from a DEBS responsibility center were mistakenly charged from a DE-Carolinas responsibility center. Accounting personnel used journal entries to credit the utility for the charges from DE-Carolinas, but mistakenly over-credited DE-Kentucky by $864. The error is not sufficiently large to justify reopening the books for 2007.

2. Duke Energy affiliates did not consistently issue formal Service Requests for work performed under the Operating Agreement and Non-utility Agreement, but corrective actions have been initiated.

During the audit period, Duke Energy affiliates did not make consistent use of formal Service Requests for work performed under the agreements. Approximately $14 million of services provided under these two agreements that should have been covered by Service Request Forms was not. The corporation has taken steps during the audit period to institutionalize the use of Service Request Forms, and has assigned organizational responsibility for ensuring their use. Liberty believes that no recommendation is required in this area; however, in the next audit, the auditor should verify if the corporation has achieved 100 percent compliance.

[11] Liberty has assumed that the overhead true-up not listed under the mutual assistance project code was for labor charged for mutual assistance.
[12] As discussed above, the utility charged some labor and loaders to DE-Carolinas using journal entries, and accounting did not retroactively apply overhead to these charges.

3. Duke Energy cannot accurately identify charges associated with each Service Request. *(Recommendation #1)*

The Financial Planning and Reporting accounting group is responsible for manually reviewing reports of inter-company charges and for identifying those that relate to specific SRFs. The group identifies potentially relevant charges through the use of work codes or other code block fields. Nevertheless, it must ultimately rely upon operating personnel to review the potential charges to identify those that are not applicable to the SRF. The process is time consuming, and involves a great deal of judgment; accounting personnel acknowledge that the results may not always be accurate.

4. In several cases, actual charges for work performed subject to Service Requests exceeded approved estimates. *(Recommendation #1)*

Liberty observed a number of instances in which total charges associated with specific Service Requests exceeded the estimated cost established at the time the SRF was approved. For example, accounting personnel estimated that the work performed by DE-Ohio for DE-Kentucky subject to three SRFs totaled $41.6 million compared to the $11.7 million initially approved. Liberty identified other examples that were less extreme. The company related that for cases in which actual work will exceed the initial estimate, the requestor should issue another Service Request Form for the additional work. For example, SRF 283 was issued to cover additional charges for work originally requested in SRF 259. This protocol was not followed in several cases.

5. Duke Energy's guidelines regarding the types of charges that can be covered by a Service Request were not consistently followed. *(Recommendation #2)*

The company's written guidelines on SRFs specify that only the labor and materials associated with providing the requested service should be charged to work codes covered by an SRF. However, Duke Energy affiliates issued charges under work codes associated with Service Requests that do not actually relate to work performed under the Operating Agreement or Non-utility Agreement. For example, DE-Ohio passed through charges for coal purchases to DE-Kentucky, which accounting personnel ultimately associated with an SRF. DE-Indiana transferred a $260 thousand asset to Cinergy Utility Solutions using project and work codes associated with an SRF. In neither case were actual services being performed under the agreements. Similarly, accounting personnel indicated that the company had not yet decided whether inventory issuances and transfers should be covered by SRFs or by other types of agreements.

6. DE-Kentucky did not charge overhead for certain labor charges.

Some of the labor charges from DE-Kentucky to affiliates did not flow through the labor distribution system, but instead were recorded by accounting personnel via journal entries. Accounting did not retroactively apply overhead to the labor charges recorded in this fashion. Therefore, the labor was charged at less than fully embedded cost. For DE-Kentucky, this resulted in a total shortfall of $32,577 of overhead that it did not collect from DE-Carolinas and DE-Ohio. Liberty believes that most or the entire shortfall specifically related to charges under the Operating Agreement.

Accounting personnel indicated that correcting this error would not merit reopening the books for 2007, and Liberty agrees that the amounts are not significantly large enough to do so.

7. DE-Kentucky retroactively applied the FE&G overhead loader to labor charges for the entire year, but DE-Carolinas applied it only for the latter half of the year.

The legacy Duke Power accounting system, FMIS, automatically applies an overhead loader. DE-Carolinas had been applying an overhead multiplier rate of .8319, which was based on an analysis done in 2005. DE-Carolinas trued up for the difference between the old rate of .8319 and the new rate of 1.2864 beginning with July 2007 charges. It did not make corrections to labor charges made to affiliates during the first half of 2007. Accounting trued up overhead charges from BDMS at the new rate for the entire year. DE-Carolinas charged DE-Kentucky a total of $595.95 in labor during this period; the difference is minimal. Given the small dollar values involved, correcting this situation would not merit reopening the books for 2007.

8. Duke Energy utility affiliates generally charged overhead as part of fully embedded costs for work under the Service Agreements, but non-utility affiliates did not.

Non-regulated affiliates applied labor loaders to labor directly charged to DE-Kentucky, but no overhead. During the audit period, DE-Kentucky received approximately $100 in labor charges from a non-regulated affiliate, and was not charged overhead. Liberty believes it was reasonable not to devote the resources to deriving overhead costs for such small and infrequent charges. The effect is *de minimis*.

9. The pricing of transactions between DE-Kentucky and DE-Carolinas satisfied the conditions of the North Carolina Code of Conduct.

The Code of Conduct requires that DE-Carolinas must pay the lower of fully distributed cost or market for goods and services purchased from affiliates for transactions over $100,000. All of the work performed by DE-Kentucky during the audit period was associated with providing mutual assistance for two separate storms subject to two separate Service Requests. Charges from DE-Kentucky for one of the storms were above $100,000, and as such this set of charges constitutes a transaction subject to the DE-Carolinas conditions.

DE-Carolinas provided an analysis indicating that the average cost per man-day from the Midwest utilities during a February 2007 ice storm was more than $200 per man-day lower than the market rate, which it derived from actual rates that it paid for similar work in 2005 inflated to the current year. Liberty found the analysis reasonable, and concluded that charging fully distributed costs for the work was appropriate.

None of the transactions involving charges from DE-Carolinas to DE-Kentucky were large enough to trigger the provisions of the Code of Conduct and were priced at fully embedded cost.

D. Recommendations

1. Develop a method to precisely identify charges associated with individual Service Requests. *(Conclusions #3 and #4)*

Parties should be able to identify all charges associated with work performed subject to a Service Request. Liberty recommends that the corporation develop an accounting process that will allow it to accurately identify all costs associated with individual SRFs. For blanket-type SRFs that are issued without specific work codes, for example, the company could maintain a reference table of all project and work codes ultimately created for work associated with each request, and adopt a policy to ensure that no extraneous charges, such as pass-through costs, are charged to these codes. Codes on this reference table could then be used to identify relevant charges in the accounting system. If all relevant work is covered by SRFs, Duke Energy would be able to quantify the affiliate transactions subject to the Operating and Non-utility Agreements.

Liberty also identified instances in which charges for services were significantly higher than those authorized by the Service Request. Allowing service providers and requestors to accurately track charges will permit the parties to recognize situations in which a supplemental SRF is required because cost estimates for work have increased.

2. **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.** *(Conclusion #5)*

Asset transfers and many pass-through costs are not services as they were envisioned by the Operating and Non-utility Agreements, although they were treated as such by some personnel. The corporation should review its guidelines as to the types of charges that may be covered by Service Requests to determine if they are sufficiently clear and detailed. It should conduct adequate training to ensure that the guidelines are well understood and consistently applied. Liberty also recommends that the internal audit group include a review of compliance in its next audit.

VII. Transaction Testing

A. Background

Liberty conducted a series of transaction tests to verify the effective implementation of methods to price, account for, and report affiliate transactions. Liberty selected its test items from company-provided data for the January to December 2007 audit period. The systems, pricing, and procedures are the same for DE-Indiana and DE-Kentucky; therefore, Liberty conducted its testing for both utilities simultaneously. Liberty presents the results of that combined testing in this chapter of the report.

B. Findings

1. Service Company Charges

The primary purpose of Liberty's testing of transactions with DE-Indiana and DE-Kentucky was to determine whether the Service Company's practices for charging the utilities for governance and shared services were consistent with the processes and procedures as described to Liberty and with the Service Company Agreement.

Liberty conducted extensive transaction testing of Service Company charges during its audit of DE-Carolinas, a portion of which covered the first quarter of 2007. Liberty identified some accounting issues requiring correction, but concluded that there were no serious issues and that the level of error was consistent with expected levels of human error inherent in such a process. Liberty was therefore comfortable in testing a smaller number of charges for this audit, and focused more heavily on charges in the second, third, and fourth quarters of 2007.

The discussion of Liberty's testing of transactions between the Service Company and the utilities in this section is divided into two parts: (1) direct charges, and (2) allocated charges. Liberty tested transactions amounting to approximately \$2.2 million of direct charges and \$6.1 million of allocated charges.

2. Direct Charges

Liberty selected 28 direct charge test items, which the following table summarizes, from the 2007 audit period, and reviewed them with accounting personnel during testing sessions.

Direct Charge Categories Tested

Item	Function	Charge Type	DEI/ DEK
	DESS Charges		
1	Gen. and Trans. Planning	Labor and loaders	DEI
2	IT PC Network & Software	Outside services	DEI
3	Finance	Journal entry	DEI
4	Legal	Primarily labor and loaders	DEI
5	Gen./Trans. Right of Way	Labor, loaders, contract labor	DEI
6	Call Center	Primarily labor and loaders	DEI

7	Power Engr. & Construct.	Accounts payable	DEI
8	Rates	Accounts payable	DEI
9	Environ., Health & Safety	Primarily labor and loaders	DEK
10	IT PC Network & Software	Outside services	DEK
11	Accounting	Journal entry	DEK
12	Human Resources	Incentives	DEK
13	IT PC Network & Software	Outside services	DEK
14	IT PC Network & Software	Outside services	Both
15	Trans. Engr. & Construct.	Contract labor	Both
16	IT PC Network & Software	Contract labor	Both
DEBS Charges			
17	T&D Engr. & Construct.	Labor loaders	DEI
18	IT	Labor, loaders, contract labor	DEI
19	Marketing/Cust. Service	Accounts payable	DEI
20	Marketing/Sales	Outside services	DEI
21	Facilities	Outside services	DEI
22	Power Plan. & Operations	Labor loaders	DEK
23	Marketing/Cust. Service	Outside services	DEK
24	Facilities	Rent	DEK
25	Power Plan. & Operations	Labor and loaders	DEK
26	Accounting	Workers' comp. insurance	Both
27	Facilities	Rent	Both
28	Accounting/Finance	Journal entries	Both

Items #1, #4, #5, and #9 involve labor and associated labor loaders charged by DESS. Item #25 and a portion of Item #18 involve labor and associated labor loaders charged by DEBS. Item #25 involves labor charges associated with an exempt employee spot bonus, to which unproductive and incentives loaders are not applied. The accounting personnel produced adequate supporting documentation, and validated the charges and loader calculations. DESS records incentives using higher level journal entries rather than applying a loader to labor charges for individual transactions. Liberty did not verify incentive charges for individual DESS test items. Many of these test items also contain incidental charges for employee expenses, accounts payable, vehicles, or materials. Accounting personnel provided support sufficient to verify a Liberty-selected sample of these items.

Item #6 involves direct charges for labor and labor loaders by a Midwest call center that takes calls for new service. The call center's costs are typically charged into an allocation pool and spread to the Midwest utilities, which treat them as an expense. Accounting personnel explained that staff at the call center had been instructed to directly charge a small percentage of time specifically for support of new service calls. The charges associated with new service calls must be separately identified because they are capitalized.

Item #12 was a journal entry made to recognize special pay incentives and associated payroll taxes. Items #3 and #11 involve journal entries used by DESS to clear out indirect labor pool costs, such as those for unproductive time, fringe benefits, and payroll taxes. Accounting personnel explained that DESS uses year-end journal entries to true up for differences between the loader rate initially used and actual costs for the year. DESS then directly assigns the difference to business units based on how DESS charges its labor during the year.

Item #22 involves a true-up adjustment for incentive loader rates. A DEBS engineering and technical services group wanted to true up the incentive amounts it had charged out on its labor year-to-date. The accounting group performed an analysis to determine the amount of incentives that had been charged to individual business units, and then charged a pro-rated amount of the adjustment to each unit. Item #17 charges are associated with a similar incentive true-up adjustment by a power delivery group.

Items #2, #10, #13, #14, #16, #20, #21, and #23 are charges for outside services. The accounting personnel provided copies of the invoices, and usually included a cover sheet identifying the responsibility centers that originated and received the charge, along with the account number and resource type. For the most part, the accounting personnel were able to reconcile the charges.

Liberty found an exception, constituting an error, in Item #23, which involves an invoice for outside services for a Midwest call center, a portion of which was directly assigned to DE-Kentucky. When asked how the charges on the invoice had been divided among the Midwest utilities, accounting personnel explained that the direct assignment percentage was based on number of customers. The correct percentage for DE-Kentucky was 10.77 percent; however, accounting personnel discovered that DEBS had inadvertently used the DE-Ohio percentage to calculate DE-Kentucky's directly assigned charges in this case. Rather than being assigned approximately 11 percent of the invoice, DE-Kentucky was assigned over 50 percent. Accounting personnel estimated that DE-Kentucky was overcharged approximately $100 thousand, and noted that the Service Company would likely not correct the error as the 2007 books were already closed.

Items #15 and a portion of Items #5 and #18 relate to contract labor charges, and Items #7, #8, and #19 relate to accounts payable, and accounting personnel again were able to provide copies of the invoices and reconcile the charges.

Item #24 involves charges for facility lease payments paid by DEBS on DE-Kentucky's behalf. Accounting personnel provided a detailed list of leases that indicated the proportion that should be directly assigned to each business unit, and reconciled the charges. Item #27 involves rent-related credits to DE-Indiana and DE-Kentucky. The majority of the amount reflects credits for facilities rent that the real estate group collected on the utilities' behalf. A small portion was a credit to DE-Indiana for a rental payment returned by the landlord. Accounting personnel were able to provide adequate documentation and support the charges for these items.

Item #26 involves the direct assignment to the utilities of the monthly amortization of workers' compensation insurance expenses. Accounting personnel explained that the insurance company provides the business unit percentage distribution, which is based on number of eligible

Items #2 and #10 are charges for contract labor, Items #11, #13, and #14 relate to charges for outside services, and Items #17 and #18 relate to accounts payable charges. Accounting personnel provided copies of the invoices supporting the charges, and usually included a cover sheet that showed the responsibility centers that originated and received the charge, along with the account number and resource type. In the case of split invoices, accounting was able to explain how the percentages were derived. Overall, the accounting personnel were able to reconcile the charges.

Item #3 pertains to two sets of journal entry charges to a Midwest-only allocation pool. One set of journal entries was used to recognize expense for 401K incentive matching amounts. Accounting personnel stated that the company recognizes an expense, and then performs a true-up after the actual incentives are paid out in the next year. The other set of journal entries relate to amortization of software and other improvements at a Cincinnati office building. Accounting personnel explained that the nature of these costs were such that the benefit would not be shared across the corporation, and thus were appropriately charged only to Midwest entities through the pool.

Item #4 consists of journal entries used to charge to an accounting allocation pool costs such as depreciation and taxes associated with one of the company's headquarters buildings in Cincinnati. Item #19 involves charges to an environmental, health and safety pool for the space the group occupies at the McGuire station. Item #9 consists of journal entries used to charge an accounting allocation pool for interest expenses arising from the Money Pool Agreement.

Item #6 consists of stock material charges to a Midwest-only meter lab pool. Accounting personnel confirmed that the materials were used by workers throughout the Midwest service territories and was therefore appropriately charged to that pool.

Item #5 relates to a payment of penalty and interest charges resulting from a late payment for withholding to the State of Indiana. Accounting personnel were unable to explain why this charge was assigned to a Midwest-only pool, when the withholding applies to DESS employees. Item #16 involves journal entries to record the expense for phantom stock, which is a long-term incentive for executives.

For all test items, Liberty substantiated that DE-Indiana and DE-Kentucky received the appropriate percentage of each charge from the allocation pools.

4. Operating Agreement and Non-utility Agreement Transactions

The primary objective of Liberty's testing in this area was to determine whether the company's practices were consistent with the processes and procedures as described to Liberty, and with the Operating Agreement and Non-utility Agreement. As part of testing, Liberty examined whether:

- Prices for services provided from DE-Indiana or DE-Kentucky to affiliated utilities, or from affiliated utilities to DE-Indiana or DE-Kentucky, were at fully embedded cost
- Prices for products and services provided by DE-Indiana or DE-Kentucky to non-utility affiliates, or from non-utility affiliates to DE-Indiana or DE-Kentucky, were at fully embedded cost

- Charges were subject to a service agreement
- Charges were accurately calculated and recorded.

As discussed in Chapter VI of this report, accounting personnel provided Liberty with data on inter-company charges that involved DE-Indiana or DE-Kentucky, but were not able to separately identify those that pertained to the two merger-related agreements. Liberty could therefore not screen out from its sample population charges not covered by these agreements. The problem is most relevant to transactions among the utilities, and in particular those between DE-Kentucky and DE-Ohio, because of the existence of substantial contracts between the two parties. The next chart summarizes inter-company changes involving DE-Indiana and DE-Kentucky as either provider or client; BDMS processed all charges.

[redacted]

To allow for the possibility that some selected test items would not be covered by the Operating Agreement or Non-utility Agreement, Liberty increased the sample size. Liberty selected for testing thirty-seven groups of charges totaling approximately [redacted], and reviewed them with accounting personnel during testing sessions. The following table summarizes these 37 groups.

Charge Categories Tested

Item	From	To	Charge Type
DE Kentucky as Provider			
1	DE-Kentucky	KO Transmission	Labor and loaders
2	DE-Kentucky	KO Transmission	Accounts payable
3	DE-Kentucky	Duke Energy One	Labor and loaders; vehicles; journal entries
4	DE-Kentucky	DE-Carolinas	Journal entries
5	DE-Kentucky	DE-Carolinas	Primarily labor and loaders
6	DE-Kentucky	DE-Ohio	Accounts payable
7	DE-Kentucky	DE-Ohio	Labor and loaders

8	DE-Kentucky	DE-Indiana	Accounts payable
9	DE-Kentucky	DE-Indiana	Accounts payable
10	DE-Kentucky	DE-Indiana	Inventory
DE-Kentucky as Client			
11	DE-Indiana	DE-Kentucky	Labor and loaders; inventory; journal entries
12	DE-Indiana	DE-Kentucky	Accounts payable
13	DE-Ohio	DE-Kentucky	Labor and loaders
14	DE-Ohio	DE-Kentucky	Primarily labor and loaders and AP
15	DE-Ohio	DE-Kentucky	Primarily inventory
16	DE-Ohio	DE-Kentucky	Labor and loaders; AP and inventory
17	DE-Ohio	DE-Kentucky	Labor and loaders; AP; inventory; journal entries
18	DE-Ohio	DE-Kentucky	Labor and loaders; inventory
DE-Indiana as Provider			
19	DE-Indiana	DE-Ohio	Accounts payable
20	DE-Indiana	DE-Ohio	Labor and loaders
21	DE-Indiana	DE-Ohio	Accounts payable
22	DE-Indiana	DE-Ohio	Labor and loaders; journal entry
23	DE-Indiana	DE-Ohio	Inventory
24	DE-Indiana	DE-Ohio	Labor and loaders; vehicles
25	DE-Indiana	DE-Kentucky	Labor and loaders
26	DE-Indiana	DE-Kentucky	Accounts payable
27	DE-Indiana	Cinergy Power Gen	Labor and loaders
28	DE-Indiana	Cinergy Power Gen	Journal entry
29	DE-Indiana	Duke Energy One	Journal entry
30	DE-Indiana	DE-Carolinas	Journal entry
DE-Indiana as Client			
31	DE-Ohio	DE-Indiana	Labor and loaders; vehicles; inventory
32	DE-Ohio	DE-Indiana	Accounts payable
33	DE-Ohio	DE-Indiana	Primarily labor and loaders
34	DE-Ohio	DE-Indiana	Primarily labor and loaders and inventory

35	DE-Kentucky	DE-Indiana	Accounts payable; inventory
36	Cinergy Capital & Trading	DE-Indiana	Labor and loaders
37	Cinergy Corp	DE-Indiana	Journal entries

Items #1, #7, #13, #20, #25, #27, and #36, along with portions of Items #3, #5 #11, #14, #16, #18, #22, #24, #31, #33, and #34, involve charges for labor and associated loaders. Accounting personnel were able to validate the charges and loader calculations. Overhead was not included as part of the test item charges, as it was applied later during a true-up procedure. Item #36, however, involves labor-related charges from Cinergy Capital and Trading. Non-utility affiliates did not charge overhead (see Chapter VI of this report), which Liberty believes was reasonable under the circumstances. Many of these test items also contained charges for vehicles, inventory, or accounts payable, but it was generally not clear if these charges were related to the work performed or if they were stand-alone charges.

Item #4 involves a series of manual journal entries to charge DE-Carolinas for mutual assistance. Accounting personnel indicated that these charges were made in February 2007, before the BDMS labor system was set up to bill DE-Carolinas directly. Accounting personnel used journal entries to move the correct amount of labor and loaders to DE-Carolinas, using separate line items to identify each resource type.

Items #2, #6, #8, #9, #12, #19, #21, #32, and portions of Item #14 consist of pass-through invoice charges. The accounting personnel provided copies of the invoices, often with a cover sheet showing the responsibility centers that originated and received the charge, along with the account number and resource type. In the case of split invoices, accounting was able to explain how the percentages were derived. Overall, the accounting personnel were able to reconcile the charges.

A portion of item #3 involves a journal entry credit of approximately $31 thousand for revenues collected by DE-Kentucky on behalf of Duke Energy One. Item #37 and a portion of Item #11 involve journal entries for interest expense charges under the Money Pool Agreement from Cinergy Corp. to DE-Indiana in one case and from DE-Indiana to DE-Kentucky in the other case. Item #29 involves a journal entry credit to Duke Energy One from DE-Indiana for rent collected on the affiliate's behalf. Item #28 was a journal entry for $260 thousand that Liberty later learned related to a transferred capital asset. Item #30 consists of journal entries that reflect the true-up for overhead that accounting applied to labor charged by DE-Indiana to DE-Carolinas through November. Accounting personnel were able to provide supporting documentation and reconcile the charges in these items.

Items #10, #15, and #23, along with portions of Items #16, #18, #31, and #34, involve charges for transfers of inventory items, which are asset transfers. In cases, the inventory items did not relate to work being provided under the two merger-related agreements. Item #15 involved inventory charges totaling $776 thousand, the largest single item being $640 thousand. Accounting personnel indicated that DE-Ohio had purchased transformers and then transferred some to DE-Kentucky. In this case, however, DE-Ohio placed the transformers into its own inventory first, rather than simply splitting the invoice charges.

Some of the test items were affiliate transactions, but not those related to the merger-related agreements. Item #35 involves inventory and accounts payable charges from DE-Kentucky to DE-Indiana; they were not related to the Operating Agreement. Item #26 involved accounts payable charges from DE-Indiana to DE-Kentucky not related to the Operating Agreement. Item #17 involves charges to DE-Kentucky from DE-Ohio subject to one of the facilities agreements between the parties, the majority of which related to coal. The majority of item #22 involved a journal entry charge from DE-Indiana to DE-Ohio that was not related to work provided under the Operating Agreement.

Liberty also reviewed the details of several labor-related charges from DE-Carolinas to DE-Indiana and DE-Kentucky, *i.e.*, charges that originated in FMIS rather than BDMS. The next table summarizes total charges from DE-Carolinas for labor and associated loaders.

[redacted]

[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

Liberty sought to substantiate that DE-Carolinas applied the appropriate payroll loaders for payroll taxes, unproductive time, incentives, and fringe benefits, and that it applied the correct percentage for overhead. Liberty selected eight separate charges for testing, as listed on the next table.

Item	Month	To
1	January	DE-Indiana
2	March	DE-Indiana
3	March	DE-Indiana
4	April	DE-Indiana
5	May	DE-Indiana
6	May	DE-Indiana
7	November	DE-Indiana
8	January	DE-Kentucky

Liberty found that DE-Carolinas did not apply a loader for unproductive time to the January charges in Items #1 and #8. Accounting personnel explained that there was an error in how the loader was calculated for the particular DE-Carolinas responsibility center. Accounting personnel had later identified the error and corrected the mistake for all labor charged from this center; however, they did not in turn assign a portion of the correction to the labor charged out to affiliates. Consequently, DE-Indiana and DE-Kentucky were charged less than fully embedded cost. Assuming an average unproductive rate of 10 percent, the shortfall was approximately $300 for DE-Indiana and $85 for DE-Kentucky for these items. DE-Carolinas also failed to apply the overhead loader at the time of the original charges, but corrected the error with a journal entry later in the year.

Liberty found that DE-Carolinas did not apply payroll taxes for Items #2 and #4. Accounting personnel explained that there was an error in how the particular responsibility center was identified in the system and the payroll tax processing step was never applied. DE-Carolinas did not fix the error until May. DE-Indiana was therefore charged less than fully embedded cost. The shortfall was approximately $100 for these items.

Liberty found that DE-Carolinas calculated the overhead loader dollars for Items #3 and #6 on an incorrect basis as the result of an error. The overhead loader percentage should be applied to labor charges; in this case, FMIS correctly calculated it, but applied the loader to both labor and unproductive charges (because the unproductive charges were incorrectly assigned a labor resource code) so that the overhead amount was overstated. DE-Indiana was therefore charged more than fully embedded cost by approximately $850 for this item.

Liberty substantiated that DE-Carolinas correctly calculated labor loaders for Items #5 and #7.

C. Conclusions

1. Service Company transaction testing identified relatively few errors, only one of which significantly affected the utilities' books.

Liberty selected and tested nearly fifty categories of charges to DE-Indiana and DE-Kentucky from the Service Company. In nearly all cases, the charges were correct and adequately supported.

Liberty identified only one significant error related to an invoice for outside services for a Midwest call center. The Service Company directly assigns to Midwest utilities a portion of charges for such services based on number of customers. For the sample invoice, DEBS had inadvertently used the DE-Ohio percentage to calculate DE-Kentucky's directly assigned charges. This error resulted in an overcharge to DE-Kentucky of approximately $100 thousand. Accounting personnel indicated that the Service Company would likely not correct the error as the 2007 books were already closed.

2. Testing of transactions subject to the Operating Agreement and Non-utility Agreement and processed within BDMS identified no significant errors.

The majority of charges to and from DE-Kentucky and DE-Indiana under the Operating Agreement and Non-utility Agreement are processed within BDMS. Liberty selected and tested nearly forty categories of inter-company charges involving DE-Indiana, DE-Kentucky, and non-Service Company affiliates processed through BDMS. A large portion of them related to transactions under these two merger-related agreements. Liberty found that the charges were correct and adequately supported.

3. Labor charges from DE-Carolinas to DE-Indiana and DE-Kentucky contained a significant number of errors. *(Recommendation #1)*

Liberty selected and tested eight separate sets of loaded labor charges from DE-Carolinas to the two Midwest utilities. Liberty found during its testing that DE-Carolinas had errors in six of the eight charges. In two cases, the utility did not apply a loader for unproductive time, and in two other cases, it did not apply a loader for payroll taxes. These errors meant that the client utility was charged less than fully embedded cost. For two other test items, DE-Carolinas calculated an incorrect overhead amount due to the use of an erroneous resource code such that the client utility was charged more than fully embedded cost. Given the high proportion of errors in the sample, it is reasonable to assume that there were other errors in how FMIS calculated loaded labor charges during the audit period.

D. Recommendations

1. Implement a more rigorous quality control review process for the calculation of loaded labor charges in FMIS. *(Conclusion #3)*

Given the relatively high percentage of errors that Liberty identified during testing, the current process to review the calculation of fully loaded labor in FMIS is not sufficiently rigorous. Duke Energy should develop and institute enhancements to its quality control procedures in order to test all aspects that may influence the accuracy of the calculation of labor loaders, including manual inputs and the logic of computer algorithms. Liberty also recommends that the internal audit group include a review of FMIS labor loader calculations in its next audit. This is particularly important since the Midwest will convert to FMIS in mid-2008 and the impact of such errors could become more widespread and significant.

VIII. Utility Money Pool Agreement

A. Background

Liberty reviewed the Utility Money Pool Agreement and the operation of the money pool for reasonableness to DE-Kentucky and its customers. DE-Kentucky entered into the Utility Money Pool Agreement as of January 2, 2007 to manage its cash and working capital requirements. The terms of the agreement are substantially similar to a prior agreement dated April 3, 2006. That earlier agreement itself replaced a pre-merger utility money pool at the Cinergy companies. The parties to the new agreement are Duke Energy, Cinergy, DE-Kentucky, DE-Carolinas, DE-Ohio, Miami Power, KO Transmission Company, DEBS, and DESS. According to the agreement:

> *The parties from time to time have the need to borrow funds on a short-term basis. Some of the parties from time to time have funds available to loan on a short-term basis. The parties desire to establish a cash management program (the "Utility Money Pool") to coordinate and provide for certain of their short-term cash and working capital requirements.*

The intent of the money pool is to use corporate cash more efficiently by pooling the daily excesses and deficits of funds among the utility entities and their supporting service companies. Borrowing from the other participants allows the members to save transaction costs and letter-of-credit fees, and to incur borrowing costs lower than the costs of borrowing directly from the financial markets. The money pool also consolidates the smaller external borrowing programs of the individual utilities into one "name" program through Duke Energy. The parent has a better-established market for its commercial paper, which also currently produces somewhat better pricing and borrowing availability.

B. Findings

1. 2007 Money Pool Borrowing and Investing

The following table summarizes DE-Kentucky money pool investments and borrowings for 2007, and provides their weighted average interest rate.

[redacted]

	[redacted]		
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
	[redacted]		
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]

2. DE-Indiana and DE-Kentucky Monthly Money Pool Activity

The following table presents the average borrowing and investment balances (in thousands of dollars) for DE-Kentucky for each month in 2007.

[redacted]

[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	
[redacted]	[redacted]	
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]

3. Liberty's Testing of Money Pool Operations

On June 6, 2008, Duke Energy provided to Liberty a demonstration of the daily operations of the utility money pool. Liberty tested the daily money pool information for nine selected sample days. The purpose of the operational money pool testing was to determine compliance with Sections 1.1, 1.2, 1.3, 2.1 and 2.2 of the Utility Money Pool Agreement, which govern daily operation of the money pool.

Liberty reviewed, discussed, and verified nine randomly selected "Daily Detail Packages" for money pool operations for February 26, March 13, April 23, May 9, July 19, September 10, October 22, November 13, and December 14, 2007. The following list describes the tests that Liberty performed:

- Test 1: Review and verify the daily determinants and calculation of the net amount of borrowing or investing required by the utility for each of the sample days. Liberty reviewed and verified the "Current Position" summary sheet for each of the sample days. The net amount of borrowing or investing required is determined by netting the cash opening balance, automated clearinghouse funds in and out, cash concentration account receipt collections, and wire transfers and controlled disbursements sent out.
- Test 2: Review and verify the internal money pool funds available and external funds available for each of the sample days. Liberty verified that internal funds are offered from the utility "lending companies" for each day, as available; the remainder of funds required by the money pool is provided by Duke Energy.
- Test 3: Review and verify the rates on invested and borrowed funds in the money pool for each of the sample days. Liberty verified that rates applied matched the market rate surveys for each date.

- Test 4: Verify that the amounts of money pool borrowings involving multiple fund sources were determined for each borrower in the same proportion as each source of funds bears to the total available funds. Liberty verified each daily calculation of internal and external funds available and allocated to borrowers.
- Test 5: Verify that the interest rate for internal loans in the money pool was the highest quality commercial paper composite rate for each day in the sample. Liberty verified that the internal funds rates for each sample day matched the "Top Tier Dealer" commercial paper rates, 30-day maturities from Bloomberg.
- Test 6: Verify that the interest rate for "external" loans in the money pool is equal to the lending party's composite borrowing rate for each day in the sample. The Duke Energy loan rates for each date matched the calculation of weighted average Duke Energy commercial paper outstanding.
- Test 7: Review and verify the movement of required funding into or out of the utility for each of the sample days. Liberty verified funds movements through the daily "Money Pool – Net Fund Movement" report for each date.
- Test 8: Verify the authorization of the borrowing party's Chief Financial Officer, Treasurer, or designee to make each sampled decision to borrow or invest. Liberty verified the delegations of borrowing authority from utility financial officers to Duke Energy cash management employees.

4. Liberty's Testing of Other Agreement Requirements

The Utility Money Pool Agreement also includes a number of other requirements related to money pool operation. Specific requirements for interest expense, interest income and their financial records verification, loan amount verification on financial records, fees and expenses charged to the utilities, verification of compliance with borrowing limits, and other miscellaneous requirements were reviewed and tested. Liberty also reviewed, discussed, and verified the borrowing and investment balances and interest income and expense from money pool operation in 2007.

- Test 9: Verify that the borrowing and investment balances in the Duke Energy "T-man" money pool system tie to the December 31, 2007 notes to audited financial statements. Liberty verified the utility's borrowing balances from the money pool system at December 31, 2007 with: a) general ledger balances; and b) money pool balances in footnotes to its Financial Statements and Auditor's Report for 2007.
- Test 10: Verify that the utility did not exceed its borrowing limits in 2007. Liberty verified that the borrowing limits, as stated in the revolving credit agreements, were not exceeded in 2007.
- Test 11: Review and verify that the interest expense and interest income recorded in the utility's general ledger tie to the utility's money pool records. Liberty verified that 2007 interest income and expense in the general ledger tied to the amounts in the money pool records.
- Test 12: Review money pool investing activity for February 26, March 13, May 9, July 19, and September 10, 2007. Verify the determination of lending sources, amounts invested, and interest rate for each sample day selected. Liberty verified that the investment procedures were in compliance with agreement Section 2.2.

- Test 13: Determine if fees and costs charged to money pool participants are a pass-through of actual money pool costs. Liberty verified that the utility pays a commitment fee monthly in proportion to their commitment from the Duke Energy revolving credit agreement. Internal money pool operational costs are charged through the Service Company.
- Test 14: Determine the form of promissory notes or legal document evidencing borrowings/investments between money pool participants. Promissory notes are provided to money pool participants only upon request, in accordance with Section 1.8 of the agreement. No parties requested promissory notes in 2007.
- Test 15: Verify that no defaults or amendments to the money pool occurred in 2007. Verified that no defaults occurred during 2007. The Utility Money Pool Agreement was amended on January 2, 2007 to reflect the name changes to the parties; no other substantive changes were made.

C. Conclusions

1. The Utility Money Pool Agreement and the operation of the money pool are beneficial to DE-Kentucky.

The money pool is structured through the Utility Money Pool Agreement to provide lower-cost working capital funds to the participating utilities. Rather than individually accessing the capital markets for short-term funding needs, the money pool provides the utilities with a source of funds, when available from other money pool utilities,. Pricing equals the Top Tier Dealer commercial paper rate in the market. This rate is lower by one percent or more, when compared to what the financial markets would offer the individual utilities. The lending utility receives the same investment rate under the money pool. This rate is higher than that available from conservative market investments.

The Duke Energy commercial paper program provides funds (at its cost) when funds are not available from the money pool utilities. The interest rates on these "external" funds are not as low as rates from the utilities, but are lower than stand-alone utility borrowing rates. The money pool also allows its borrowers to avoid certain transaction costs of accessing external capital markets.

2. The utility money pool operations during 2007 met the borrowing, investment, and funds allocation requirements of the Utility Money Pool Agreement.

Liberty's testing of Duke Energy's operation of the money pool determined that it meets the requirements of the Utility Money Pool Agreement. The agreement has specific limitations for the participants that are allowed to borrow and invest in the money pool. The utilities and utility-related subsidiaries of the holding companies may borrow from the money pool. The holding companies may invest in but may not borrow from the money pool.

An important requirement of the agreement is the allocation of the available utility funds to other money pool utilities as loans. When utility funds are available for loans, the borrowing utilities are allocated the use of these lower-cost funds in proportion to their borrowing needs as a percentage of the total money pool borrowing needs. The application of this allocation method serves to fairly divide the lowest cost "internal funds" among the utilities requiring funding. DE-Kentucky borrowed funds from the money pool late in 2007. At this time internal utility funds were not available. However, the rate on the Duke Energy "external funds" was only slightly above the internal rates that would have applied during that period.

3. The money pool records for loan and investment balances outstanding and interest expense and income for DE-Kentucky in 2007 were consistent with its accounting records and financial statements.

Liberty's testing of the loan balances and investment balances of DE-Kentucky confirmed that the financial information in the money pool records and reports tied to the general ledgers, as well as to the Financial Statements and Auditor's Report for 2007.

4. The operation of the money pool meets the other requirements of the Utility Money Pool Agreement.

Liberty determined that the operations of the money pool complied with the following additional requirements of the agreement:

- DE-Kentucky did not exceed borrowing limits as expressed in the revolving credit agreements.
- DE-Kentucky borrowings were from the allocation of utility internal funds, when available. As noted previously, internal utility funds (from CG&E) were not available when DE-Kentucky required short-term funding in late 2007.
- The money pool passes revolving credit commitment fees and money pool administrative charges to the utilities at cost.
- Promissory notes are available to money pool borrowers and lenders upon request.
- No defaults or substantive amendments to the agreement occurred in 2007.

D. Recommendations

Liberty has no recommendations in this area.

IX. Income Tax Agreement

A. Background

DE-Kentucky entered into the Agreement for Filing Consolidated Tax Returns and for Allocation of Consolidated Income Tax Liabilities and Benefits (Tax Sharing Agreement) with Duke Energy as of April 1, 2006. Duke Energy and its "members" under the Duke holding company organization agree to join annually in the filing of a consolidated federal income tax return and to allocate the federal tax liabilities and benefits among the members. The Tax Sharing Agreement governs the consolidated filing and allocation of federal and state income taxes.

Liberty's evaluation included:

- An examination of the agreement's fairness and reasonableness to DE-Kentucky
- The conformity of 2007 quarterly tax estimations, annual tax provision, and tax payment processes with the agreement's "separate company" principles
- Verification that DE-Kentucky 2007 income tax expense as reported in audited financial statements was consistent with the annual provisions for income taxes.

B. Findings

1. The Tax Sharing Agreement

a. Agreement Language

The Tax Sharing Agreement states that, "The consolidated tax shall be allocated among the members of the group utilizing the separate corporate taxable income method…" The agreement defines "Separate Return Tax" as the tax on corporate taxable income or loss of an associate company as though such company were not a member of the consolidated group. DE-Kentucky therefore undertakes responsibility for paying income taxes in the same amount that would be due if it were totally separate from the Duke Energy group of entities.

This "stand-alone" requirement means that the calculation of DE-Kentucky's individual federal and state tax liabilities should be the same as if DE-Kentucky filed such returns as an independent company. If any Duke Energy member's tax liability should exceed its stand-alone liability, the excess gets reallocated to members whose liability is less than their stand-alone liability. Any consolidated tax liabilities still remaining are assigned to Duke Energy.

The Tax Sharing Agreement requires Duke Energy to make calculations for estimated tax payments to comply with the Internal Revenue Service (IRS) Code on behalf of the members. Duke Energy is also responsible for paying the consolidated federal income tax liability to the IRS. Duke Energy may charge or refund to the members their share of the federal tax liability consistent with the Duke Energy tax payment dates set forth in the IRS Code. After Duke Energy files the consolidated income tax return, it must then charge or credit the members for the difference between their prior payments (or credits) and their tax liability, as filed. This process is known as the "true-up" of the tax liability among the agreement participants.

State and local income tax liabilities also get allocated among Duke Energy members in accordance with the same "stand alone" principles used for federal income taxes. Tax return adjustments made by the IRS and state tax authorities, or by Duke Energy due to amended returns or claims for refund, are allocated in the same manner as if the adjustments were part of the original consolidated return.

b. Duke Energy Income Tax Procedures and Policies

Duke Energy does not have written procedures or policies specifying how to implement the Tax Sharing Agreement. However, Duke Energy does conduct regular implementation activities, which include quarterly income tax estimates, estimated payments, tax provisioning and the allocation of consolidated taxes with the specific intent of meeting the requirements of the agreement.

Duke Energy prepares independent income tax calculations for each of its member entities from a stand-alone, bottom-up perspective. It makes quarterly calculations of estimated tax liabilities for the member entities, which then form the basis for making periodic estimated tax payments. Annual tax provisioning takes place following the close of the books at end of the calendar year, using the full year of actual financial information. The annual tax provisioning process provides the calculation of the calendar year federal and state income tax liability of each Duke Energy member and the consolidation of all income tax responsibilities at the holding company, acting as the tax-paying entity for all of the members.

2. 2007 Income Tax Testing

a. Income Tax Estimates

The tax department at Duke Energy prepares quarterly estimates of federal and state tax liabilities for DE-Kentucky and other tax member companies. The estimating process begins with DE-Kentucky's book Income before Income Tax. The tax department makes the numerous additions and deductions required for income tax purposes in order to produce the resulting Federal Taxable Income before State Income Tax and Federal Loss Carryforward. The tax department then deducts the separately-calculated estimate of state income tax for the quarter, to produce Federal Taxable Income, to which it then applies the federal tax rate of 35 percent to determine the current federal tax liability. Current income taxes are the amounts currently due and payable under income tax regulations; they do not include the deferred tax portion of total income taxes. The state income tax estimate results from a separate, but similar calculation, using the specific additions and deductions specified in state tax regulations.

The quarterly tax estimates accumulate during the year, *i.e.*, the second, third and fourth quarter estimates use year-to-date financial information for DE-Kentucky. The next table presents the quarterly federal and state income tax estimates (in millions of dollars) for DE-Kentucky for 2007.

DE-Kentucky 2007 Quarterly Income Tax Estimates and Payments

	Q1	Q2YTD	Q3YTD	Q4YTD
Income Before Income Taxes	$20.9	$27.1	$38.5	$51.9
Federal Income Tax Estimate (Current)	6.5	7.2	9.1	13.2

Indiana State Income Tax Estimate (Current)	(1.1)	(1.1)	(1.5)	(2.2)
Tax Payments to Parent		7.7		8.5

b. Accounting Entries and Payments

DE-Kentucky records on its books current and deferred income taxes in the following accounts:

- Current Taxes
  - Account 236000 – Taxes Accrued, Prepaid and Charged during the Year
  - Account 400900 – Income Taxes
- Deferred Taxes
  - Account 410100 – Provision for Deferred Income Taxes
  - Account 411100 – Provision for Deferred Income Taxes
  - Account 410200 – Provision for Deferred Income Taxes
  - Account 411200 – Provision for Deferred Income Taxes
  - Account 190000 – Accumulated Deferred Income Taxes
  - Account 281000 – Accumulated Deferred Income Taxes – Accelerated Amortization Property
  - Account 282000 – Accumulated Deferred Income Taxes – Other Property
  - Account 283000 – Accumulated Deferred Income Taxes – Other.

DE-Kentucky records entries on its books twice each year to reflect the payment of estimated income taxes to the IRS and the state. DE-Kentucky makes entries on its books to release the income tax liabilities from DE-Kentucky and transfer them to Cinergy; Cinergy in turn releases the tax liabilities to Duke Energy. DE-Kentucky concurrently records an account payable to Cinergy, which in turn records a payable to Duke Energy. The payables become cash payments for the income tax liabilities when inter-company accounts are settled on a monthly basis. DE-Kentucky made an income tax payment of $7.7 million in July 2007 to Cinergy/Duke Energy to pay for estimated current tax liabilities for January through June. DE-Kentucky made an additional payment of $36.7 $0.8 million in December 2007 to pay for estimated current tax liabilities for July through November.

c. Annual Income Tax Provision and Verification

The estimates of DE-Kentucky federal and state current income taxes for the fourth quarter serve as the annual provision for income taxes. For 2007, the current federal income tax provision for DE-Kentucky was $13,249,840; the state tax provision was $2,179,672.

Duke Energy also prepares an effective tax rate reconciliation for the tax year. This calculation includes pre-tax book income, reconciling items and deductions for tax purposes, deferred taxes, and total federal and state book income taxes. The reconciliation is prepared on a company-specific basis, and is consolidated for the tax-paying entity. Liberty compared the DE-Kentucky-specific tax information in this reconciliation and the annual tax provision to the audited financial information from DE-Kentucky's Financial Statements and Auditor's Report for 2007. DE-Kentucky's "Statement of Operations" entries for pre-tax income of $52 million and total income tax expense (including both current and deferred taxes) of $18 million were consistent with both the annual tax provision and the detailed tax reconciliation statement for DE-Kentucky.

The following chart summarizes (in millions of dollars) the key components of the DE-Kentucky federal income tax reconciliation.

DE-Kentucky 2007 Income Tax Components

Federal Pre-tax Income	$51.922
Gross Federal Tax @ 35%	$18.173
Permanent Reconciling Items, Tax Effected	$(0.578)
Additional Reconciling Items, Tax Effected	$(1.282)
Federal Tax Effect of State Taxes	$(1.152)
Federal Income Taxes, Total[1]	$15.161
State Income Taxes , Total[2]	$3.291
Total Income Taxes, per General Ledger	$18.452

1 Includes an estimated $13.5 million in current taxes, remainder in deferred taxes

2 Includes an estimated $(2.2) million in current taxes

d. Tax Return and True-ups

DE-Kentucky has made two estimated income tax payments for the 2007 tax year. Duke Energy was preparing the consolidated 2007 income tax returns at the time of this report; the return will be filed on September 15, 2008. The differences between the estimated tax payments and the tax liabilities as filed in the returns will be calculated after filing. These "true-ups" of the 2007 tax liabilities will be recorded on the DE-Kentucky books in the fourth quarter of 2008.

3. Tax Return Amendments and Adjustments

a. Tax Return Amendments

Three amended corporate tax returns were filed for DE-Kentucky during 2007. Each of the amendments addressed the outcome of federal income tax audits for the DE-Kentucky federal tax returns in 1997, 1998, and 1999. The following table summarizes the net changes in federal income tax liability resulting from these amendments.

Return Year	DE-Kentucky Tax Liability Change
1997	$1,759 in reduced tax
1998	$16,573 in reduced tax
1999	$34,833 in additional tax

b. Other Agreement Verifications

Sections 3b, 3c and 3d of the Tax Sharing Agreement address the allocation of environmental taxes, alternative minimum taxes, and general business credits and foreign tax benefits. The environment tax described in Section 3b has not existed since 1996, and is not applicable to DE-Kentucky's 2007 taxes. Duke Energy has indicated that none of the Section 3c alternative minimum taxes generated by Cinergy or Duke Energy have been allocated to DE-Kentucky or any of the Duke Energy utilities. Duke Energy also stated that DE-Kentucky did not generate any Section 3d business or foreign tax credits in 2007.

The Tax Sharing Agreement was amended effective January 2, 2007. The purpose of the amendment was to reflect that some members changed names after the original agreement signing as of April 1, 2006, and to revise the list of signatories. No substantive changes to the agreement came with this amendment. Duke Energy is currently considering, but has not yet committed, to make another amendment to the agreement. The company also reports that no other amendments occurred and there were no new or departing group members following the spin-off of Spectra Energy on January 1, 2007.

C. Conclusions

1. The Tax Sharing Agreement is structured in a manner that is fair, reasonable, and equitable for DE-Kentucky and its customers.

The Tax Sharing Agreement entered into by DE-Kentucky provides for federal and state income taxes to be allocated among the members of the Duke Energy consolidated group under the separate "corporate taxable income method". This method ensures that DE-Kentucky will pay the same amount of income taxes as if it were a stand-alone company, and is fair to DE-Kentucky and its customers.

2. The 2007 quarterly tax estimations, annual tax provision, and tax payment processes performed for DE-Kentucky are consistent with the "separate company" principles of the Tax Sharing Agreement.

The quarterly tax estimates and annual tax provisioning for DE-Kentucky use the utility's stand-alone financial information from its accounting records to calculate current tax liabilities. These estimates and provisions for 2007 were based on DE-Kentucky's actual financial results for each quarter and at year-end. Two tax payments were made to the parent companies in 2007 that were consistent with the estimates for the cumulative tax liabilities for the year at the time of the payments.

3. DE-Kentucky's 2007 income tax expense as reported in its audited financial statements is consistent with the annual provisions for income taxes.

The pre-tax income and total income tax expense (including current and deferred taxes) included in the DE-Kentucky income tax provisions and tax reconciliations matches that included in the company's audited financial statements.

4. Amendments to the 1997, 1998 and 1999 DE-Kentucky federal income tax returns filed in 2007 resulted in small changes to tax liabilities.

Federal income taxes due increased about $16,500 due to the three return amendments.

5. The 2007 consolidated tax return was not yet been by Duke Energy as audit field work ended.

The Duke Energy consolidated tax return was to be filed on September 15, 2008. True-up entries to adjust the final income taxes due from income statement amounts to the level represented in the return filing were to occur in the fourth quarter of 2008.

D. Recommendations

Liberty has no recommendations in this area.