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STANDARD FILING REQUIREMENT SCHEDULES

KENTUCKY PUBLIC SERVICE COMMISSION

GAS CASE NO. 2009-00202

DATE: July 1, 2009

GENERAL APPLICATION FOR CHANGE IN
GAS RATES BEFORE KENTUCKY PUBLIC
SERVICE COMMISSION

NAME: DUKE ENERGY KENTUCKY
ADDRESS: 1697-A MONMOUTH STREET
NEWPORT, KENTUCKY 41071

MAILING
ADDRESS: P. O. BOX 960
CINCINNATI, OHIO 45201

TELEPHONE: AREA CODE 513 NUMBER 419-5908

COMPANY OFFICIAL TO BE CONTACTED
PERTAINING TO RATE CASE MATTERS William Don Wathen Jr.

FILING DATE: July 1, 2009

ATTORNEYS FOR APPLICANT:

NAME: Rocco D'Ascenzo

ADDRESS: P. O. Box 960
Cincinnati, Ohio 45202
TELEPHONE: (513) 419-1852

* * * FOR COMMISSION USE ONLY * * *

DATE RECEIVED BY COMMISSION ________________

DOCKET NUMBER ASSIGNED ____________________

RECEIVED BY __________________________________

DATE ACCEPTED ________________________________

ACCEPTED BY __________________________________

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE ADJUSTMENT
OF GAS RATES OF DUKE ENERGY KENTUCKY, INC.

CASE NO. 2009-00202

FILING REQUIREMENTS

VOLUME 8

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE ADJUSTMENT	)	
OF GAS RATES OF	)	CASE NO. 2009-00202
DUKE ENERGY KENTUCKY, INC.	)	

DIRECT TESTIMONY OF

JAY R. ALVARO

ON BEHALF OF

DUKE ENERGY KENTUCKY, INC.

July 1, 2009

271889

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ATTACHMENTS

I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Jay R. Alvaro. My business address is 139 East Fourth Street, Cincinnati Ohio.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Duke Energy Business Services, LLC, an affiliate service company of Duke Energy Kentucky, Inc. (Duke Energy Kentucky or the Company) as Vice President, Total Rewards.

Q. PLEASE SUMMARIZE YOUR EDUCATION.

A. I have a Bachelor of Science in Accountancy from Miami University, Oxford, Ohio, and Luxembourg. I earned my Certificate of Public Accounting (CPA) in 1990. I also earned a Juris Doctor degree from the Salmon P. Chase College of Law in 1995.

Q. PLEASE SUMMARIZE YOUR WORK EXPERIENCE.

A. I began my career with the Cincinnati Gas & Electric Company in 1986 in the Internal Audit Department. After obtaining my CPA, I began working as a Financial and Information Systems Auditor. After I completed law school and became a licensed Attorney in the State of Ohio, I joined Cinergy Corp.'s (Cinergy) Legal Department in July 1996 as a Labor & Employment Attorney, with a focus on labor law. In July 2005, I joined Cinergy's Human Resources Department and served as Director, Client Services in Human Resources for the Commercial Business Unit. In April 2006, following the merger of Cinergy and Duke Energy Corporation (Duke Energy), I became Managing Director, Labor

Relations for Duke Energy and served in this role for two years. My primary responsibilities included acting as chief spokesperson for Duke Energy in labor negotiations. In May 2008, I was promoted to Vice President, Human Resources for the Commercial Businesses of Duke Energy and served in that capacity until being promoted to my current position in February 2009.

Q. PLEASE DESCRIBE YOUR DUTIES AS VICE PRESIDENT, TOTAL REWARDS.

A. I am responsible for all areas of compensation, benefits and executive rewards for Duke Energy, including all of its affiliated regulated and non-regulated companies (collectively the Companies).

Q. HAVE YOU EVER TESTIFIED BEFORE THE KENTUCKY PUBLIC SERVICE COMMISSION?

A. No, I have not.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I support the reasonableness of Duke Energy Kentucky's compensation and benefit programs. I also support the Company's proposal to share the costs of incentive compensation programs between shareholders and customers using the same method approved in the Kentucky Public Service Commission's Orders in Case Nos. 2005-00042 and 2006-0172.

II. COMPANIES' EMPLOYMENT CHARACTERISTICS

Q. PLEASE DESCRIBE THE GENERAL COMPOSITION OF THE COMPANIES' EMPLOYEE POPULATIONS.

A. According to the Employee Census Summary as of December 2008, Duke Energy Kentucky has 254 employees, comprised of 10 exempt employees, 235 union employees, and 9 employees in other classifications (disability, temporary, etc.). Duke Energy Business Services, LLC (DEBS) has 7,031 employees, comprised of 4,274 exempt employees, 1517 non-exempt employees, 866 union employees, and 374 employees in other classifications (disability, temporary, etc).

Q. WHERE DO THESE EMPLOYEES WORK WHEN PERFORMING SERVICES FOR DUKE ENERGY KENTUCKY CUSTOMERS?

A. Duke Energy Kentucky's customers receive services from employees of Duke Energy Kentucky and affiliated companies. The employees work at the East Bend Generating Station (East Bend), the Miami Fort Unit 6 Generating Station (Miami Fort 6) and the Woodsdale Generating Station (Woodsdale) (collectively, the Plants). They also work at our 19th and Augustine facility in Covington, which is dedicated to gas operations, and at our Erlanger, Kentucky construction and maintenance center. They also work in our Cincinnati, Ohio headquarters and in the Duke Energy headquarters in Charlotte, North Carolina.

Q. WHAT TYPE OF SPECIAL SKILLS OR KNOWLEDGE IS REQUIRED IN ORDER TO OPERATE A LOCAL GAS DISTRIBUTION UTILITY SUCH AS DUKE ENERGY KENTUCKY?

A. The operation and maintenance of gas lines and mains requires specialized technical skills. Employees must have the requisite knowledge and technical skills to plan, design, construct, operate and maintain pressurized gas lines and mains in a manner that provides safe, adequate and reliable service. The operation and maintenance of a field office and a customer call center requires a detailed knowledge of all aspects of customer service. Field office and call center employees must understand the characteristics of the gas delivery service provided by Duke Energy Kentucky, the metering, billing and collection processes and various other customer service matters. At the corporate level, highly-skilled managers, engineers, accountants, computer hardware and software experts, computer programmers and other highly-trained professionals are needed to support the employees who are directly responsible for procuring and delivering natural gas to Duke Energy Kentucky's customers.

Q. HOW IMPORTANT IS THE RECRUITMENT AND RETENTION OF SUCH EMPLOYEES TO THE COMPANIES' SUCCESS?

A. The recruitment and retention of such employees is critical to the Companies' success. The skills needed for employees to render safe and high-quality utility service take several years to develop. For example, gas plant operators and control technicians are highly-skilled positions that require experience and knowledge that is acquired over several years. If we were to lose such employees, we would incur additional costs to train replacements for these positions. Consequently, the fact that we strive to be an "employer of choice" that attracts qualified employees and retains such employees, benefits customers by providing a more highly-skilled work force that provides safe and reliable service to customers at a reasonable cost.

Q. WHAT FACTORS AFFECT THE RECRUITMENT AND RETENTION OF SUCH EMPLOYEES?

A. The recruitment and retention of such employees is directly related to the compensation, benefits, and career development opportunities provided by Duke Energy. In addition, management values, including but not limited to, maintaining a safe work environment, training, ethics, opportunities for a work/life balance, and the nature of the work itself also affect Duke Energy's ability to recruit and retain highly-skilled employees. Industry and market conditions also impact the Companies' ability to recruit and retain employees.

Q. WHERE DO THE COMPANIES OBTAIN APPLICANTS FOR VACANT POSITIONS?

A. We draw applicants from various geographic areas, depending on the job we need to fill. As a general rule, the more highly-skilled the job position being filled, the broader the scope of the Companies' recruitment efforts. We generally recruit executives on a national level; exempt employees locally and regionally; and non-exempt employees locally. The Companies employ applicants drawn from other utilities and from diverse employment backgrounds in other industries.

III. <u>COMPENSATION PHILOSOPHY</u>

Q. PLEASE DESCRIBE DUKE ENERGY'S BASIC COMPENSATION PHILOSOPHY.

A. Duke Energy's basic compensation philosophy is to design a compensation program consisting of base salary and annual incentives that provides employees with an opportunity to earn total compensation competitive with the market. This philosophy supports the Companies' goal to attract, retain and motivate the caliber of employees with the education, experience, judgment and skills necessary to carry out the responsibilities of the positions that the employees are hired to fill. The Companies' compensation strategy for executive employees is to provide a compensation package consisting of a combination of fixed and variable pay, using base salary, short-term incentives and long-term incentives. These components, in the aggregate, are targeted to deliver total compensation at the 50th percentile of the applicable peer group. However, if Duke Energy delivers superior performance, our compensation program is designed to provide total compensation above market median based on performance. Conversely, if Duke Energy's performance is below expectations, its executives' total compensation is designed to decline to a level commensurate with such performance.

The Companies adopted this executive compensation strategy in order to attract, retain and motivate the executive talent required to deliver superior performance. This strategy emphasizes performance-based compensation that balances rewards for both short-term and long-term results and that aligns the executives' interests with the long-term success of Duke Energy and its subsidiaries, including Duke Energy Kentucky.

Q. PLEASE DESCRIBE HOW THE COMPANIES STRUCTURE THEIR COMPENSATION PROGRAMS.

A. The Companies' compensation programs consist of a base pay component and an incentive pay component. The base pay component is a set amount, reviewed by management at least annually, and established at a level that: (1) provides competitive compensation based on the nature and responsibilities of the employee's position; and (2) is fair relative to the pay for other similarly-situated positions in the organization. The incentive pay component is variable and is at risk to the employees. Incentive pay is generally linked to the accomplishment of specific goals established in advance for the individual employee, his or her business unit, and/or the corporation. The purpose of incentive pay is: (1) to encourage employees to perform at a high level in order to accomplish specific objectives intended to ensure safe, reliable and economical utility service to our customers; (2) to ensure their business unit's and Duke Energy's overall success; and (3) to constitute a component of a compensation package that is competitive with the market.

The designs of the short-term and long-term incentive programs are reviewed annually. Any changes to these programs are reviewed by management. Once approved by management, approval is then obtained from the Compensation Committee of the Board of Directors.

Q. HOW DOES THE INCENTIVE PAY ENSURE SAFE, RELIABLE AND ECONOMICAL UTILITY SERVICE TO CUSTOMERS?

A. Safety is of utmost importance and is not only encouraged but continuously reinforced through all levels of the Company, including through incentive pay opportunities. For example, the Company maintains a zero tolerance policy for workplace fatalities by rewarding all employees, exempt and non-exempt, with an additional 5% for their short-term incentive payout, if there are no fatalities during the year. Conversely, if the Company does not meet previously established total incident case rate (TICR) goals, then all executives' incentive compensation is reduced by up to 5%.

In 2009, an Operations and Maintenance (O&M) cost reduction goal was added to employee incentives to be mindful of controlling costs and prudently managing budgets. To ensure that cost control would not be achieved by sacrificing our ability to provide reliable service, a reliability component was also added to the short-term incentive program. The reliability component included among other things, System Average Interruption Duration Index (SAIDI) and System Average Interruption Frequency Index (SAIFI) targets.

IV. BASE PAY PROGRAMS

Q. PLEASE DESCRIBE THE COMPANIES' BASE PAY PROGRAMS.

A. Every employee receives base pay in the form of semi-monthly earnings (for exempt employees) or weekly wages (for non-exempt and union employees).

Q. HOW DOES THE COMPANIES' BASE PAY COMPARE WITH THE MARKET TRENDS?

A. The Companies have adjusted their base pay in recent years to stay within a target range of paying on the 50th percentile of comparably-sized companies. On an annual basis we look at market and survey data for both general industry positions and energy service positions and compare that data to our compensation packages. This information is used to develop a salary range for a particular position. The information is reviewed and used to come up with an overall general wage increase recommendation. We compare our packages with the market survey information to remain competitive and attract and retain talent.

In 2008, the overall general wage increase for exempt and non-exempt non-union employees was 3.5%. In anticipation of external economic conditions, the 2009 general wage increase for exempt employees, including executives, was zero percent. The general increase for non-union non-exempt employees was 3.8%. It should be noted that employees' individual increases may vary relative to the base pay budget to allow for individual differentiators based on performance and current pay levels relative to the market.

Duke Energy Kentucky and the International Brotherhood of Electrical Workers (IBEW) Local No. 1347 entered into a new five-year collective bargaining agreement effective April 1, 2009. The collective bargaining agreement provides for a 2.0% wage increase for each of the first three years of the contract along with a 1% lump sum bonus opportunity if the Company meets certain financial targets. There is a 3.0% wage increase for the fourth and fifth years of the contract, with increased employee contributions to health care costs throughout the term of the contract.

Duke Energy Kentucky and the United Steelworkers of America (USWA) Local No. 12049 and Local No. 5541-06 entered into a four-year collective bargaining agreement in 2007 that expires on June 12, 2011. The collective bargaining agreement provides for a 3.5% wage increase each year for the term of the agreement along with increased employee contributions to health care costs

Duke Energy Kentucky and the Utility Workers Union of America (UWUA) Local No. 600 entered into a four-year collective bargaining agreement in 2008 that expires on April 1, 2012. Under the Collective Bargaining

Agreement, the clerical unit (which includes meter reading) receives a 2.5% wage increase each year for the term of the contract along with a 1% lump sum in only one year of the contract. The technical and manual units of the UWUA will receive a 3.0% wage increase each year for the term of the contract.

V. INCENTIVE PAY PROGRAMS

Q. PLEASE DESCRIBE THE COMPANIES' INCENTIVE PAY PROGRAMS.

A. Duke Energy and Cinergy had various incentive pay programs prior to the merger. We have incorporated features from those programs in designing Duke Energy's current incentive plan. The Companies' major incentive pay programs are: (1) Duke Energy Short-Term Incentive Plan (STI); (2) Duke Energy Union Employees' Incentive Plan (UEIP); and (3) Duke Energy Long-Term Incentive Plan (LTI).

Q. WHAT WAS THE STI PLAN FOR 2008?

A. For 2008, the STI plan is reflected in the table below:

TABLE 1: SUMMARY 2008 STI PLAN

	Leadership Weight	Non Leadership Weight	Payout range
EPS	80.00%	80/50%	0-200%
Individual	20.00%	20/50%	0-150%
Safety	plus/minus 5%	plus 5%	N/A

For 2008, the non-leadership weight varied by department and could be either an 80/20% or 50/50% split between earnings per share (EPS) and individual goals. The corporate performance goal was based on Duke Energy's EPS. The payout with respect to the 2008 corporate performance goal was 64.29% of target (100%)

achievement for all employees. So, corporate performance for 2008 EPS was at less than target.

In 2008, the business unit goals of Duke Energy Kentucky's Gas Operations were based on the following factors: (1) Safety-Gas Operations; (2) Reliability-Percent Reduction gas mains and services - leaks repaired; (3) Customer Satisfaction – Corporate Perceptional Survey; and (4) Accelerated Main Replacement Program (AMRP) Expenditure Target. Individual goals were established by individuals or teams to support the business unit and corporate goals so that everyone worked toward common goals and objectives. Attachment JRA-1 shows the results of the Leadership 2008 STI Plan for Gas Operations.

Q. PLEASE DESCRIBE THE CURRENT STI PLAN.

A. The current STI plan is a short-term incentive plan that allows employees to receive cash payments if certain pre-determined performance goals are attained during the relevant calendar year. The STI plan is available to exempt and certain non-exempt, non-union employees of Duke Energy Kentucky and its affiliated companies who do not participate in another incentive plan. The purpose of the annual incentive plan is to attract, retain and motivate employees; enhance teamwork and high levels of achievement; and facilitate the accomplishment of specific corporate, business unit and individual goals.

At the beginning of each calendar year, corporate, business unit and individual performance goals are established for the annual plan, and a thorough review is performed at the end of the calendar year to determine the achievement levels for each performance goal. The Compensation Committee of the Duke

Energy Board of Directors (Compensation Committee) approves the corporate performance goals (for executive officers) at the beginning of each calendar year and certifies the payout level achieved for such goals at the end of the calendar year.

The performance goals are the objectives that the Company business unit and individual employees must attain in order for the employees to receive payment under the short-term incentive plan. The performance goals may consist of a combination of corporate, business unit and individual goals. The corporate performance goals must be an objective measure of Duke Energy's performance, efficiency or profitability. Business unit goals are related to specific financial and operational objectives of the unit such as safety, reliability, cost control and cost management. Individual goals are set cascading down from and supporting the business unit and corporate goals so that everyone works towards common goals and objectives. This ensures that there is an appropriate balance between corporate goals and individual goals so employees can have a direct impact relative to their goals.

All applicable goals are weighted, with a possible range of scores from 0% to 190% of target based upon achievement of these goals. Once an achievement level is determined, the achievement level is multiplied by the weighting assigned to each respective goal to determine an overall payout level. The corporate goals/ measures have a payout ranging from 0% to 200% of target. Individual goals have a payout ranging from 0% to 150%. In general, employees in leadership have a weighting of 80% of their incentive pay tied to the various corporate goals and 20% tied to their individual goals. In general, exempt (non-leadership) and non-union, non-exempt employees have an incentive weighting of 50% tied to achieving various corporate goals and 50% tied to individual goals.

The Compensation Committee-approved 2009 STI plan (and forecasted future period STI plan) structure is reflected in the table below:

TABLE2: SUMMARY 2009 STI PLAN

	Leadership Weight	Non Leadership Weight	Payout range
EPS	50.00%	31.25%	0-200%
O&M	20.00%	12.50%	0-200%
Reliability	10.00%	6.25%	0-200%
Safety	plus/minus 5%	plus 5%	N/A
Individual	20.00%	50%	0-150%

As I discussed earlier, once approved by management, approval is then obtained from the Compensation Committee of the Board of Directors who certify the results. The results of the 2009 STI plan will be available in the first quarter of 2010. Attachment JRA-2 shows Gas Operations' 2009 and forecasted period STI Leadership and Non-Leadership goals.

Q. PLEASE DESCRIBE THE UEIP.

A. The UEIP is available to union employees of Duke Energy Kentucky and its affiliated companies that do not participate in another incentive plan. The UEIP is a short-term incentive plan that allows union employees to receive cash payments if the Company attains certain corporate performance goals or if their group attains certain performance goals during a calendar year. The purpose of the UEIP is to attract, retain and motivate employees, enhance teamwork and high levels of achievement, and to facilitate the accomplishment of specific corporate and business unit goals.

The UEIP award levels consist of a percentage of the employee's base and overtime earnings based on corporate and business unit goals, such as Company financial results, safety, and customer satisfaction. The payout for the incentive bonuses for employees participating in the UEIP will vary based upon their participation in the various retirement programs. In conjunction with the new retirement program, all participants who volunteer or upon mandatory conversion will be eligible for up to a 5% maximum annual incentive payment. Employees who elect to remain in the Cinergy Traditional Program, which provides benefits under the final average pay pension formula, will not be eligible for higher incentive payout, but will participate in an annual incentive plan, with a maximum award of 2%. Additionally, regardless of which retirement program they participate in, represented employees are eligible for a safety incentive of up to 5% of their incentive payout if there are no workplace fatalities for the year. JRA-3 shows the breakdown by union and the percentage incentive payout for the 2009 and forecasted plan.

Q. PLEASE DESCRIBE THE LTI PLAN.

A. This plan pays equity-based compensation to executive employees and non-employee directors in a manner that aligns their interests with the long-term interests of Duke Energy and its affiliates, including Duke Energy Kentucky. The purpose of the LTI plan is: (1) to assist in attracting, retaining and motivating executives by keeping the Companies' compensation package competitive; and

(2) to align a portion of executive compensation with stakeholder interests by encouraging and enabling executives to acquire Duke Energy stock.

VI. PROPOSAL FOR SHARING INCENTIVE PAY EXPENSE

Q. WHAT INCENTIVE PAY EXPENSE DOES DUKE ENERGY KENTUCKY PROPOSE TO RECOVER IN THIS PROCEEDING?

A. Duke Energy Kentucky proposes to share its incentive plan expense between shareholders and customers in a manner consistent with what the Commission approved in Case Nos. 2005-00042 and 2006-0172. In those cases, the Commission approved recovery of incentive pay expense related to performance objectives that directly benefit customers, such as reliability, customer satisfaction and individual performance objectives. The Commission disallowed recovery of incentive pay expense related to performance objectives based on achieving corporate EPS.

Q. PLEASE FURTHER EXPLAIN DUKE ENERGY KENTUCKY'S PROPOSAL FOR RECOVERY OF INCENTIVE PLAN EXPENSE.

A. As shown above in Table 2: 2009 STI PLAN, the Company's Leadership and Non-Leadership STI continue to include a weighting factor for achieving corporate EPS. For 2009, Duke Energy has also added a weighting for achieving other goals such as O&M savings and reliability targets. Reliability targets were added as a means to balance the need to prudently manage costs and provide reasonably priced, safe service to customers, thereby lowering overall rate impact, with the need to maintain reliable service. The Company budgets based upon reaching 100% of its target achievement levels. Accordingly, Duke Energy

Kentucky proposes to recover the following amount of incentive compensation costs in its revenue requirement calculation, based on the following allocations:

TABLE 3: 2009 STI SHARING PROPOSAL

Incentive Plan	Incentive Plan Components	Percentage Of Total Plan	Percentage to Shareholders	Percentage to Customers	Percentage of Total Shared by Customers
STI – Non Leadership	EPS	31.25%	100%	0%	0%
	O&M	12.5%	0%	100%	12.50%
	Reliability	6.25%	0%	100%	6.25%
	Individual Goals	50%	0%	100%	50%
STI - Leadership	EPS	50%	100%	0%	0%
	O&M	20%	0%	100%	20%
	Reliability	10%	0%	100%	10%
	Individual Goals	20%	0%	100%	20%
Executive LTI	Total shareholder return and compounded annual growth rate of EPS	100%	100%	0%	0%
UEIP	Various by union - based on EPS, safety, customer satisfaction, etc.	100%	50%	50%	50%

Q. WHY DOES THE COMPANY'S PROPOSAL FOR INCENTIVE COMPENSATION ASSUME REACHING 100% OF TARGET ACHIEVEMENT LEVELS?

A. These are the budgeted achievement levels for the performance goals for the STI and the UEIP. The 100% target achievement level is used for the budget because this is what the Company expects to achieve on average over time. Over the past three years, the Company's performance, on average, has been higher than the budgeted amounts.

Q. PLEASE EXPLAIN HOW THE COSTS RELATED TO THE STI'S CORPORATE PERFORMANCE OBJECTIVES ARE DIVIDED BETWEEN CUSTOMERS AND SHAREHOLDERS.

A. The STI has four separate components: EPS, O&M cost reduction, reliability, and individual goals/business unit operational goals. There is also an additional 5% safety bonus for all employees if safety goals are achieved and a 5% safety reduction for executives if certain safety goals are not achieved. We propose that the expense attributable to the EPS goal be allocated 100% to the shareholders with nothing allocated directly to customer. We propose 100% of the objectives tied to O&M cost reduction, reliability and safety, as well as individual and business unit goals be allocated to customers.

Q. PLEASE EXPLAIN HOW THE COSTS RELATED TO THE STI'S O&M COST REDUCTION, RELIABILITY, SAFETY, AND INDIVIDUAL/

BUSINESS UNIT OPERATIONAL PERFORMANCE OBJECTIVES ARE DIVIDED BETWEEN CUSTOMERS AND SHAREHOLDERS.

A. Duke Energy Kentucky's rates should reflect 100% of the costs of the O&M cost reduction, reliability, safety, and individual/business unit incentive goals. These goals are operationally focused and directly benefit the customer. O&M cost reduction ultimately benefits rate payers because, to the extent the Company is able to reasonably and prudently manage costs, customer's total rates for safe and reliable service will be reflective of those reductions. Because customers ultimately benefit from any reductions and costs savings achieved through lower rates, it is reasonable that the incentives encouraging those cost reductions be reflected in rates. Similarly, customer s dire ctly benefit from the Company's provision of safe and reliable service. The reliability goal operates as a counter-balance to the O&M goal to motivate appropriate behavior. As a result, customers should be allocated this portion of employees' incentive pay.

Finally, the STI's individual/business unit operational goals for employees directly benefit customers. The individuals measured by these goals and included in the rate base are employed directly by Duke Energy Kentucky or allocate their time to Duke Energy Kentucky, and they work on Duke Energy Kentucky matters that directly benefit customers. Similarly, the business unit goals are tied to reliability, percent reduction gas mains and services- leaks repaired, meeting TICR goals, customer satisfaction scores, O&M expense levels and capital expenditures. Superior performance relating to these goals directly benefits Duke

Energy Kentucky customers through safe and reliable service, customer service quality, and low energy costs.

Q. PLEASE EXPLAIN HOW THE COSTS FOR THE UEIP PLAN ARE REFLECTED IN DUKE ENERGY KENTUCKY'S PROPOSAL.

A. The UEIP is an incentive plan for union employees not eligible for any other incentive compensation plans. These union employees include many of our back office personnel, including administrative and clerical, as well as meter readers and employees who construct and maintain the Company's gas distribution system. All are functions that are critical to reliable customer service. The UEIP performance objectives vary by union and are based a combination of corporate financial performance and on customer-oriented objectives, namely safety, customer satisfaction and reliability. We propose allocating the objectives related to achieving corporate EPS to shareholders and the portion related to achieving customer-oriented objectives to customers. This amounts to an even sharing (50/50) of UEIP incentive costs between customers and shareholders.

Q. ARE THE STI BUSINESS UNIT AND INDIVIDUAL GOALS DIRECTED MORE TOWARD SHAREHOLDER BENEFITS OR CUSTOMER BENEFITS?

A. Gas Operations 2009 goals and 2008 actual results are at Attachment JRA-2 and JRA-1, respectively. These goals clearly incent behavior that furthers the customers' interest. As I previously discussed, the goals are based on items such as: (1) keeping capital expenditures and operation and maintenance expense at reasonable levels, which tends to produce lower rates; (2) operational excellence, which produces more reliable service for customers; and (3) providing high quality customer service. The 2009 Gas Operations Leadership STI goals listed in JRA-2 clearly further customers' interests by incenting favorable behavior. The Gas Operations Non-Leadership STI Goals also further customers' interests and are designed to roll up into Gas Operation's goals. Therefore, the goal achievement of individual Gas Operations employees' helps Gas Operations achieve its goals.

As can be seen, these business unit and individual goals are closely tied to metrics such as safety, reliability, cost control and customer satisfaction, which provide customer benefits. Thus, I believe that Duke Energy Kentucky's rates should reflect these incentive compensation costs.

Q. BASED ON ALL OF THE ABOVE-MENTIONED ALLOCATIONS TO CUSTOMERS AND SHAREHOLDERS, HOW MUCH OF DUKE ENERGY KENTUCKY'S TOTAL INCENTIVE COMPENSATION EXPENSE WOULD BE REFLECTED IN ITS EXPENSES FOR THE FORECASTED TEST PERIOD?

A. Duke Energy Kentucky proposes to recover $451,320 of the $1,067,821 Gas Operations incentive compensation costs originally included in the forecasted test period. This represents approximately 42% of the total Duke Energy Kentucky incentive compensation expense originally included as an expense in the forecasted test period.

Q. **DO YOU HAVE AN OPINION AS TO THE REASONABLENESS OF DUKE ENERGY KENTUCKY'S PROPOSED TREATMENT FOR INCENTIVE COMPENSATION COSTS?**

A. Yes. In my opinion, all of Duke Energy Kentucky's incentive compensation costs are properly recoverable. Nevertheless, Duke Energy Kentucky's proposal allocates the costs of its incentive compensation plans between shareholders and customers in a manner consistent with the Commission's Orders in Case Nos. 2005-00042 and in 2007-172.

VII. COMPETITIVE MARKET ANALYSES – COMPENSATION

Q. **WERE ANY STUDIES CONDUCTED IN 2008 REGARDING THE COMPETITIVENESS OF THESE COMPENSATION PROGRAMS?**

A. Yes. Annually, Duke Energy participates in a variety of third party salary surveys. Data from these surveys is analyzed to determine overall competitiveness. Primary surveys used are Towers Perrin Energy Services Industry and Energy Technical Craft and Clerical Survey.

Q. **PLEASE DESCRIBE THESE COMPENSATION STUDIES.**

A. The analysis generally reported that Duke Energy's compensation program is competitive within the energy services industry and general industry.

VIII. REASONABLENESS OF COMPENSATION PROGRAMS

Q. **DO YOU HAVE AN OPINION AS TO WHETHER DUKE ENERGY'S EMPLOYEE COMPENSATION PROGRAMS ARE REASONABLE AND NECESSARY TO ATTRACT, RETAIN, AND MOTIVATE THE QUALIFIED EMPLOYEES NEEDED TO PROVIDE SAFE, RELIABLE,**

EFFICIENT AND ECONOMICAL SERVICE TO DUKE ENERGY KENTUCKY'S RETAIL GAS CUSTOMERS?

A. Yes. In my opinion, the Companies' base pay, short-term and long-term incentive compensation programs are competitive, reasonable, and necessary to attract, retain, and motivate qualified employees that the Companies need to provide safe, reliable, effective, efficient and economical gas service to Duke Energy Kentucky's retail customers.

IX. <u>BENEFIT PLAN DESIGN</u>

Q. HOW DO BENEFITS TIE INTO THE COMPANIES' OVERALL COMPENSATION PHILOSOPHY?

A. Benefits are the non-pay portion of an employee's total rewards. Generally, benefits are provided through one of two vehicles; retirement plans and welfare benefit plans. Retirement plans include pension and 401(k) plans. Welfare benefit plans include medical, dental, life insurance, and disability plans.

Q. WHAT IS THE COMPANIES' BENEFITS PHILOSOPHY?

A. We offer a competitive, comprehensive benefits program in order to establish ourselves as an employer of choice. In order to attract, retain and motivate a high caliber work force, a company must offer a competitive benefits program as well as a competitive compensation program. Benefits also play an important role in retaining employees, which is important for us as our business involves complex processes such that employees must receive long-term training to perform their jobs safely and effectively. Our benefits program is designed not only to attract qualified employees but also to retain employees, thus the Companies are able to maintain a highly trained, experienced work force that is capable of rendering excellent utility service.

X. COST MANAGEMENT CONTROLS

Q. HOW HAVE THE COMPANIES MANAGED HEALTH CARE COSTS?

A. The Companies are self-insured on most of their medical and dental benefits options. This avoids a risk premium that the Companies would otherwise have to pay to a third party for underwriting the plans. The medical plans have utilization management requirements in place to help eliminate unnecessary or inappropriate medical treatment and are designed to help employees receive quality care and needed medications while preventing unnecessary expenses for the employee and the Companies. Such requirements include hospital pre-certification, prior authorizations and step therapy for certain medications, ordering maintenance prescriptions through the mail order program and specialty biotech drugs through the specialty prescription drug program. We also apply usual and customary reimbursement guidelines on health and dental claims. In 2008, copays and deductibles were increased and new contracts with health care administrators were negotiated resulting in lower fees. The Company has comprehensive Disease Management and Wellness Programs, which encourage employees to adopt healthier lifestyles as well as to manage chronic illnesses that are associated with increased expense.

Q. HAVE ANY OTHER COST REDUCTIONS BEEN IMPLEMENTED WITH REGARD TO RETIREE BENEFITS?

A. We have in place the same utilization management requirements for both active employees and retirees. We made the same benefit changes in 2008 for retirees that applied to active employees. The Company continues to pass along normal premium increases to retirees on an annual basis. Beginning in 2009, most newly hired employees will not be eligible for a subsidy towards the cost of retiree healthcare coverage.

Q. IN YOUR OPINION, WILL THE COMPANIES ELIMINATE MEDICAL AND DENTAL BENEFITS FOR RETIREES?

A. In my opinion, medical and dental benefits for retirees are necessary to attract and retain the qualified employees needed to provide quality service to our customers. Although Duke Energy reserves the right to eliminate or modify any of its benefits, I believe that it is unlikely that access to retiree benefits would be eliminated in the future. However, beginning January 1, 2009, most newly hired employees will not be eligible for a subsidy towards the cost of retiree healthcare coverage. They will be required to pay 100% of the cost of coverage.

XI. REASONABLENESS OF BENEFITS PROGRAM

Q. DO YOU HAVE AN OPINION REGARDING THE REASONABLENESS AND NECESSITY OF THE COMPANIES' EMPLOYEE BENEFITS PROGRAMS TO ATTRACT, RETAIN AND MOTIVATE QUALIFIED EMPLOYEES TO PROVIDE SAFE, RELIABLE, EFFICIENT, AND ECONOMICAL SERVICE TO DUKE ENERGY KENTUCKY'S RETAIL GAS CUSTOMERS?

A. Yes. In my opinion, the Companies' employee benefits programs are both reasonable and necessary to attract, retain and motivate qualified employees to provide quality service to our retail gas customers in a safe, reliable, efficient and economical manner.

Q. WHY DO YOU HOLD THAT OPINION?

A. As workforce diversity has evolved, employees have become increasingly concerned about the level of financial protection and pay. Yet, we must continue to manage and control benefits costs. Based on my experience and day-to-day contact with employees, I believe that in numerous cases, the employee's ultimate employment decision gives a lot of weight to our benefits package. Therefore, our benefit levels must be competitive and reflect current benefit trends.

XII. WAGE AND BENEFIT COST ESTIMATES

Q. DID YOU PROVIDE ANY COST ESTIMATES TO DUKE ENERGY KENTUCKY WTINESS STEPHEN R. LEE FOR HIS USE IN PREPARING THE FORECASTED FINANCIAL DATA?

A. Yes, I provided Mr. Lee with certain compensation and fringe benefit costs for his use in preparing the forecasted financial data.

Q. HOW DID YOU ESTIMATE THESE LABOR AND BENEFIT COST CHANGES FOR THE FORECASTED PERIOD?

A. I made reasonable estimates based on recent trends, current conditions, the market studies by independent consultants that I discussed previously in my testimony, and my previous experience with compensation and benefits matters. Based on these considerations, I provided Mr. Lee with the following estimates for the forecasted test period consisting of the twelve months ending January 31, 2011: the union and non-union labor rate increases the fringe benefit loading rates, payroll tax, and indirect labor loading rates for union and non-union labor.

XIII. CONCLUSION

Q. WERE ATTACHMENTS JRA-1, JRA-2, AND JRA-3 PREPARED BY YOU OR AT YOUR DIRECTION?

A. Yes.

Q. ARE ATTACHMENTS JRA-1, JRA-2 AND JRA-3 TRUE AND ACCURATE COPIES OF THE DOCUMENTS THEY PURPORT TO REPRESENT?

A. Yes.

Q. IS THE INFORMATION YOU PROVIDED TO MR. LEE ACCURATE TO THE BEST OF YOUR KNOWLEDGE AND BELIEF?

A. Yes.

Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?

A. Yes.

VERIFICATION

State of Ohio)
)
County of Hamilton)

The undersigned, Jay R. Alvaro, being duly sworn, deposes and says that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his knowledge, information and belief.

Jay R. Alvaro

Jay R. Alvaro, Affiant

Subscribed and sworn to before me by Jay R. Alvaro on this 15TH day of June, 2009.

ADELE M. DOCKERY
Notary Public, State of Ohio
My Commission Expires 01-05-2014

Adele M. Dockery

NOTARY PUBLIC

My Commission Expires: 01/05/2014

Duke Energy
2008 STIP Gas Operations Objectives Summary for Leadership

Financial Objectives				
Weight %	Threshold (Payout: 50%)	Target (Payout: 100%)	Maximum (Payout: 200%)	Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section
Achieve Duke Energy EPS				
80%	**1.20**	**1.27**	**1.35**	1.22, payout 64.29%
80%	**Financial Objectives Aggregate Results:**			

Leadership Objectives				
Weight %	Threshold (Payout: 50%)	Target (Payout: 100%)	Maximum (Payout: 150%)	Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section
Safety – Gas Operations				
5%	2.99	1.89	1.79	2.66, payout 65%
Reliability - Percent Reduction Gas main & services – leaks repaired				
5%	(4%)	(6%)	(8%)	Revised 5.8%, payout 95%
Customer Satisfaction – Corporate Perceptional Survey				
5%	76.4%	78.8%	82.3%	83.6%, payout 150%
AMRP Expenditure Target				
5%	2%/-4%	+/-2%	+/-1%	-.26%, payout 150%
20%	**Individual Objectives Aggregate Results:**			Revised payout level 115%
100%	**Total Financial Objectives and Individual Objectives Aggregate Results:**			Payout 74.43%

Duke Energy
2008 STIP Gas Operations Objectives Summary for Non-Leadership

Financial Objectives				
Weight %	*Threshold (Payout: 50%)*	*Target (Payout: 100%)*	*Maximum (Payout: 200%)*	*Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section*
Achieve Duke Energy EPS				
50%	**1.20**	**1.27**	**1.35**	1.22, payout 64.29%
50%	**Financial Objectives Aggregate Results:**			

Non-Leadership Objectives				
Weight %	*Threshold (Payout: 50%)*	*Target (Payout: 100%)*	*Maximum (Payout: 150%)*	*Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section*
Safety – Gas Operations				
10%	2.99	1.89	1.79	2.66, payout 65%
Reliability - Percent Reduction Gas main & services – leaks repaired				
10%	(4%)	(6%)	(8%)	Revised 5.8%, payout 95%
Customer Satisfaction – Customer Contact Survey				
10%	82%	83%	84%	84%, payout 150%
AMRP Expenditure Target				
10%	2%/-4%	+/-2%	+/-1%	-.26%, payout 150%
O&M				
10%	$35.2M	$35.0M	$34.3M	.71% under, payout 115%
50%	**Individual Objectives Aggregate Results:**			Revised, payout 115%
100%	**Total Financial Objectives and Individual Objectives Aggregate Results:**			Payout 89.65%

Duke Energy
2008 STIP Objectives Summary for Leadership

Operational Measure 1: Safety (Gas Ops TICR)

Intent

Gas Operations management, supervision and employees are responsible for safety. The Total Incident Case Rate (TICR) is a nationally accepted rate for measuring the success of a safety environment for an organization. Gas Operations management is committed to providing tools and guidance to the organization which positively promotes safety and in turn positively impacts the TICR for Gas Operations. The 2008 safety plan for Gas Operations were one of the many tools used to promote safe work practices within the organization.

Rational and Logic for Performance levels

Minimum:	5% improvement over 3 yr avg
Target:	5% Improvement over 2007 actual results, or 5% improvement over last year's goal (whichever is lower – used 5% improvement over last year's goal)
Maximum:	10% Improvement over 2007 actual results, or 10% improvements over last year's goal (whichever is lower – used 10% improvement over last year's goal)

Operational Measure 2: Reliability – percent reduction of leaks repaired on mains and services

Intent

The overall goal of this metric is to measure the percent reduction of leaks repaired on mains and services. The accelerated main replacement program (AMRP) was developed to enhance the safety and reliability of Gas Operations' system with Cast Iron and Bare Steel pipe having a leak rate of 1.3 leaks per mile of main vs. plastic and coated steel having a leak rate of .05 leaks per mile of main. Gas Operations has replaced pipe segments based on nine priorities with the highest potential for incident being replaced first. The AMRP maintenance annual savings targets established in the tracker were calculated based off the reduction of leaks on mains and services (excluding third party damages). In addition, the Next Generation of Environmental Goals established a metric for methane reduction through the reduction of leaks repaired of 4% on an annual basis. The baseline is established per the number of leaks repaired in 2007.

Rational and Logic for Performance levels

Duke Energy
2008 STIP Objectives Summary for Leadership

Minimum:	4% reduction over 2007 leaks repaired
Target:	6% reduction over 2007 leaks repaired
Maximum:	8% reduction over 2007 leaks repaired

Operational Measure 3: FE&G Customer Satisfaction

Intent

Achieve top quartile performance relative to regional or national customer satisfaction benchmark studies conducted by J.D. Power and TQS Research. The performance philosophy is to achieve between top quartile and top decile rankings among mass residential, mass business, and large business customers. Operating companies and functions are encouraged to include additional measures related to the drivers of customer satisfaction that are more closely aligned to their operational needs and/or specific customer segments they support.

Rational and Logic for Performance levels

Mass Market Relationship Survey (Residential and Business):

This survey is conducted monthly for a random sample of customers. To arrive at the 2008 customer satisfaction target scores, the 12 most recent months of survey results were averaged. Observed standard deviations were used to generate 20th percentile and 80th percentile scores, to be used as the Minimum and Maximum performance thresholds, respectively. Given the lack of direct peer benchmark ratings for monthly results, targets are set using the historical trending information with an implicit tie back to regional benchmark studies. Where historical performance is below top quartile, a continuous improvement plan has been adopted with target scores set at a 10th percentile increase above the past year's performance (i.e. 60th percentile). Where historical performance is within top quartile, target thresholds are established to maintain top quartile performance.

Minimum:	20th percentile score.
Target:	Maintain top quartile or 60th percentile score.
Maximum:	80th percentile score.

Duke Energy
2008 STIP Objectives Summary for Leadership

CUSTOMER SATISFACTION

Measure for Use by Operating Departments: Power Delivery and Customer Service

Duke Energy	Weight	Min	Target	Max
Customer Satisfaction – Overall		76.4%	78.8%	82.3%
Mass Market	41%	74.6%	76.9%	78.9%
Residential Transactional	20%	83.4%	84.3%	85.2%
Large Business Market	34%	73.4%	77.1%	83.8%

Operational Measure 4: AMRP Expenditure Target

Intent

The Accelerated Main Replacement Program (AMRP) was developed to enhance the safety and reliability of the Gas Operations' system by replacing cast iron and bare steel pipe with plastic pipe. This measure allows Gas Operations to track the dollars being spent by the program and approved by both the Kentucky and Ohio Regulatory Commissions. The metric encompasses capital, O&M, and a maintenance savings dollar amount for Ohio and a capital amount for Kentucky. The maintenance savings dollar amount for Ohio is based on the reduction of leaks on mains and services (as discussed in operational measure 2 above)

Rational and Logic for Performance levels

Minimum:	2%/-4% of 2008 Budget for AMRP in OH/KY
Target:	+/-2% of 2008 Budget for AMRP in OH/KY
Maximum:	+/-1% of 2008 Budget for AMRP in OH/KY

OH/KY Gas Operations

2009 Leadership Short Term Incentive Plan

Corporate Objectives				
Weight %	*Minimum (Payout: 25%)*	*Target (Payout: 100%)*	*Maximum (Payout: 200%)*	*Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section*
Achieve Corporate EPS				
50%	$1.13	$1.20	$1.28	
Weight %	*Minimum (Payout: 50%)*	*Target (Payout: 100%)*	*Maximum (Payout: 200%)*	*Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section*
Achieve O&M Expense Reduction				
20%	$60 million	$100 million	$140 million	
Achieve Reliability Measures				
10%	Results based on composite score of reliability metrics			
80%	Corporate Objectives Aggregate Results:			
Individual or Operational Objectives				
Weight %	*Minimum (Payout: 50%)*	*Target (Payout 100%)*	*Maximum (Payout 150%)*	*Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section*
Objective #1: Safety - Gas Operations				
5%	2.66	1.89	1.79	
Weight %	*Minimum (Payout: 50%)*	*Target (Payout 100%)*	*Maximum (Payout 150%)*	*Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section*
Objective #2: Reliability - Percent Reduction gas mains and services - leaks repaired				
5%	-8%	-10%	-12%	
Weight %	*Minimum (Payout: 50%)*	*Target (Payout 100%)*	*Maximum (Payout 150%)*	*Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section*
Objective #3: Customer Satisfaction - Duke Energy Customer Satisfaction - Overall (Operational Measure)				
5%	77.20%	79.50%	83.30%	
Weight %	*Minimum (Payout: 50%)*	*Target (Payout 100%)*	*Maximum (Payout 150%)*	*Year-End Results Indicate Min, Target, Max Indicate attachments in documentation section*
Objective #4: AMRP Expenditure Target				
5%	2%/-4%	+/-2%	+/-1%	
20%	**Aggregate for Individual or Operational Objectives:**			
100%	**Total Corporate Objectives and individual or Operational Objectives Aggregate Results:**			

OH/KY Gas Operations
2009 Non-Leadership Short Term Incentive Plan

Corporate Objectives				
Weight %	Minimum (Payout: 25%)	Target (Payout: 100%)	Maximum (Payout: 200%)	Year-End Results Indicate Min, Target, Max Indicate attachments in documentation
Achieve Corporate EPS				
31.25%	**$1.13**	**$1.20**	**$1.28**	
Weight %	Minimum (Payout: 50%)	Target (Payout: 100%)	Maximum (Payout: 200%)	Year-End Results Indicate Min, Target, Max Indicate attachments in documentation
Achieve O&M Expense Reduction				
12.50%	**$60 million**	**$100 million**	**$140 million**	
Achieve Reliability Measures				
6.25%	**Results based on composite score of reliability metrics**			
50%	**Corporate Objectives Aggregate Results:**			

Individual or Operational Objectives				
Weight %	Minimum (Payout: 50%)	Target (Payout 100%)	Maximum (Payout 150%)	Year-End Results Indicate Min, Target, Max Indicate attachments in documentation
Objective #1: Safety - Gas Operations				
10%	2.66	1.89	1.79	
Weight %	Minimum (Payout: 50%)	Target (Payout 100%)	Maximum (Payout 150%)	Year-End Results Indicate Min, Target, Max Indicate attachments in documentation
Objective #2: Reliability - Percent Reduction gas mains and services - leaks repaired				
10%	-8%	-10%	-12%	
Weight %	Minimum (Payout: 50%)	Target (Payout 100%)	Maximum (Payout 150%)	Year-End Results Indicate Min, Target, Max Indicate attachments in documentation
Objective #3: Customer Satisfaction - Residential Transactional Survey (OH/KY)				
10%	80.80%	81.70%	82.70%	
Weight %	Minimum (Payout: 50%)	Target (Payout 100%)	Maximum (Payout 150%)	Year-End Results Indicate Min, Target, Max Indicate attachments in documentation
Objective #4: AMRP Expenditure Target				
10%	2%/-4%	+/-2%	+/-1%	
Weight %	Minimum (Payout: 50%)	Target (Payout 100%)	Maximum (Payout 150%)	Year-End Results Indicate Min, Target, Max Indicate attachments in documentation
Objective #5: O&M				
10%	.5% over budget	budget	2% under budget	
50%	**Aggregate for Individual or Operational Objectives:**			
100%	**Total Corporate Objectives and Individual or Operational Objectives Aggregate Results:**			

2009 Employee Incentive Plan (UEIP)
Mid-West Unions Only

USWA - Traditional Pension Plan Participants	2% Incentive Potential					
Measure	Targets			Incentive Opportunity		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
EPS	1.13	1.20	1.28	0.50	1.00	2.00

USWA - Cash Balance Pension Plan Participants	5% Incentive Potential					
Measure	Targets			Incentive Opportunity		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
EPS	1.13	1.20	1.28	1.25	2.50	5.00

UWUA - Traditional Pension Plan Participants	2% Incentive Potential					
Measure	Targets			Incentive Opportunity		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
EPS	1.13	1.20	1.28	0.50%	0.750%	1.00%
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Safety	4.26	3.18	3.02	0.25%	0.375%	0.50%
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Customer Satisfaction	63.7%	65.2%	65.9%	0.25%	0.375%	0.50%

UWUA - Cash Balance Pension Plan Participants	5% Incentive Potential					
Measure	Targets			Incentive Opportunity		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
EPS	1.13	1.20	1.28	0.75%	1.500%	3.00%
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Safety	4.26	3.18	3.02	0.50%	0.750%	1.00%
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Customer Satisfaction	63.7%	65.2%	65.9%	0.50%	0.750%	1.00%

IBEW 1347 Generation	2% Safety Incentive Potential (1% Station + 1% Combined)					
	Targets (OHSA Recordable Injuries)			Incentive Opportunity		
Plant	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Miami Fort Station (UE1004)	4	3	2	0.50%	0.750%	1.00%
W.C. Beckjord Station (UE1006)	4	3	2	0.50%	0.750%	1.00%
Zimmer Station (UE1005)	4	3	2	0.50%	0.750%	1.00%
East Bend Station (UE1007)	3	2	1	0.50%	0.750%	1.00%
Woodsdale Station (UE1008)	1	0	0	0.50%	0.750%	1.00%
Combined Station	16	11	8	0.50%	0.750%	1.00%
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
EPS	1.13	1.20	1.28	0.50%	0.750%	1.00%

IBEW 1347 Non-generation	2% Incentive Potential					
Measure	Targets			Incentive Opportunity		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
OSHA Recordable Injuries	5.55	4.92	4.66	0.75%	1.125%	1.50%
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Preventable Traffic Accidents	26	25	23	0.25%	0.375%	0.50%
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
EPS	1.13	1.20	1.28	0.50%	0.750%	1.00%

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF AN ADJUSTMENT	)	
OF GAS RATES OF	)	CASE NO. 2009-00202
DUKE ENERGY KENTUCKY, INC.	)	

DIRECT TESTIMONY OF

STEPHEN G. DE MAY

ON BEHALF OF

DUKE ENERGY KENTUCKY, INC.

July 1, 2009

269194

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I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Stephen G. De May. My business address is 526 South Church Street, Charlotte, North Carolina 28202.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Duke Energy Business Services LLC, an affiliate service company of Duke Energy Kentucky, Inc. (Duke Energy Kentucky or the Company), as Senior Vice President, Treasurer and Chief Risk Officer.

Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS.

A. I have a Bachelor of Arts degree in Political Science from the University of North Carolina in Chapel Hill, North Carolina, and a Master of Business Administration degree from the McColl School of Business at Queens University in Charlotte, North Carolina. I am a Certified Public Accountant (CPA) in the state of North Carolina and I am a member of the American Institute of Certified Public Accountants and the North Carolina Association of Certified Public Accountants.

Q. PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.

A. My professional work experience began in 1986 with the public accounting firm of Price Waterhouse (now PricewaterhouseCoopers) and, subsequently, Deloitte, Haskins and Sells (now Deloitte & Touche), where my work focused on tax accounting and consulting for a variety of clients, including C-corporations, S-corporations, partnerships, and high-net-worth individuals. In 1990, I joined Crescent Resources Inc., a then-wholly-owned real estate development subsidiary of Duke Power Company (a predecessor company to today's Duke Energy Corporation or Duke Energy), where I was responsible for real estate accounting and finance. In 1994, I moved to the Treasury and Corporate Finance Department where I have held, except for a two-year period of time, various positions of increasing responsibility. The two-year exception was for the majority of 2004 and 2005, during which time I had the lead responsibility for developing and managing Duke Energy's energy and regulatory policies. I was named to my current position in February 2009.

Q. PLEASE DESCRIBE YOUR DUTIES AS SENIOR VICE PRESIDENT, TREASURER AND CHIEF RISK OFFICER.

A. As Senior Vice President, Treasurer and Chief Risk Officer, I am responsible for treasury and risk management-related services to Duke Energy and its subsidiaries, including Duke Energy Kentucky. Under my supervision, the Treasury Department arranges and executes all capital raising and liquidity transactions, including credit facilities and commercial paper, debt securities, preferred and hybrid securities, and common stock, as well as daily cash management for Duke Energy and its subsidiaries. My responsibilities include managing Duke Energy's and its subsidiaries' credit ratings and relationships with the major credit rating agencies, commercial banks and the capital markets. I am responsible for overall risk management oversight of Duke Energy through the identification, quantification, monitoring and reporting of financial, market and credit risks across the enterprise. My responsibilities also encompass finance-related due diligence for major capital expenditure proposals as well as corporate merger, acquisition or divestiture transactions. Finally, my responsibilities include the oversight and administration of investments supporting Duke Energy's pension and retirement benefit plans and nuclear decommissioning trust funds.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE KENTUCKY PUBLIC SERVICE COMMISSION OR OTHER STATE PUBLIC UTILITY COMMISSIONS?

A. I have not previously testified before the Kentucky Public Service Commission (Commission). I have filed testimony on behalf of Duke Energy Ohio, Inc. with the Public Utility Commission of Ohio in 2008 in support of an electric distribution general rate case and in 2007 in support of a gas distribution general rate case. I have also recently filed testimony on behalf of Duke Energy Carolinas, LLC with the North Carolina Utilities Commission in support of a general rate case.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. My testimony addresses Duke Energy Kentucky's current credit ratings, its financial objectives and the expected cash requirements. Additionally, my testimony addresses the capital structure of Duke Energy Kentucky and its cost of debt included in Schedules J-1, J-1.1, J-1.2, J-2, and J-3, which I support. I also sponsor the coverage ratios and the rating agencies' credit ratings in Schedule K. I reviewed and approved the financing plan included in both the base and forecasted test periods in this proceeding. Additionally, I, or others under my direction and control, provided certain data to Duke Energy Kentucky witness Mr. Stephen R. Lee in preparation of these forecasts, which included assumptions around dividend policy and debt rates, as well as existing debt and equipment lease information. I also sponsor Filing Requirements FR 6(1), FR 6(2), FR 6(3), FR 6(4), FR 6(5), FR 6(6), FR 6(7), and FR 6(8), FR 10(9)(h)(11) and FR 10(9)(j).

II. CREDIT QUALITY AND CURRENT CREDIT RATINGS

Q. HOW DO THE CREDIT RATING AGENCIES AND OTHERS ASSESS CREDIT QUALITY?

A. Duke Energy Kentucky's creditworthiness is an assessment of its financial strength by the credit rating agencies and other creditors, including its ability to raise capital and meet its future financial obligations, and its ability to withstand changes in its business environment. Many qualitative and quantitative factors go into such an assessment. Qualitative aspects may include Duke Energy Kentucky's regulatory climate, its track record for delivering on its commitments, the strength of its management team, its operating performance, and the strength of its service area. Quantitative measures are primarily based on operating cash flow and focus on Duke Energy Kentucky's ability to meet its fixed obligations (such as interest expense) on the basis of internally-generated cash and the level at which Duke Energy Kentucky maintains debt leverage in relation to its generation of cash. Interest coverage ratios and the percentage of debt to total capital are examples of quantitative measures. Creditors and credit rating agencies generally view both qualitative and quantitative factors in the aggregate when assessing the credit quality of a company.

Q. HOW ARE DUKE ENERGY KENTUCKY'S OUTSTANDING SECURITIES CURRENTLY RATED BY THE CREDIT RATING AGENCIES?

A. As of the date of this testimony, Duke Energy Kentucky's outstanding debt is rated by Standard & Poor's (S&P) and Moody's Investors Service (Moody's) as follows:

Rating Agency	**S&P**	**Moody's**
Senior Unsecured Rating	A-	Baa1
Ratings Outlook	Positive	Stable

Q. PLEASE EXPLAIN WHAT IS MEANT BY THESE CREDIT RATINGS FOR DUKE ENERGY KENTUCKY'S DEBT.

A. Obligations carrying a credit rating in the "A" category are considered strong, investment-grade securities subject to low credit risk for the investor. "A" rated debt is presumed to be somewhat susceptible to changes in circumstances and economic conditions; however, the debt issuer's capacity to meet its financial commitments is considered strong.

S&P may also modify its ratings with the use of a plus or minus sign to further indicate the relative standing within a major rating category. An "A+" credit rating is at the higher end of the "A" credit rating category and an "A-" is at the lower end of the category. Moody's credit rating assignments use the numbers "1", "2", and "3", with the numbers "1" and "3" analogous to a "+" and

"-", respectively. For example, Moody's credit ratings of "A2" and "A3" would be analogous to "A" and "A-" credit ratings at S&P, respectively.

Q. WHAT IS MEANT BY A "STABLE OR POSITIVE OUTLOOK"?

A. A rating outlook assesses the potential direction of a long-term credit rating over an intermediate term (typically six months to two years). A "Stable Outlook" means the credit ratings are not likely to change whereas a "Positive Outlook" means the credit ratings may be raised based on the rating agency's view of potential changes to economic or fundamental business conditions.

Q. WHEN WERE DUKE ENERGY KENTUCKY'S CURRENT CREDIT RATINGS ESTABLISHED?

A. Duke Energy Kentucky's current credit ratings were established by S&P in May 2007 and by Moody's in November 1995. The positive ratings outlook was assigned by S&P to Duke Energy Kentucky's ratings in September 2008, while the stable ratings outlook was assigned by Moody's in January 2008.

Q. WHAT FACTORS CAUSED S&P TO CHANGE ITS RATINGS OUTLOOK IN SEPTEMBER 2008 AND MOODY'S TO CHANGE ITS RATINGS OUTLOOK IN JANUARY 2008?

A. As stated in S&P's September 26, 2008, research update at the time of the outlook revision from stable to positive, the outlook revision on Duke Energy and its subsidiaries "reflects the potential for higher ratings in the next nine to twelve months, provided credit metrics remain buoyant and Duke Energy Kentucky continues to achieve favorable regulatory outcomes that provide for the timely recovery of its sizable utility construction program." Moody's changed its outlook from positive to stable on January 18, 2008[1], stating that the previously assigned positive rating outlook "largely incorporated a view that the financial performance would improve over the next several years." However, "given the company's September 2007 announcement regarding its capital investment plans and the intention to finance that plan largely with debt, Duke Energy's key financial credit metrics are no longer expected to improve and, most likely, will deteriorate over the next few years." As a result, Moody's changed the outlook to stable.

Q. HAVE THE CREDIT RATING AGENCIES IDENTIFIED ANY ISSUES REGARDING DUKE ENERGY KENTUCKY'S CREDIT QUALITY?

A. In general, the rating agencies believe Duke Energy Kentucky operates in a generally supportive regulatory environment and expects that the Company's regulatory relationships will continue to support long-term credit quality with timely and sufficient rate relief recovery for prudently incurred costs and expenses. Nonetheless, the credit rating agencies have identified the challenges of managing a higher capital expenditure program and prospects for more stringent environmental mandates as issues affecting Duke Energy Kentucky's credit quality.

Q. WHY IS IT IMPORTANT FOR DUKE ENERGY KENTUCKY TO HAVE STRONG INVESTMENT-GRADE CREDIT RATINGS?

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[1] In its January 18, 2008 outlook revision, Moody's revised the outlook from positive to stable on Duke Energy Corp., Duke Energy Carolinas, Cinergy Corp., Duke Energy Carolinas, Duke Energy Ohio and Duke Energy Kentucky. The outlook for Duke Energy Indiana, which was already stable, was left unchanged.

A. Strong investment-grade credit ratings provide Duke Energy Kentucky with greater financial flexibility, lower debt financing costs and greater access to the capital markets. Strong credit ratings are essential to being able to raise debt capital on reasonable terms, under various market conditions, to fund infrastructure requirements and to refinance maturing debt.

To assure reliable and cost effective service, Duke Energy Kentucky must be able to finance its capital projects without interruptions, regardless of capital market conditions. Capital markets can exhibit extreme volatility, as we have recently witnessed, and Duke Energy Kentucky must be capable of financing its needs throughout such periods. Lack of access to capital can force interruption of capital projects to the long-term detriment of customers. Strong investment-grade credit ratings provide Duke Energy Kentucky with greater assurance of continued access to capital on favorable terms during periods of extreme volatility.

Although recent debt market conditions have improved, the financial crisis of 2008/2009 illustrated the importance of strong investment-grade credit ratings such as the A- / Baa1 senior unsecured ratings that Duke Energy Kentucky currently enjoys. As Anthony Ianno, Managing Director, Global Risk Capital Markets, Morgan Stanley stated in his prepared remarks at the "FERC Technical Conference on Credit and Capital Issues affecting the U.S. Electricity Power Industry" on January 13, 2009,[2] the costs for issuing debt in the investment-grade debt market increased during the credit crisis, in some cases substantially:

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[2] See conference transcript, including Anthony Ianno's prepared remarks at http://www.ferc.gov/EventCalendar/Files/20090122072648-AD09-2-01-14-09.pdf.

> Before the credit crisis, investors would calculate the expected return, by adding the credit spread associated with default risk, to the risk-free rate. This equation has now changed.
>
> In addition to default risk, investors are asking that return accrue the premium for volatility, a premium for liquidity, and an excess return in the form of a new-issue premium. The lower the credit rating, the greater the premium investors are expecting.

Mr. Ianno also addressed the importance of strong investment-grade credit ratings in terms of companies' ability to access the debt markets when needed. As Mr. Ianno's materials indicated on the page titled "2008 Utility Issuance by Credit Rating,"[3] of the $13.6 billion of issuance since the Lehman bankruptcy, only 35% was issued by companies rated in the "BBB" category. The remaining 65% came from utilities that were rated in the "A" category. This compares to a split for 2008 utility issuance up to the date of the Lehman bankruptcy of 52% from "A" rated utilities and 48% from "BBB" rated utilities.

Q. DO YOU EXPECT THIS FILING TO HAVE ANY SUBSTANTIAL IMPACT ON THE COMPANY'S CREDIT RATINGS?

A. No, assuming the Commission approves a constructive outcome. As I previously stated, the rating agencies perceive the regulatory environment in which Duke Energy Kentucky operates as being generally supportive of credit quality. As evidence of the rating agencies' assessment of these regulatory environments, in its November 2008 assessment of regulatory climates for United States investor-owned utilities, S&P assessed the regulatory jurisdictions in which Duke Energy Kentucky operates as "credit supportive." This assessment was based on a five-

[3] See Anthony Ianno's prepared materials at http://www.ferc.gov/EventCalendar/Files/20090122072645-Ianno,%20Morgan%20Stanley.pdf.

category scale that included "least credit supportive," "less credit supportive," "credit supportive," "more credit supportive," and "most credit supportive."

S&P laid out the factors it utilizes to assess regulation in its November 26, 2008 Criteria for Utilities, "Key Credit Factors: Business and Financial Risks in the Investor-Owned Utilities Industry." The critical success factors S&P delineated include consistency and predictability of decisions; support for recovery of fuel and investment costs; history of timely and consistent rate treatment, permitting satisfactory profit margins and timely return on investment; and support for a reasonable cash return on investment. Furthermore, S&P stated that regulation is the most critical aspect that underlies regulated utilities' creditworthiness, stating "regulatory decisions can profoundly affect financial performance. S&P's assessment of the regulatory environments in which a utility operates is guided by certain principles, most prominently consistency and predictability, as well as efficiency and timeliness."

Assuming a constructive outcome is achieved, I do not believe that this proceeding will adversely impact Duke Energy Kentucky's credit ratings. I believe if the Commission approves a strong equity component of the capital structure and the cost of equity as requested in this filing, it will be supportive of Duke Energy Kentucky's objective of having strong credit ratings.

III. <u>DUKE ENERGY KENTUCKY'S FINANCIAL OBJECTIVES</u>

Q. WHAT ARE DUKE ENERGY KENTUCKY'S FINANCIAL OBJECTIVES?

A. Duke Energy Kentucky's overall financial objective is to maintain financial strength with assured and reasonable access to low cost capital in order to continue to provide cost-effective, safe, adequate, environmentally-compliant and reliable service to our customers. Specific financial objectives necessary to maintain financial strength include: (a) maintaining at least a 50% common equity for Duke Energy Kentucky on a financial capitalization basis; (b) maintaining current credit ratings; (c) maintaining sufficient cash flows to meet obligations; and (d) maintaining a sufficient return on equity to fairly compensate shareholders for their invested capital.

Q. DO YOU BELIEVE THAT DUKE ENERGY KENTUCKY'S CUSTOMERS WILL BENEFIT IF DUKE ENERGY KENTUCKY IS ABLE TO ACHIEVE ITS FINANCIAL OBJECTIVES?

A. Yes, our customers will benefit from the financial objectives that we have established. Maintaining a strong capital structure with a sufficient return on equity helps to ensure safer returns to debt holders, which translates into higher credit quality, allowing Duke Energy Kentucky the financial flexibility to attract capital from the debt and equity markets as needed. The benefits of these financial objectives include not only lower debt financing costs, but also greater assurance of access to capital as needed, thus improving Duke Energy Kentucky's ability to maintain a safe, reliable, and low-cost level of customer service for its customers, even in a recessionary period such as we are currently experiencing.

IV. DUKE ENERGY KENTUCKY'S CASH REQUIREMENTS

Q. WHAT ARE DUKE ENERGY KENTUCKY'S CAPITAL NEEDS DURING THE 2009-2011 TIME PERIOD?

A. Based on schedule FR 10(9)(h)(3) sponsored by Duke Energy Kentucky witness Mr. Lee, for the three calendar years 2009 through 2011, Duke Energy Kentucky anticipates capital needs of approximately $273 million, principally from the use of cash for investing activities totaling approximately $253 million over the three-year period, as well as a $20 million long-term debt maturity in September 2009.

Q. HOW WILL DUKE ENERGY KENTUCKY'S CAPITAL REQUIREMENTS BE FUNDED?

A. Based on schedule FR 10(9)(h)(3) sponsored by Mr. Lee, Duke Energy Kentucky's capital requirements are expected to be principally funded from internal cash generation of approximately $184 million and the issuance of debt (both short-term and long-term) of approximately $110 million, partially offset by dividends to its parent of approximately $9 million. Equity funding requirements, to the extent they are required to maintain an appropriate capital structure for Duke Energy Kentucky, may be satisfied through either a reduction in the dividends that Duke Energy Kentucky pays to its parent or through the receipt of equity contributions from its parent.

V. DUKE ENERGY KENTUCKY'S CAPITAL STRUCTURE

Q. WHAT WAS DUKE ENERGY KENTUCKY'S CAPITAL STRUCTURE ON A FINANCIAL REPORTING BASIS FOR PURPOSES OF THIS PROCEEDING?

A. Duke Energy Kentucky's corporate capital structure at the date of the base period, September 30, 2009, is expected to be approximately 49% debt (both long-term and short-term, including the balance of proceeds from the sale of Accounts Receivable), and approximately 51% common equity as detailed on Schedule J-1, page 1 of 2.

In this proceeding, Duke Energy Kentucky's capital structure is based on the projected 13-month average for Duke Energy Kentucky as of January 31, 2011, of approximately 50% debt (both long-term and short-term, including the balance of proceeds from the sale of Accounts Receivable), and approximately 50% common equity as detailed on Schedule J-1, page 2 of 2.

Q. IS THE COMPANY'S PROPOSED CAPITAL STRUCTURE CALCULATED ON A BASIS CONSISTENT WITH HOW THE CREDIT RATING AGENCIES CALCULATE THE COMPONENTS OF DEBT AND EQUITY?

A. No. The credit rating agencies will calculate the Company's capital structure from publicly-filed financial statements. In calculating the debt component of capital structure, the credit rating agencies will include both short-term and long-term debt (including current maturities of long-term debt) and then impute *pro forma* debt amounts to include in their capital structure calculations for long-term fixed obligations, which they consider to be "debt equivalents." Examples of "debt equivalents" would include certain operating lease obligations, long-term purchased power agreements, and under-funded pension plan obligations. Therefore, credit rating agency calculations of capital structure typically result in a higher debt component. This increased leverage imputed by the credit rating agencies reinforces the need for a strong equity component in Duke Energy Kentucky's capital structure.

Q. WHAT EFFECT DOES CAPITAL STRUCTURE AND RETURN ON EQUITY HAVE ON CREDIT QUALITY?

A. Capital structure and return on equity are important components of credit quality. Equity investors provide the foundation of a company's capitalization by providing significant amounts of capital, for which an appropriate economic return is required. Returns to equity investors are realized only after all operating expenses and fixed payment obligations (*e.g.*, debt principal and interest) of the business have been paid. Because these investors are the last to receive surplus earnings and cash flows, it is their capital that is most at risk if the company suffers a downturn in business or general financial conditions. This dynamic of equity investors receiving "residual" earnings and cash flows provides debt investors a measure of protection. Therefore, the greater the equity component of capitalization, the safer the returns are to debt investors, which translates into higher credit quality. In addition, the allowed return on equity is a key component in the generation of earnings and cash flows. An adequate return on equity helps ensure equity investors receive fair compensation for the capital they have at risk while, at the same time, the cash flow generated helps to protect debt holders. A strong capital structure and an adequate return on equity provide balance sheet protection and cash flow generation to support strong credit quality. Strong credit quality creates financial flexibility by providing more readily available access to the capital markets on reasonable terms, and ultimately lower debt financing costs.

Q. DO YOU BELIEVE THAT DUKE ENERGY KENTUCKY'S PROPOSED CAPITAL STRUCTURE HAS AN ADEQUATE EQUITY COMPONENT TO ENABLE IT TO ACHIEVE THE COMPANY'S FINANCIAL STRENGTH AND CREDIT QUALITY OBJECTIVES?

A. Yes, I believe Duke Energy Kentucky's equity component, as requested in this proceeding, enables it to maintain its current credit ratings, financial strength and flexibility. This level of equity enables Duke Energy Kentucky to tolerate the volatility of different business cycles while also providing a cushion to the Company's lenders and bondholders.

Q. DESCRIBE DUKE ENERGY KENTUCKY'S DIVIDEND POLICY WITH RESPECT TO PAYING DIVIDENDS TO ITS PARENT.

A. Duke Energy Kentucky must, over time, pay dividends of approximately 70-80% of its earnings to support dividend payments to Duke Energy's shareholders. In any given year, Duke Energy Kentucky will vary the level of dividend payments based upon its capital needs and as needed to properly maintain its desired capital structure.

VI. DUKE ENERGY KENTUCKY'S COST OF DEBT

Q. WHAT IS DUKE ENERGY KENTUCKY'S PROJECTED AVERAGE COST OF SHORT-TERM DEBT FOR THE THIRTEEN MONTHS ENDING JANUARY 31, 2011?

A. For the thirteen months ending January 31, 2011, Duke Energy Kentucky's cost of short-term debt (including the balance of proceeds from the sale of Accounts Receivable) is projected to be 1.928%. Forecasts of short-term interest rates for commercial paper and the sale of Accounts Receivable are based on Bloomberg's Implied Forwards Curve for one-month LIBOR plus a credit spread of 20 basis points. For commercial paper, this represents an approximation of the pricing in the commercial paper markets for issuers with short-term credit ratings of A-2 / P-2[4]. For the sale of Accounts Receivable, this represents the creditworthiness of banks involved in Duke Energy Kentucky's sale of its retail receivables. The details of this calculation are shown in Schedule J-2, Page 2 of 2.

Q. WHAT IS DUKE ENERGY KENTUCKY'S PROJECTED AVERAGE COST OF LONG-TERM DEBT FOR THE THIRTEEN MONTHS ENDING JANUARY 31, 2011?

A. For the thirteen months ending January 31, 2011, Duke Energy Kentucky's cost of long-term debt is projected to be 4.657%. The projected interest rates related to the drawn amount under the Duke Energy Corporation Master Credit Facility were based on Bloomberg's Implied Forwards Curve for one-month LIBOR plus a credit spread of 24 basis points, which is the amount Duke Energy Kentucky is charged under the credit facility. The projected interest rates related to the

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[4] Per Moody's short-term ratings category definitions see: http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=rdef&subtopic=moodys%20credit%20ratings&title=Short-Term+Ratings.htm, obligations carrying the P-2 short-term credit rating refer to issuers with a "strong ability to repay short-term debt obligations" (compared to P-1 ratings, which are commensurate with a "superior ability to repay" and P-3 ratings, which are commensurate with an "acceptable ability to repay"). On an equivalent basis, S&P's short-term credit ratings of "A-1" and "P-1" are analogous to Moody's short-term credit ratings of "P-1" and "P-2," respectively.

approximately $26.7 million floating-rate pollution control debt were based on a forecast of LIBOR multiplied by two (the failed auction rate for this security), using Bloomberg's Implied Forwards Curve for one month LIBOR. Finally, the projected interest rates related to the $50 million floating-rate pollution control debt were based on a forecast of LIBOR using approximately 75% of Bloomberg's Implied Forwards Curve for one month LIBOR as a proxy for a Securities Industry and Financial Markets Association (SIFMA) Municipal Index Forward Curve. The details of this calculation are shown in Schedule J-3, Page 2 of 2.

Q. HAS DUKE ENERGY KENTUCKY SUCCESSFULLY MANAGED ITS FINANCING COSTS, THUS MITIGATING THE RATE INCREASE PROPOSED IN THIS CASE?

A. Yes. Since its last gas rate case, Duke Energy Kentucky has successfully managed its financings costs and was able to reduce the cost of long-term debt from 5.926% for the 13-month average forecasted test period ended September 30, 2006, (the end of the test period in Case No. 2005-00042), to 5.707% for the 13-month average forecasted test period ended December 31, 2007, (end of the test period in the Company's last electric rate case, Case No. 2006-00172) to 4.657% for the 13-month average forecasted test period ending January 31, 2011, as proposed in this case.

Q. DID YOU OR OTHERS UNDER YOUR DIRECTION AND CONTROL PROVIDE CERTAIN DATA TO DUKE ENERGY KENTUCKY WITNESS STEPHEN R. LEE FOR HIS PREPARATION OF THE FORECASTED

FINANCIAL STATEMENTS IN THIS PROCEEDING AND IF SO, WHAT DATA DID YOU PROVIDE?

A. Yes. We provided certain data to Mr. Lee for use in the preparation of the forecasts for both the base and the test periods in this proceeding and I reviewed the results of the financial forecasts Mr. Lee is sponsoring to determine if any financing plan changes were needed. We provided the short-term and long-term debt interest rate assumptions, all assumptions related to outstanding and new issuances of long-term debt and associated expenses and the equipment lease data, including the payment schedules for these leases. All of this data was developed in the normal course of developing the 2009 annual budget and the update of the five-year forecast. Mr. Lee's testimony discusses the annual budget process and the update to the five-year forecast.

Q. WHAT FINANCIAL INFORMATION DO YOU NORMALLY REVIEW?

A. I typically provide inputs to and review the results of the Company's financial forecasts which would have included review of the two-year period included in this proceeding. For example, I review to see if there are appropriate levels of short-term and long-term debt and that the dividend levels appear reasonable. If the short-term debt levels have grown too large, I will provide instructions to fund the short-term debt by issuing long-term debt with the specific parameters that should be assumed with that debt issuance.

VII. <u>SCHEDULES SPONSORED BY WITNESS</u>

Q. PLEASE DESCRIBE SCHEDULES J-2 AND J-3.

A. Schedule J-2, entitled "Embedded Cost of Short-Term Debt," and Schedule J-3, entitled "Embedded Cost of Long-Term Debt," set forth the calculations of the cost of short-term debt and long-term debt, respectively, of Duke Energy Kentucky. The information on page 1 of these schedules was computed at the date of the base period, September 30, 2009. On page 2, the balances and interest rates are based on the average of the projected balances and rates for the thirteen month period ending January 31, 2011.

Q. WHY IS SCHEDULE J-4 NOT INCLUDED?

A. Schedule J-4 is designed to provide the embedded cost of preferred stock for Duke Energy Kentucky. Since Duke Energy Kentucky has no preferred stock, this schedule has not been filed.

Q. PLEASE DESCRIBE SCHEDULES J-1, J-1.1 AND J-1.2

A. Schedule J-1, entitled "Cost of Capital Summary," sets forth the projected capital structure and capitalization ratios of Duke Energy Kentucky at September 30, 2009, and the average of the projected balances and rates for the thirteen-month period ending January 31, 2011. The cost of the long-term and short-term debts capitalization components are developed on Schedules J-2 and J-3. The weighted cost of the various capital components is computed by multiplying the respective capitalization ratio by the computed annualized cost rate. The overall weighted cost of capital is reflected in the rate of return requested for the thirteen-month period ending January 31, 2011.

Schedules J-1.1 and J-1.2 entitled "Average Forecasted Period Capital Structure - Current Rates" and "Average Forecasted Period Capital Structure -

Proposed Rates," respectively, set forth Duke Energy Kentucky's projected weighted cost of capital based of the average of the projected balances and rates for the thirteen-month period ending January 31, 2011. Schedule J-1.1 assumes no rate increase and Schedule J-1.2 reflects the balances assuming the proposed rates are in effect.

Duke Energy Kentucky witness Mr. Robert M. Parsons supports the accumulated deferred investment tax credit related portions of Schedules J-1, J-1.1 and J-1.2.

Q. DO YOU SPONSOR ANY OF THE INFORMATION CONTAINED IN ANY OTHER SCHEDULES?

A. Yes. I sponsor the coverage ratios in Schedule K and the ratings agencies ratings in Schedule K.

Q. PLEASE DESCRIBE FR 6(1).

A. FR 6(1) provides the amount and kinds of stock authorized.

Q. PLEASE DESCRIBE FR 6(2).

A. FR 6(2) provides the amount and kinds of stock issued and outstanding.

Q. PLEASE DESCRIBE FR 6(3).

A. FR 6(3) is a requirement to provide certain terms and conditions for any preferred stock. Since Duke Energy Kentucky has no preferred stock, there is no information to provide.

Q. PLEASE DESCRIBE FR 6(4).

A. FR 6(4) provides a description of certain terms and conditions for any mortgages.

Q. PLEASE DESCRIBE FR 6(5).

A. FR 6(5) provides certain terms and conditions for any bonds authorized and issued.

Q. PLEASE DESCRIBE FR 6(6).

A. FR 6(6) provides certain terms and conditions for any notes issued.

Q. PLEASE DESCRIBE FR 6(7).

A. FR 6(7) is a requirement to provide certain terms and conditions for other indebtedness.

Q. PLEASE DESCRIBE FR 6(8).

A. FR 6(8) provides certain information regarding dividend payments by Duke Energy Kentucky during the past five years.

Q. PLEASE DESCRIBE FR 10(9)(h)(11).

A. FR 10(9)(h)(11) Duke Energy Kentucky's capital structure requirements.

Q. PLEASE DESCRIBE FR 10(9)(j).

A. FR 10(9)(j) is a requirement to provide copies of the prospectuses of the most recent stock or bond offering.

VIII. CONCLUSION

Q. HOW WAS THE RATE OF RETURN FOR COMMON EQUITY DETERMINED?

A. The return on Common Equity, as contained on Schedules J-1, J-1.1 and J-1.2, reflects the recommendation of Duke Energy Kentucky witness Dr. Roger A. Morin, as supported by his testimony in this case.

Q. WERE SCHEDULES J-1, J-1.1, J-1.2, J-2, J-3, FR 6(1), FR 6(2), FR 6(3), FR 6(4), FR 6(5), FR 6(6), FR 6(7), FR 6(8), FR 10(9)(h)(11), FR 10(9)(j) AND

THE INFORMATION YOU SPONSOR IN SCHEDULE K PREPARED OR PROVIDED BY YOU OR PERSONS UNDER YOUR DIRECTION AND CONTROL?

A. Yes.

Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?

A. Yes.

VERIFICATION

State of North Carolina)
)
County of Mecklenburg)

The undersigned, Stephen G. De May, being duly sworn, deposes and says that he is employed by Duke Energy Corporation (Duke Energy) affiliated companies and its principal subsidiary companies, including Duke Energy Kentucky, Inc. (Duke Energy Kentucky), its parent company, Duke Energy Ohio, Inc. (DE-Ohio), Duke Energy Indiana, Inc. and Duke Energy Carolinas, LLC (DE-Carolinas), that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.

Steve May

Stephen G. De May, Affiant

Subscribed and sworn to before me by Stephen G. De May on this 19th day of June, 2009.

Kathy S. Moraloda

NOTARY PUBLIC

My Commission Expires: 12/13/2013

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF AN ADJUSTMENT OF GAS RATES OF DUKE ENERGY KENTUCKY, INC.	)))	CASE NO. 2009-00202

DIRECT TESTIMONY OF

DAVID L. DOSS, JR.

ON BEHALF OF

DUKE ENERGY KENTUCKY, INC.

July 1, 2009

TABLE OF CONTENTS

ATTACHMENTS

I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is David L. Doss, Jr. My business address is 526 South Church Street, Charlotte, North Carolina 28202.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Duke Energy Business Services, LLC (DEBS), an affiliate service company of Duke Energy Kentucky, Inc. (Duke Energy Kentucky or the Company), as General Manager, Corporate Accounting.

Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS.

A. I have a bachelor's degree in Accounting from the University of Texas at Austin and am a licensed Certified Public Accountant in the state of Texas.

Q. PLEASE SUMMARIZE YOUR WORK EXPERIENCE.

A. I began my professional career in 1985 as an entry-level accountant in the International Exploration & Production Accounting group at Texas Eastern Corporation (TEC) in Houston, Texas. Later I transferred into TEC's Consolidations & External Reporting group, which is where I was working in 1989 when TEC was acquired by Panhandle Eastern Corp. (Panhandle Eastern Corp. later changed its name to PanEnergy Corp.) Between that merger and the Duke Power Company/PanEnergy merger in 1997, which created Duke Energy Corp. (Duke Energy), I served in positions including Supervisor of the Federal Energy Regulatory Commission (FERC) and Internal Management Reporting for PanEnergy's Panhandle Eastern Pipe Line (PEPL) subsidiary, Supervisor of PEPL

Gas Revenue Accounting, and Administrator in PanEnergy's Corporate Insurance group. Following the Duke Power Company/PanEnergy merger, I assumed the role of Project Manager of Planning and Analysis in the Energy Services business group. I was later promoted to Manager within that group and had responsibility for the preparation of consolidated financial analyses and management reports for Duke Energy's unregulated businesses. In 2001, I transferred to the Duke Energy North America (DENA) business unit and assumed the role of Director of the Financial Planning and Analysis group, which prepared internal financial forecasts, budgets and analyses. In 2004, I transferred within DENA to become Director of the Financial Reporting group that was responsible for publishing internal monthly financial/performance reports and analyses for business unit and corporate management, and providing data to the corporate reporting group for external earnings releases and reporting requirements for the Securities and Exchange Commission (SEC). Following the Duke Energy/Cinergy Corp. merger in 2006, I transferred from the Houston office to the Charlotte office of Duke Energy to assume the role of General Manager of the Corporate Accounting group, with responsibility for accounting for benefits, captive insurance, corporate commodity hedges and other corporate transactions/operations. In 2007, I assumed additional responsibilities, including oversight of Service Company accounting and allocations, accounting for telecommunications subsidiaries, and accounting for the remaining business of DENA and Duke Energy Trading and Marketing.

Q. PLEASE DESCRIBE YOUR DUTIES AS GENERAL MANAGER, CORPORATE ACCOUNTING.

A. As General Manager, Corporate Accounting, I am responsible for the accounting associated with Duke Energy's actuarial benefit plans (*e.g.*, pensions and other post-retirement employee benefits), stock-based compensation awards, captive insurance program, Service Company, and various other subsidiaries and corporate entities. My group is also responsible for allocating Service Company costs to the business units and for preparing the annual FERC Form 60 for the Service Company. In addition, my group is responsible for the internal and external financial reporting and analysis related to Duke Energy's other segment for SEC purposes (*i.e.*, all operations that are not included in Duke Energy's three reportable segments of US Franchised Electric and Gas, Commercial Power and International Energy).

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE KENTUCKY PUBLIC SERVICE COMMISSION?

A. No, I have not.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. My testimony in this proceeding addresses the various cost assignment processes utilized by Duke Energy Kentucky and its affiliates. I also sponsor Filing Requirement FR 10(9)(u).

II. COST ASSIGNMENTS FROM THE SERVICE COMPANY

Q. WHAT IS COST ASSIGNMENT?

A. Cost assignment is the process whereby the cost associated with the provision of a product or service by and between Duke Energy affiliates or operating functions is charged to the appropriate account, operating function, and/or company.

Q. WHAT TYPES OF COSTS ARE SUBJECT TO COST ASSIGNMENT AMONG DUKE ENERGY KENTUCKY AND ITS AFFILIATES?

A. With respect to Duke Energy Kentucky, there are three general categories of costs to which cost assignment processes are applied: (1) costs from the service company; (2) common costs shared by Duke Energy Kentucky and Duke Energy Ohio, Inc. (Duke Energy Ohio); and (3) common costs between Duke Energy Kentucky's gas and electric operations.

Q. PLEASE DESCRIBE THE SERVICE COMPANY.

A. Prior to the merger of Cinergy and Duke Energy on April 3, 2006, Cinergy had one service company, Cinergy Services, Inc., which was approved and audited by the SEC. Duke Energy was not a holding company and had no SEC-approved service company. But it did have a subsidiary, Duke Energy Business Services, LLC (DEBS) that provided certain non-power goods and services to Duke Energy affiliates. On the merger date, Duke Energy became a holding company, and from April 3, 2006, until June 30, 2008, Duke Energy's service company was actually composed of two entities: Duke Energy Shared Services, Inc. (f/k/a Cinergy Services, Inc.) and DEBS. On July 1, 2008, these two entities merged with the surviving entity being DEBS. For the remainder of my testimony, therefore, DEBS is also referred to as the Service Company. DEBS provides a variety of administrative, management, and support services (Functions) to Duke Energy and its affiliates pursuant to two agreements: the Utility Service Agreement and the Non-Utility Service Agreement. Under the Utility Service Agreement, DEBS provides services to and on behalf of Duke Energy's utility operating companies, including Duke Energy Kentucky. Under the Non-Utility Service Agreement, DEBS provides services to and on behalf of Duke Energy's non-utility companies. These affiliate companies receiving services from DEBS are referred to as "Client Companies."

Q. PLEASE DESCRIBE THE UTILITY AND NON-UTILITY SERVICE AGREEMENTS.

A. The Utility Service Agreement and Non-Utility Service Agreement were entered into and either accepted or approved by the state utility regulatory commissions in Kentucky, Ohio, Indiana, and North Carolina. These agreements describe the types of services that DEBS provides and how the costs of such services are determined, including the methods of assigning costs among the Client Companies. The Utility Service Agreement is at Attachment DLD-1 and a copy of the Non-Utility Service Agreement is at Attachment DLD-2. The Client Companies that are parties to the Utility Service Agreement are Duke Energy Kentucky, Duke Energy Carolinas, Duke Energy Ohio, Duke Energy Indiana, and Miami Power Corporation. The Client Companies that are parties to the Non-Utility Service Agreement include certain of Duke Energy's non-utility affiliates, both domestic and foreign.

Q. PLEASE DESCRIBE WHAT IS MEANT BY THE TERM "COST."

A. "Cost," as used in the Utility Service Agreement and Non-Utility Service Agreement, means fully embedded cost, which is the sum of: (1) direct costs; (2) indirect costs; and (3) cost of capital. Direct costs include labor, material and other expenses incurred specifically for a particular service and any associated loadings. Indirect costs include labor, material and other expenses, and any associated loadings that cannot be directly identified with any particular service. Indirect costs include, but are not limited to, overhead costs, administrative support costs, and taxes. Cost of capital represents financing costs, including, but not limited to, interest on debt and a fair return on equity to shareholders.

Q. WHAT ARE "LOADINGS"?

A. "Loadings" represent costs that are incurred and aggregated in balance sheet accounts (termed "cost pools"), which are then subsequently "loaded" out to specific entities and projects by attaching an additional charge (loading rate) to the associated direct cost. Duke Energy's loadings include fringe benefits (*e.g.*, medical, dental, pension, postretirement), indirect labor (*e.g.*, vacation, holiday, sick-time), stores, freight and handling (*e.g.*, material management labor, freight), transportation (*e.g.*, vehicle leases, fuel, oil), and payroll taxes (*e.g.*, Federal Insurance Contributions Act (FICA) taxes, and state and federal unemployment taxes). Loading rates are determined through annual studies of both actual and budgeted information and are calculated by dividing the anticipated component costs by anticipated labor cost, material issues, or vehicle utilization, as applicable.

Q. PLEASE DESCRIBE HOW COSTS INCURRED BY DEBS ARE ACCOUNTED FOR UNDER THE UTILITY AND NON-UTILITY SERVICE AGREEMENTS.

A. DEBS maintains an accounting system in which all of its costs are accumulated. These costs are charged to the appropriate Client Companies monthly, using one of the three approved methods of assignment contained in the Utility and/or Non-Utility Service Agreements.

Q. WHAT ARE THE APPROVED METHODS OF ASSIGNMENT?

A. The approved methods of assignment are: (1) directly assignable; (2) distributable; and (3) allocable.

Q. PLEASE DESCRIBE EACH METHOD OF ASSIGNMENT.

A. The directly assignable basis of cost assignment is utilized to directly charge costs for services specifically performed for a single Client Company. The distributable cost assignment method is used to assign costs for services rendered specifically for two or more Client Companies. The allocable method of assignment is used to allocate costs for services of a general nature, which are applicable to all Client Companies or to a class or classes of Client Companies.

Q. WHAT TYPES OF EXPENDITURES ARE DIRECTLY ASSIGNED FROM DEBS TO DUKE ENERGY KENTUCKY?

A. DEBS employees who work on a project specifically for Duke Energy Kentucky charge their labor and expenses directly to Duke Energy Kentucky. For example, the legal services Function will charge Duke Energy Kentucky directly for work performed specifically for Duke Energy Kentucky.

Q. PLEASE EXPLAIN THE ALLOCABLE CHARGES FROM DEBS TO DUKE ENERGY KENTUCKY.

A. Allocable charges to Duke Energy Kentucky are for a portion of expenditures originating on DEBS' books that are applicable to Duke Energy Kentucky and one or more other Client Companies, but which are not directly assignable to Duke Energy Kentucky. These charges are allocated to Duke Energy Kentucky based on allocation ratios set forth in Appendix A of the Utility Service Agreement.

Q. UNDER WHAT CIRCUMSTANCES ARE THE ALLOCATION RATIOS SET FORTH IN APPENDIX A OF THE UTILITY SERVICE AGREEMENT USED TO DETERMINE CHARGES TO DUKE ENERGY KENTUCKY?

A. The allocation ratios provided in Appendix A of the Utility Service Agreement are used by DEBS to assign charges to Client Companies, including Duke Energy Kentucky, for activities that cannot be charged directly. For example, costs associated with the human resources Function are allocated to the Client Companies, including Duke Energy Kentucky, using the Number of Employees Ratio as provided in the Utility Service Agreement.

Q. WHAT WAS THE RATIONALE BEHIND THE SELECTION OF THE ALLOCATION RATIOS SET FORTH IN APPENDIX A OF THE UTILITY SERVICE AGREEMENT?

A. Consistent with traditional cost causation principles, the ratios represent "cost drivers" for a particular Function (*i.e.*, those factors that are the greatest contributors to costs). For example, costs of a general nature related to the human resources Function, and the installation and operation of communications systems in the information systems Function are allocated based on the Number of Employees Ratio. Costs of a general nature related to the meters Function, and to customer billing and payment processing in the customer services Function are allocated based on the Number of Customers Ratio. For some Functions, costs of a general nature are allocated based on a weighted-average of more than one ratio. Pages 2 and 3 in Appendix A of the Utility Service Agreement describe how the weighted-average ratios are calculated.

Q. HOW IS DEBS' NON-UTILITY COST ASSIGNMENT PROCESS DIFFERENT FROM THE UTILITY COST ASSIGNMENT PROCESS?

A. The non-utility cost assignment process is virtually identical to the utility cost assignment process as described above. The only difference between the two processes is the type of allocation ratios prescribed by the applicable service agreement. Appendix A of the Non-Utility Service Agreement describes the allocation ratios utilized for allocating costs to non-utility Client Companies.

Q. WHAT PROCESSES DO DEBS EMPLOYEES FOLLOW IN ALLOCATING THEIR TIME AND EXPENSES UNDER THE UTILITY AND NON-UTILITY SERVICE AGREEMENTS?

A. All source documents (*e.g.*, time records, expense accounts, and journal entries) applicable to DEBS require a special input code, "Operating Unit" (OU), to be used. The initiating department determines the appropriate OU for each transaction. The specific OU indicates whether the cost should be assigned directly, distributed, or allocated, and it also determines the appropriate percentage allocation to be used. Using the OU, the accounting system will process each transaction and assign the appropriate costs to each respective Client Company. For the allocable OUs, the percentage allocated to each Client Company is determined periodically, at a minimum on an annual basis, by way of a cost study.

Q. PLEASE DESCRIBE FURTHER THE COST STUDY USED TO DETERMINE THE OU ALLOCATION PERCENTAGES.

A. On a periodic basis, but no less than annually, DEBS conducts a cost study, applying the applicable data to the allocation ratios specified in the Utility and Non-Utility Service Agreements. From these cost studies, DEBS updates the allocation percentages of each allocable OU to reflect the current underlying foundation of the allocation ratios. For example, annually, the OU based on the number of employees, which is primarily utilized by the human resources Function within DEBS, is updated to reflect the number of employees of each of DEBS' affiliate companies.

Q. PLEASE DESCRIBE FR 10(9)(u), PAGE 1 OF 4.

A. FR 10(9)(u), page 1 of 4 outlines the methods used to allocate costs that cannot be charged directly by DEBS to the utility and non-utility Duke Energy affiliates, including Duke Energy Kentucky. FR 10(9)(u), page 1(a) of 4 summarizes the total amount of expenditures charged from the Service Company to Duke Energy Kentucky for the three years ended December 31, 2006, 2007 and 2008 and for the base period and the forecasted test period, which include the twelve-month periods ending September 30, 2009, and January 31, 2011, respectively.

Q. ARE THE ALLOCATION METHODS DESCRIBED IN FR 10(9)(u), PAGE 1 OF 4 THE SAME COST ALLOCATION METHODS CONTAINED IN THE UTILITY SERVICE AGREEMENT?

A. Yes.

Q. PLEASE PROVIDE A COPY OF ANY REPORTS ISSUED WITH RESPECT TO INTERNAL OR EXTERNAL AUDITS OF DEBS, OR ITS AFFILIATE TRANSACTIONS WITH DUKE ENERGY KENTUCKY, PERFORMED DURING THE PERIODS PRESENTED IN FR 10(9)(U).

A. Please see attachments:

DLD-3	Franchised Electric and Gas Service Company Allocations Audit #306026, December 13, 2006
DLD-4	U.S. Franchised Electric and Gas State Affiliate Code of Conduct (Kentucky) Audit #107001, May 18, 2007
DLD-5	Final Report, Audit of Merger-Related Agreements Duke Energy Kentucky Presented to Kentucky Public Service Commission May 19, 2009

In addition, on November 13, 2008, the Office of Enforcement of the FERC commenced an audit of Duke Energy, including its service companies and other affiliates. As of July 1, 2009, this audit was still in progress and no report had been issued by FERC.

III. COST ASSIGNMENTS FOR COMMON COSTS SHARED BY DUKE ENERGY KENTUCKY AND DUKE ENERGY OHIO

Q. DO ALL CHARGES FOR DUKE ENERGY KENTUCKY ORIGINATE ON DUKE ENERGY KENTUCKY'S BOOKS?

A. No. Charges can originate either on Duke Energy Kentucky's books for its own operations or can originate from its parent company, Duke Energy Ohio, and/or other affiliated companies.

Q. PLEASE EXPLAIN THE DIRECT CHARGES FROM DUKE ENERGY OHIO TO DUKE ENERGY KENTUCKY.

A. Direct charges from Duke Energy Ohio to Duke Energy Kentucky are for costs such as employee labor, employee expenses, and inventory (material) transactions that are specifically incurred for Duke Energy Kentucky's gas and/or electric operations.

Q. WHAT TYPES OF CHARGES ARE ALLOCATED TO DUKE ENERGY KENTUCKY FROM DUKE ENERGY OHIO?

A. Charges allocated to Duke Energy Kentucky from Duke Energy Ohio represent a portion of costs originating on Duke Energy Ohio's books that apply to gas and/or electric activities which cannot be charged directly and which apply to both Duke Energy Kentucky and Duke Energy Ohio.

Q. WHAT TYPES OF EXPENDITURES ARE CHARGED DIRECTLY VERSUS ALLOCATED TO DUKE ENERGY KENTUCKY?

A. Expenditures incurred directly for a specific project can be charged directly to Duke Energy Kentucky. Certain expenditures for items such as supervision of system-wide construction and/or operation and maintenance activities or customer service functions are allocated to Duke Energy Kentucky.

Q. PLEASE DESCRIBE THE TYPES OF COMMON COSTS SHARED BY DUKE ENERGY OHIO AND DUKE ENERGY KENTUCKY.

A. Certain of Duke Energy Ohio's departments provide services to both Duke Energy Ohio and Duke Energy Kentucky. In providing these services, certain costs of a general nature (*i.e.*, common costs) cannot be directly assigned to Duke Energy Kentucky or Duke Energy Ohio and therefore must be allocated. Examples of these types of common costs include the marketing department's development costs associated with customer bill inserts, as well as certain expenses associated with the customer services department's credit and collection activities.

Q. PLEASE DESCRIBE FR 10(9)(U), PAGE 2 OF 4.

A. FR 10(9)(u), page 2 of 4 outlines the allocation bases used to allocate costs between Duke Energy Ohio and Duke Energy Kentucky for costs that cannot be directly charged by Duke Energy Ohio to Duke Energy Kentucky, because the expenses are of a general nature. FR 10(9)(u), page 2(a) of 4, summarizes the total amount of expenditures allocated from Duke Energy Ohio to Duke Energy Kentucky for the three years ended December 31, 2006, 2007 and 2008 and for the twelve-month base period and the twelve-month forecasted test periods ending September 30, 2009, and January 31, 2011, respectively.

Q. ARE THE ALLOCATIONS INDICATED ON FR 10(9)(u), PAGE 2 OF 4 USED TO DETERMINE ALL CHARGES FROM DUKE ENERGY OHIO TO DUKE ENERGY KENTUCKY?

A. No. Expenditures applicable to Duke Energy Kentucky ar e charged directly whenever possible. For example, Duke Energy Ohio's employees performing work at specific field job sites of Duke Energy Kentucky charge directly to the appropriate expense or capital account applicable to that job on Duke Energy Kentucky, which incurs the cost. These direct charges occur regularly by both Duke Energy Ohio's employees for Duke Energy Kentucky or by Duke Energy Kentucky's employees for Duke Energy Ohio.

IV. CUSTOMER AND ADMINISTRATIVE AND GENERAL COST ASSIGNMENTS BETWEEN DUKE ENERGY KENTUCKY'S GAS AND ELECTRIC OPERATIONS

Q. WHAT TYPES OF EXPENDITURES ARE CHARGED DIRECTLY TO DUKE ENERGY KENTUCKY GAS OR ELECTRIC EXPENSE ACCOUNTS?

A. Most expenditures incurred directly for a specific project can be charged directly to a gas or an electric expense account. Certain customer and administrative costs for general support functions, such as Meter Reading and Planning, are common to both gas and electric operations for expense and must be allocated.

Q. HOW ARE THE ALLOCATION BASES FOR CUSTOMER AND ADMINSTRATIVE AND GENERAL (A&G) EXPENDITURES DETERMINED?

A. The allocation bases are determined using the same cost study results performed by DEBS for the allocation ratios specified in the Utility Service Agreements. From these cost studies, Duke Energy Kentucky updates the percentages associated with the allocation codes used to pool the costs to be allocated.

Q. HOW IS THIS INFORMATION USED TO DETERMINE ASSIGNMENT OF COMMON CUSTOMER AND A&G COSTS?

A. The cost allocation process for common customer and A&G expenditures allocates costs based on statistical data that best relates to the specific activity to be allocated. For example, Meter Reading activities are allocated to expense accounts for both gas and electric operations based on the number of customers identified during the period of the study.

Q. PLEASE BRIEFLY DESCRIBE FR 10(9)(u), PAGES 3 AND 4.

A. FR 10(9)(u), page 3 of 4 provides the bases used to allocate customer and A&G charges between gas and electric operations for those items that cannot be directly charged. FR 10(9)(u), page 3(a) of 4, summarizes the total amount of customer and A&G expenditures allocated between gas and electric customer and A&G expense accounts for the three years ended December 31, 2006, 2007 and 2008 and for the twelve-month base period and the twelve-month forecasted test periods ending September 30, 2009, and January 31, 2011, respectively. FR 10(9)(u), page 4 of 4 provides the bases used to allocate customer and A&G charges for those items that cannot be directly charged.

Q. ARE THE ALLOCATIONS INDICATED ON FR 10(9)(u), PAGES 3 AND 4 USED TO DETERMINE WHICH CHARGES SHOULD BE RECORDED TO GAS AND ELECTRIC OPERATIONS EXPENSE ACCOUNTS?

A. No. Expenditures applicable to gas or electric operations are charged directly whenever possible. For example, employees performing work on a specific project will charge direct to the appropriate gas and/or electric expense account.

Q. UNDER WHAT CIRCUMSTANCES ARE THE ALLOCATIONS INDICATED ON FR 10(9)(u), PAGES 3 AND 4 USED?

A. The allocation bases on these schedules are used to allocate charges for activities that cannot be charged directly, such as costs applicable to both gas and electric expense accounts.

V. CONCLUSION

Q. DO YOU HAVE AN OPINION AS TO WHETHER THE METHODS USED TO PRICE SERVICES AND ASSIGN COSTS ARE REASONABLE AND APPROPRIATE METHODS FOR ASSIGNING COSTS TO ALL OF THE DUKE ENERGY SUBSIDIARIES AND AFFILIATES, INCLUDING DUKE ENERGY KENTUCKY?

A. Yes.

Q. PLEASE STATE YOUR OPINION.

A. The methods used by Duke Energy to price services and assign costs among its subsidiaries result in reasonable and appropriate cost assignments to Duke Energy Kentucky and its affiliates.

Q. WAS FR 10(9)(u) PREPARED BY YOU OR UNDER YOUR DIRECTION AND CONTROL?

A. Yes.

Q. WAS THE OTHER ADDITIONAL INFORMATION YOU SPONSORED OBTAINED BY YOU OR ON YOUR BEHALF FROM COMPANY RECORDS?

A. Yes.

Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?

A. Yes.

VERIFICATION

State of North Carolina)
)
County of Mecklenburg)

The undersigned, David L. Doss, Jr. being duly sworn, deposes and says that he is the General Manager of Accounting for Duke Energy Business Services, Inc., that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.

David L. Doss, Jr.

David L. Doss, Jr., Affiant

Subscribed and sworn to before me by David L. Doss, Jr. on this 17th day of June, 2009.

Elizabeth Love Rothrock

NOTARY PUBLIC

My Commission Expires: 12/7/2013

280060

SECOND AMENDED AND RESTATED SERVICE COMPANY UTILITY SERVICE AGREEMENT

This Second Amended and Restated Service Company Utility Service Agreement (this "Second Amended and Restated Service Agreement" or "Agreement")), dated September 1, 2008 (the "Effective Date") by and among Duke Energy Carolinas, LLC ("DE-Carolinas"), a North Carolina limited liability company, Duke Energy Ohio, Inc., an Ohio corporation ("DE-Ohio"), Duke Energy Indiana, Inc., an Indiana corporation ("DE-Indiana"), Duke Energy Kentucky, Inc., a Kentucky corporation ("DE-Kentucky"), Miami Power Corporation, an Indiana corporation ("Miami"), and Duke Energy Business Services LLC, a Delaware limited liability company, on its own behalf and as successor in interest to Duke Energy Shared Services, Inc. (the "Service Company") (DE-Carolinas, DE-Ohio, DE-Indiana, DE-Kentucky and Miami are sometimes hereinafter referred to individually as a "Client Company" and collectively as the "Client Companies"), supersedes and restates in its entirety the Amended and Restated Service Company Utility Service Agreement entered into by the parties dated January 2, 2007 (the "Amended and Restated Service Agreement").

WITNESSETH

WHEREAS, the terms of this Agreement are substantially similar to the Amended and Restated Service Agreement and the purpose of this Second Amended and Restated Service Agreement is to clarify the parties' intentions regarding the scope of services. WHEREAS, each of the Client Companies and the Service Company is a subsidiary of Duke Energy Corporation;

WHEREAS, the Service Company and the Client Companies have entered into this Agreement whereby the Service Company agrees to provide and the Client Companies agree to accept and pay for various services as provided herein at cost, except to the extent otherwise required by Section 482 of the Internal Revenue Code; and

WHEREAS, economies and efficiencies benefiting the Client Companies will result from the performance by the Service Company of services as herein provided;

NOW, THEREFORE, in consideration of the premises and the mutual agreements herein contained, the parties to this Agreement covenant and agree as follows:

ARTICLE I – SERVICES

Section 1.1 The Service Company shall furnish to the Client Companies, upon the terms and conditions hereinafter set forth, such of the services described in Appendix A hereto, at such times, for such periods and in such manner as the Client Companies may from time to time request and which the Service Company concludes it is equipped to perform. The Service Company shall also provide Client Companies with such special services, including without limitation cost management services, in addition to those services described in Appendix A hereto, as may be requested by a Client Company and which the Service Company concludes it is equipped to perform. In supplying such services, the Service Company may (i) arrange, where it deems appropriate, for the services of such experts, consultants, advisers and other persons with necessary qualifications as are required for or pertinent to the rendition of such services, and (ii) tender payments to third parties as agent for and on behalf of Client Companies, with such charges being passed through to the appropriate Client Companies.

Section 1.2 Each of the Client Companies shall take from the Service Company such of the services described in Section 1.1 and such additional general or special services, whether or not now contemplated, as are requested from time to time by the Client Companies and which the Service Company concludes it is equipped to perform.

Section 1.3 The services described herein shall be directly assigned, distributed or allocated by activity, process, project, responsibility center, work order or other appropriate basis. A Client Company shall have the right from time to time to amend, alter or rescind any activity, process, project, responsibility center or work order, provided that (i) any such amendment or alteration which results in a material change in the scope of the services to be performed or equipment to be provided is agreed to by the Service Company, (ii) the cost for the services covered by the activity, process, project, responsibility center or work order shall include any expense incurred by the Service Company as a direct result of such amendment, alteration or rescission of the activity, process, project, responsibility center or work order, and (iii) no amendment, alteration or rescission of an activity, process, project, responsibility center or work order shall release a Client Company from liability for all costs already incurred by or contracted for by the Service Company pursuant to the activity, process, project, responsibility center or work order, regardless of whether the services associated with such costs have been completed.

Section 1.4 The Service Company shall maintain a staff trained and experienced in the design, construction, operation, maintenance and management of public utility properties.

ARTICLE II - COMPENSATION

Section 2.1 Except to the extent otherwise required by Section 482 of the Internal Revenue Code, as compensation for the services to be rendered hereunder, each of the Client Companies shall pay to the Service Company all costs which reasonably can be identified and related to particular services performed by the Service Company for or on its behalf. Where more than one Client Company is involved in or has received benefits from a service performed, costs will be directly assigned, distributed or allocated, as set forth in Appendix A hereto, between or among such companies on a basis reasonably related to the service performed to the extent reasonably practicable.

Section 2.2 The method of assignment, distribution or allocation of costs described in Appendix A shall be subject to review annually, or more frequently if appropriate. Such method of assignment, distribution or allocation of costs may be modified or changed by the Service Company without the necessity of an amendment to this Agreement, provided that in each instance, all services rendered hereunder shall be at actual cost thereof, fairly and equitably assigned, distributed or allocated, except to the extent otherwise required by Section 482 of the Internal Revenue Code. The Service Company shall promptly advise the Client Companies and the North Carolina Utilities Commission ("NCUC"), the Public Service Commission of South Carolina ("PSCSC"), the Indiana Utility Regulatory Commission ("IURC"), The Public Utilities Commission of Ohio ("PUCO"), the Kentucky Public Service Commission ("KPSC;" and together with the NCUC, the PSCSC, the IURC and the PUCO, the "Affected State Commissions") from time to time of any material changes in such method of assignment, distribution or allocation. Such notice shall be in compliance with the requirements of applicable state law, regulations and regulatory conditions.

Section 2.3 The Service Company shall render a monthly statement to each Client Company which shall reflect the billing information necessary to identify the costs charged for that month. By the last day of each month, each Client Company shall remit to the Service Company all charges billed to it. For avoidance of doubt, the Service Company and each Client Company may satisfy the foregoing requirement by recording billings and payments required hereunder in their common accounting systems without rendering paper or electronic monthly statements or remitting cash payments.

Section 2.4 Subject to Section 482 of the Internal Revenue Code, it is the intent of this Agreement that the payment for services rendered by the

Service Company to the Client Companies shall cover all the costs of its doing business (less the cost of services provided to affiliated companies not a party to this Agreement and to other non-affiliated companies, and credits for any miscellaneous income items), including, but not limited to, salaries and wages, office supplies and expenses, outside services employed, property insurance, injuries and damages, employee pensions and benefits, miscellaneous general expenses, rents, maintenance of structures and equipment, depreciation and amortization and compensation for use of capital. Without limitation of the foregoing, "cost," as used in this Agreement, means fully embedded cost, namely, the sum of (1) direct costs, (2) indirect costs and (3) costs of capital.

ARTICLE III - TERM

Section 3.1 This Agreement is entered into as of the Effective Date and shall continue in force with respect to a Client Company until terminated by the Service Company and Client Company with respect to such Client Company (provided that no such termination with respect to less than all of the Client Companies shall thereby affect the term of this Agreement or any of the provisions hereof) or until terminated by unanimous agreement of all the parties then signatory to this Agreement.

ARTICLE IV – ACCOUNTS AND RECORDS

Section 4.1 The Service Company shall utilize the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission.

Section 4.2 The Service Company shall permit each Affected State Commission and applicable statutory utility consumer representative(s), together with other interested parties as required under applicable law, access to its accounts and records, including the basis and computation of allocations, necessary for each Affected State Commission to review a Client Company's operating results.

ARTICLE V – MISCELLANEOUS

Section 5.1 Counterparts. This Agreement may be executed in one or more counterparts, all of which shall be considered one and the same agreement and shall become effective when one or more counterparts have been signed by each party and delivered to the other parties.

Section 5.2 Entire Agreement; No Third Party Beneficiaries. This Agreement (including Appendix A and any other appendices or other exhibits or schedules hereto) (i) constitutes the entire agreement, and supersedes any prior agreements and understandings, both written and oral, among the parties with respect to the subject matter of this Agreement (including without limitation the Amended and Restated Service Agreement; and (ii) is not intended to confer upon any person other than the parties hereto any rights or remedies.

Section 5.3 Governing Law. This Agreement shall be governed by, and construed in accordance with, the laws of the State of New York, regardless of the laws that might otherwise govern under applicable principles of conflict of laws.

Section 5.4 Assignment. Neither this Agreement nor any of the rights, interests or obligations hereunder shall be assigned, in whole or in part, by operation of law or otherwise by any of the parties hereto without the prior written consent of each of the other parties. Any attempted or purported assignment in violation of the preceding sentence shall be null and void and of no effect whatsoever. Subject to the preceding two sentences, this Agreement shall be binding upon, inure to the benefit of, and be enforceable by, the parties and their respective successors and assigns.

Section 5.5 Amendments. This Agreement may not be amended except by an instrument in writing signed on behalf of each of the parties. To the extent that applicable state law or regulation or other binding obligation requires that any such amendment be filed with any Affected State Commission for its review or otherwise, each Client Company shall comply in all respects with any such requirements.

Section 5.6 Interpretation. When a reference is made in this Agreement to an Article, Section or Appendix or other Exhibit, such reference shall be to an Article or Section of, or an Appendix or other Exhibit to, this Agreement unless otherwise indicated. The headings contained in this Agreement are for convenience of reference only and shall not affect in any way the meaning or interpretation of this Agreement. Whenever the words "include", "includes" or "including" are used in this Agreement, they shall be deemed to be followed by the words "without limitation". The words "hereof", "herein" and "hereunder" and words of similar import when used in this Agreement shall refer to this Agreement as a whole and not to any particular provision of this Agreement. The definitions contained in this Agreement are applicable to the singular as well as the plural forms of such terms and to the masculine as well as to the feminine and neuter genders of such term. References to a person are also to its permitted successors and assigns.

Section 5.7 DE-Carolinas Conditions. In addition to the terms and conditions set forth herein, with respect to DE-Carolinas, the provisions set out in Appendix B are hereby incorporated herein by reference. In addition, DE-Carolinas' participation in this Agreement is explicitly subject to the Regulatory Conditions and Code of Conduct approved by the NCUC in its Order Approving Merger Subject to Regulatory Conditions and Code of Conduct issued March 24, 2006, in NCUC Docket No. E-7, Sub 795. In the event of any conflict between the provisions of this Agreement and the approved Regulatory Conditions and Code of Conduct provisions, the Regulatory Conditions and Code of Conduct shall govern.

[REMAINDER OF PAGE INTENTIONALLY LEFT BLANK]

IN WITNESS WHEREOF, the parties hereto have caused this Second Amended and Restated Service Agreement to be executed as of the date and year first above written.

DUKE ENERGY BUSINESS SERVICES LLC

By: ______________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY CAROLINAS, LLC

By: ______________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY OHIO, INC.

By: ______________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY INDIANA, INC.

By: ______________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY KENTUCKY, INC.

By: ______________________
Richard G. Beach
Assistant Secretary

MIAMI POWER CORPORATION

By________________________
Richard G. Beach
Assistant Secretary

APPENDIX A

Description of Services and Determination
of Charges for Services

I. The Service Company will maintain an accounting system for accumulating all costs on an activity, process, project, responsibility center, work order, or other appropriate basis. To the extent practicable, time records of hours worked by Service Company employees will be kept by activity, process, project, responsibility center or work order. Charges for salaries will be determined from such time records and will be computed on the basis of employees' labor costs, including the cost of fringe benefits, indirect labor costs and payroll taxes. Records of employee-related expenses and other indirect costs will be maintained for each functional group within the Service Company (hereinafter referred to as "Function"). Where identifiable to a particular activity, process, project, responsibility center or work order, such indirect costs will be directly assigned to such activity, process, project, responsibility center or work order. Where not identifiable to a particular activity, process, project, responsibility center or work order, such indirect costs within a Function will be distributed in relationship to the directly assigned costs of the Function. For purposes of this Appendix A, any costs not directly assigned or distributed by the Service Company will be allocated monthly.

II. Service Company costs accumulated for each activity, process, project, responsibility center or work order will be directly assigned, distributed, or allocated to the Client Companies or other Functions within the Service Company as follows:

1. Costs accumulated in an activity, process, project, responsibility center or work order for services specifically performed for a single Client Company or Function will be directly assigned and charged to such Client Company or Function.

2. Costs accumulated in an activity, process, project, responsibility center or work order for services specifically performed for two or more Client Companies or Functions will be distributed among and charged to such Client Companies or Functions. The appropriate method of distribution will be determined by the Service Company on a case-by-case basis consistent with the nature of the work performed and will be based on the application of one or more of the methods described in paragraphs IV and V of this

Appendix A. The distribution method will be provided to each such affected Client Company or Function.

3. Costs accumulated in an activity, process, project, responsibility center or work order for services of a general nature which are applicable to all Client Companies or Functions or to a class or classes of Client Companies or Functions will be allocated among and charged to such Client Companies or Functions by application of one or more of the methods described in paragraphs IV and V of this Appendix A.

III. For purposes of this Appendix A, the following definitions or methodologies shall be utilized:

1. Where applicable, the following will be utilized to convert gas sales to equivalent electric sales: 1 cubic foot of gas sales equals 0.303048 kilowatt-hour of electric sales (based on electricity at 3412 Btu/kWh and natural gas at 1034 Btu/cubic foot).

2. "Domestic utility" refers to a utility which operates in the contiguous United States of America.

3. "Gross margin" refers to revenues as defined by Generally Accepted Accounting Principles, less cost of sales, including but not limited to fuel, purchased power, emission allowances and other cost of sales.

4. "Distribution" means electric distribution and local gas distribution as applicable.

5. "Distribution Lines" mean electric power lines at distribution voltages measured in circuit miles, and gas mains and lines, as applicable.

The weights utilized in the weighted average ratios in paragraph V of this Appendix A shall represent the percentage relationship of the activities associated with the function for which costs are to be allocated. For example, if an expense item is to be allocated on the weighted average of the Gross Margin Ratio, the Labor Dollars Ratio and the Total Property, Plant and Equipment ("PP&E") Ratio, and the activity to be allocated is one-third gross margin related, one-third labor related and one-third PP&E related, 33 percent of the Gross Margin Ratio would be utilized, 33 percent of the Labor Dollars Ratio and 34 percent of the PP&E Ratio would be utilized. To illustrate this application, assuming that the Gross Margin Ratio were 53.75 percent for Company A and 46.25 percent for Company B, the Labor Dollars Ratio were 25 percent for Company A and 75 percent for Company B, and the Total PP&E Ratio were 60 percent for Company A and 40 percent for Company B, the following weighted average ratio would be computed:

		Company A		Company B	
Activity	Weight	Ratio	Weighted	Ratio	Weighted
Gross Margin Ratio	33%	53.75%	17.74%	46.25%	15.26%
Labor Dollars Ratio	33%	25.00%	8.25%	75.00%	24.75%
Total Property, Plant and Equipment Ratio	34%	60.00%	20.40%	40.00%	13.60%
	100%		46.39%		53.61%

IV. The following allocation methods will be applied, as specified in paragraph V of this Appendix A, to assign costs for services applicable to two or more clients and/or to allocate costs for services of a general nature.

1. Sales Ratio

A ratio, based on the applicable domestic firm kilowatt-hour electric sales (and/or the equivalent cubic feet of gas sales, where applicable), excluding intra-system sales, for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all utility Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable), This ratio will be determined annually, or at such time as may be required due to a significant change.

2. Electric Peak Load Ratio

A ratio, based on the sum of the applicable monthly domestic firm electric maximum system demands for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all utility Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable). This ratio will be determined annually, or at such time as may be required due to a significant change.

3. Number of Customers Ratio

A ratio, based on the sum of the applicable domestic firm electric customers (and/or gas customers, where applicable) at the end of a recent month in the preceding twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all domestic utility Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable). This ratio will be determined annually, or at such time as may be required due to a significant change.

4. Number of Employees Ratio

A ratio, based on the applicable number of employees at the end of a recent month in the preceding twelve consecutive month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually, or at such time as may be required due to a significant change.

5. Construction-Expenditures Ratio

A ratio, based on the applicable projected construction expenditures for the following twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable). Separate ratios will be computed for total construction expenditures and appropriate functional plant (i.e., production, transmission, Distribution, and general) classifications. This ratio will be determined annually, or at such time as may be required due to a significant change.

6. <u>Miles of Distribution Lines Ratio</u>

In the case of electric Distribution, a ratio, based on the applicable installed circuit miles of domestic electric Distribution Lines, and in the case of gas Distribution, a ratio, based on the applicable installed miles of domestic gas Distribution Lines, in either case at the end of the preceding calendar year, the numerator of which is for a Client Company and the denominator of which is for all domestic utility Client Companies. This ratio will be determined annually, or at such time as may be required due to a significant change.

7. <u>Circuit Miles of Electric Transmission Lines Ratio</u>

A ratio, based on the applicable installed circuit miles of domestic electric transmission lines at the end of the preceding calendar year; the numerator of which is for a Client Company and the denominator of which is for all domestic utility Client Companies. This ratio will be determined annually, or at such time as may be required due to a significant change.

8. <u>Number of Central Processing Unit Seconds Ratio</u>

A ratio, based on the sum of the applicable number of central processing unit seconds expended to execute mainframe computer software applications for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company or Service Company Function, and the denominator of which is for all Client Companies, (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually, or at such time as may be required due to a significant change.

9. <u>Revenues Ratio</u>

A ratio, based on the total applicable revenues for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable). This ratio will be determined annually or at such time as may be required due to a significant change.

10. Inventory Ratio

A ratio, based on the total applicable inventory balance for the preceding year, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable). Separate ratios will be computed for total inventory and the appropriate functional plant (i.e., production, transmission, Distribution, and general) classifications. This ratio will be determined annually or at such time as may be required due to a significant change.

11. Procurement Spending Ratio

A ratio, based on the total amount of applicable procurement spending for the preceding year, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable) and/or the Service Company. Separate ratios will be computed for total procurement spending and appropriate functional plant (i.e., production, transmission, Distribution, and general) classifications. This ratio will be determined annually or at such time as may be required due to a significant change.

12. Square Footage Ratio

A ratio, based on the total amount of applicable square footage occupied in a recent month in the preceding twelve consecutive month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

13. Gross Margin Ratio

A ratio, based on the total applicable gross margin for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable). This ratio will be determined annually or at such time as may be required due to a significant change.

14. Labor Dollars Ratio

A ratio, based on the total applicable labor dollars for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

15. Number of Personal Computer Work Stations Ratio

A ratio, based on the total number of applicable personal computer work stations at the end of a recent month in the preceding twelve consecutive month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

16. Number of Information Systems Servers Ratio

A ratio, based on the total number of applicable servers at the end of a recent month in the preceding twelve consecutive month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

17. <u>Total Property, Plant and Equipment Ratio</u>

A ratio, based on the total applicable Property, Plant and Equipment balance (net of accumulated depreciation and amortization) for the preceding year, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable). This ratio will be determined annually or at such time as may be required due to a significant change.

18. <u>Generating Unit MW Capability Ratio</u>

A ratio, based on the total applicable installed megawatt capability for the preceding year, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable). This ratio will be determined annually or at such time as may be required due to a significant change.

19. <u>Number of Meters Ratio</u>

A ratio, based on the number of electric and/or gas meters, as applicable, the numerator of which is for a Client Company and the denominator of which is for all domestic utility Client Companies. Separate ratios will be computed for appropriate meter classifications (e.g., type of metering technology). This ratio will be determined annually, or at such time as may be required due to a significant change.

20. O&M Expenditures Ratio

A ratio, based on the operation and maintenance (O&M) expenditures for a prior twelve month period, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's non-utility and non-domestic utility affiliates, where applicable). Separate ratios will be computed for total O&M expenditures and appropriate functional plant (i.e., production, transmission, Distribution, and general) classifications. This ratio will be determined annually.

V. A description of each Function's activities, which may be modified from time to time by the Service Company, is set forth below in paragraph "a" under each Function. As described in paragraph II, "1" and "2" of this Appendix A, where identifiable, costs will be directly assigned or distributed to Client Companies or to other Functions of the Service Company. For costs accumulated in activities, processes, projects, responsibility centers, or work orders which are for services of a general nature that cannot be directly assigned or distributed, as described in paragraph II, "3" of this Appendix A, the method or methods of allocation are set forth below in paragraph "b" under each Function. For any of the functions set forth below other than Information Systems, Transportation, Human Resources or Facilities, costs of a general nature to be allocated pursuant to this Agreement shall exclude costs of a general nature which have been allocated to affiliated companies not a party to this Agreement. Substitution or changes may be made in the methods of allocation hereinafter specified, as may be appropriate, and will be provided to state regulatory agencies and to each Client Company. Any such substitution or changes shall be in compliance with the requirements of applicable state law, regulations and regulatory conditions.

1. <u>Information Systems</u>

a. Description of Function

Provides communications and electronic data processing services. The activities of the Function include:

(1) Development and support of mainframe computer software applications.

(2) Procurement and support of personal computers and related network and software applications.

(3) Development and support of distributed computer software applications (e.g., servers).

(4) Installation and operation of communications systems.

(5) Information systems management and support services.

b. Method of Allocation

(1) Development and support of mainframe computer software applications - allocated between the Client Companies and other Functions of the Service Company based on the number of Central Processing Unit Seconds Ratio, or allocated among the Client Companies on a weighted average of the Gross Margin Ratio, the Labor Dollar Ratio and the PP&E Ratio as appropriate.

(2) Procurement and support of personal computers and related network and software applications - allocated to the Client Companies and to other Functions of the Service Company based on the Number of Personal Computer Work Stations Ratio.

(3) Development and support of distributed computer software applications - allocated to the Client Companies and to other Functions of the Service Company based on the Number of Information Systems Servers Ratio.

(4) Installation and operation of communications systems - allocated to the Client Companies and to other Functions of the Service Company based on the Number of Employees Ratio.

(5) Information systems management and support services – allocated to the Client Companies and to other Functions of the Service Company based

on a weighted average of the Gross Margin Ratio, the Labor Dollar Ratio and the PP&E Ratio.

2. <u>Meters</u>
   a. Description of Function
      Procures, tests and maintains meters.
   b. Method of Allocation
      Allocated to the Client Companies based on the Number of Customers Ratio.

3. <u>Transportation</u>
   a. Description of Function
      (1) Procures and maintains vehicles and equipment.
      (2) Procures and maintains aircraft and equipment.
   b. Method of Allocation
      (1) The costs of maintaining vehicles and equipment are allocated to the Client Companies and to other Functions of the Service Company based on the Number of Employees Ratio.
      (2) The costs of maintaining aircraft and equipment are allocated to the Client Companies and to other Functions of the Service Company based on a weighted average of the Gross Margin Ratio, the Labor Dollars Ratio and the PP&E Ratio.

4. <u>System Maintenance</u>
   a. Description of Function
      Coordinates maintenance and support of electric transmission systems and Distribution systems.
   b. Method of Allocation
      (1) Services related to electric transmission systems - allocated to the Client Companies based on the Circuit Miles of Electric Transmission Lines Ratio.

(2) Services related to electric Distribution systems - allocated to the Client Companies based on the Miles of Distribution Lines Ratio.

(3) Services related to gas Distribution systems – allocated to the Client Companies based on the Labor Dollars Ratio.

5. Marketing and Customer Relations

a. Description of Function

Advises the Client Companies in relations with domestic utility customers. The activities of the Function include:

(1) Design and administration of sales and demand-side management programs.

(2) Customer meter reading, billing and payment processing.

(3) Customer services including the operation of call center.

b. Method of Allocation

(1) Design and administration of sales and demand-side management programs - allocated to the Client Companies based on the Sales Ratio.

(2) Customer billing and payment processing - allocated to the Client Companies based on the Number of Customers Ratio.

(3) Customer Services - allocated to the Client Companies based on the Number of Customers Ratio.

6. Transmission and Distribution Engineering and Construction

a. Description of Function

Designs and monitors construction of electric transmission and Distribution Lines and associated facilities. Prepares cost and schedule estimates, visits construction sites to ensure that construction activities coincide with plans, and administers construction contracts.

b. Method of Allocation

(1) Transmission engineering and construction allocated to the Client Companies based on the Electric Transmission Plant's Construction-Expenditures Ratio.

(2) Distribution engineering and construction allocated to the Client Companies based on the Distribution plant's Construction-Expenditures Ratio.

7. Power Engineering and Construction
   a. Description of Function
   Designs, monitors and supports the construction and retirement of electric generation facilities. Prepares specifications and administers contracts for construction of new electric generating units, improvements to existing electric generating units, and the retirement of existing electric generating equipment, including developing associated operating processes with operations personnel. Prepares cost and schedule estimates and visits construction sites to ensure that construction and retirement activities meet schedules and plans..
   b. Method of Allocation
   Allocated to the Client Companies based on the Electric Production Plant's Construction-Expenditures Ratio.

8. Human Resources
   a. Description of Function
   Establishes and administers policies and supervises compliance with legal requirements in the areas of employment, compensation, benefits and employee health and safety. Processes payroll and employee benefit payments. Supervises contract negotiations and relations with labor unions.
   b. Method of Allocation
   Allocated to the Client Companies and to other Functions of the Service Company based on the Number of Employees Ratio.

9. Materials Management
   a. Description of Function

Provides services in connection with the procurement of materials and contract services, processes payments to vendors, and provides management of material and supplies inventories.

b. Method of Allocation

(1) Procurement of materials and contract services and vendor payment processing - allocated to the Client Companies and to other Functions of the Service Company based on the Procurement Spending Ratio.

(2) Management of materials and supplies inventory – allocated to the Client Companies on the Inventory Ratio.

10. Facilities

a. Description of Function

Operates and maintains office and service buildings. Provides security and housekeeping services for such buildings and procures office furniture and equipment.

b. Method of Allocation

Allocated to the Client Companies and to other Functions of the Service Company based on the Square Footage Ratio.

11. Accounting

a. Description of Function

Maintains the books and records of Duke Energy Corporation and its affiliates, prepares financial and statistical reports, prepares tax filings and supervises compliance with the laws and regulations.

b. Method of Allocation

Allocated to the Client Companies based on a weighted average of the Gross Margin Ratio, the Labor Dollar Ratio and the PP&E Ratio.

12. Power and Gas Planning and Operations

a. Description of Function

Coordinate the planning, management and operation of Duke Energy Corporation's power generation, transmission and Distribution systems. The activities of the Function include:

(1) System Planning - planning of additions and retirements to the electric generation units and transmission and Distribution systems belonging to the regulated utilities owned by Duke Energy Corporation.

(2) System Operations - coordination of the dispatch and operation of the electric generating units and transmission and Distribution systems belonging to the regulated utilities owned by Duke Energy Corporation.

(3) Power Operations – provides management and support services for the electric generation units owned or operated by subsidiaries of Duke Energy Corporation.

(4) Wholesale Power Operations – coordination of Duke Energy Corporation's wholesale power operations.

b. Method of Allocation

(1) System Planning

(a) Generation planning - allocated to the Client Companies based on the Electric Peak Load Ratio.

(b) Transmission planning – allocated to the Client Companies based on the Electric Peak Load Ratio.

(c) Electric Distribution planning - allocated to the Client Companies based on a weighted average of the Miles of Distribution Lines Ratio and the Electric Peak Load Ratio.

(d) Gas Distribution planning – allocated to the Client Companies based on the Construction-Expenditures Ratio.

(2) System Operations –

(a) Generation Dispatch - allocated to the Client Companies based on the Sales Ratio.

(b) Transmission Operations - allocated to the Client Companies based on a weighted average of the Circuit Miles of Electric Transmission Lines Ratio and the Electric Peak Load Ratio.

(c) Electric Distribution Operations - allocated to the Client Companies based on a weighted average of the Miles of Distribution Lines Ratio and the Electric Peak Load Ratio.

(d) Gas Distribution Operations – allocated to the Client Companies based on the Construction-Expenditures Ratio.

(3) Power Operations – allocated to the Client Companies based on the Generating Unit MW Capability Ratio.

(4) Wholesale Power Operations – allocated to the Client Companies based on the Sales Ratio.

13. Public Affairs

a. Description of Function

Prepares and disseminates information to employees, customers, government officials, communities and the media. Provides graphics, reproduction lithography, photography and video services.

b. Method of Allocation

(1) Services related to corporate governance, public policy, management and support services - allocated to the Client Companies based on a weighted average of the Gross Margin Ratio, the Labor Dollar Ratio and the PP&E Ratio.

(2) Services related to utility specific activities - allocated to the Client Companies based on a weighted average of the Number of Customers Ratio and the Number of Employees Ratio.

14. Legal

a. Description of Function

Renders services relating to labor and employment law, litigation, contracts, rates and regulatory affairs, environmental matters, financing, financial reporting, real estate and other legal matters.

b. Method of Allocation

Allocated to the Client Companies based on a weighted average of the Gross Margin Ratio, the Labor Dollar Ratio and the PP&E Ratio.

15. Rates
    a. Description of Function

       Determines the Client Companies' revenue requirements and rates to electric and gas requirements customers. Administers interconnection and joint ownership agreements. Researches and forecasts customers' usage.
    b. Method of Allocation

       Allocated to the Client Companies based on the Sales Ratio.

16. Finance
    a. Description of Function

       Renders services to Client Companies with respect to investments, financing, cash management, risk management, claims and fire prevention. Prepares budgets, financial forecasts and economic analyses.
    b. Method of Allocation

       Allocated to the Client Companies based on a weighted average of the Gross Margin Ratio, the Labor Dollar Ratio and the PP&E Ratio.

17. Rights of Way
    a. Description of Function

       Purchases, surveys, records, and sells real estate interests for Client Companies.
    b. Method of Allocation
       (1) Services related to Distribution system - allocated to the Client Companies based on the Miles of Distribution Lines Ratio.
       (2) Services related to electric generation system- allocated to the Client Companies based on the Electric Peak Load Ratio.
       (3) Services related to electric transmission system – allocated to the Client Companies based on the Circuit Miles of Electric Transmission Lines Ratio.

18. Internal Auditing

    a. Description of Function

       Reviews internal controls and procedures to ensure that assets are safeguarded and that transactions are properly authorized and recorded.

    b. Method of Allocation

       Allocated to the Client Companies based on a weighted average of the Gross Margin Ratio, the Labor Dollar Ratio and the PP&E Ratio.

19. Environmental, Health and Safety

    a. Description of Function

       Establishes policies and procedures and governance framework for compliance with environmental, health and safety ("EHS") issues, monitors compliance with EHS requirements and provides EHS compliance support to the Client Companies' personnel.

    b. Method of Allocation

       (1) Services related to corporate governance, environmental policy, management and support services - allocated to the Client Companies based on a weighted average of the Gross Margin Ratio, the Labor Dollar Ratio and the PP&E Ratio.

       (2) Services related to utility specific activities – allocated to the Client Companies based on the Sales Ratio

20. Fuels

    a. Description of Function

       Procures coal, gas and oil for the Client Companies. Ensures compliance with price and quality provisions of fuel contracts and arranges for transportation of the fuel to the generating stations.

    b. Method of Allocation

       Allocated to the Client Companies based on the Sales Ratio.

21. Investor Relations

a. Description of Function

Provides communications to investors and the financial community, performs transfer agent and shareholder record keeping functions, administers stock plans and performs stock-related regulatory reporting.

b. Method of Allocation

Allocated to the Client Companies based on a weighted average of the Gross Margin Ratio, the Labor Dollars Ratio and the PP&E Ratio.

22. Planning

a. Description of Function

Facilitates preparation of strategic and operating plans, monitors trends and evaluates business opportunities.

b. Method of Allocation

Allocated to the Client Companies based on a weighted average of the Gross Margin Ratio, the Labor Dollars Ratio and the PP&E Ratio.

23. Executive

a. Description of Function

Provides general administrative and executive management services.

b. Method of Allocation

Allocated to the Client Companies based on a weighted average of the Gross Margin Ratio, the Labor Dollars Ratio and the PP&E Ratio.

APPENDIX B

DE-CAROLINAS CONDITIONS

1. In connection with the NCUC approval the Merger in NCUC Docket No. E-7, Sub 795, the NCUC adopted certain Regulatory Conditions and a revised Code of Conduct governing transactions between DE-Carolinas and its affiliates. Pursuant to the Regulatory Conditions, the following provisions are applicable to DE-Carolinas:

(a) DE-Carolinas' participation in this Agreement is voluntary. DE-Carolinas is not obligated to take or provide services or make any purchases or sales pursuant to this Agreement, and DE-Carolinas may elect to discontinue its participation in this Agreement at its election after giving notice under <u>Section 3.1</u> of the Agreement.

(b) DE-Carolinas may not make or incur a charge under this Agreement except in accordance with North Carolina law and the rules, regulations and orders of the NCUC promulgated thereunder.

(c) DE-Carolinas may not seek to reflect in rates any (i) costs incurred under this Agreement exceeding the amount allowed by the NCUC or (ii) revenue level earned under this Agreement less than the amount imputed by the NCUC; and

(d) Except to the extent that requesting FERC review and authorization pursuant to Section 1275(b) of Subtitle F in Title XII of PUHCA 2005, as provided in Regulatory Condition No. 21, may be determined to have preemptive effect under the law, DE-Carolinas will not assert in any forum that the NCUC's authority to assign, allocate, make pro-forma adjustments to or disallow revenues and costs for retail ratemaking and regulatory accounting and reporting purposes is preempted and will bear the full risk of any preemptive effects of federal law with respect to this Agreement.

2. With respect to the transfer by DE-Carolinas under this Agreement of the control of, operational responsibility for, or ownership of any DE-Carolinas assets used for the generation, transmission or distribution of electric power to its North Carolina retail customers with a gross book value in excess of ten million dollars ($10 million), the following shall apply:

(a) DE-Carolinas may not commit to or carry out the transfer except in accordance with all applicable law, and the rules, regulations and orders of the NCUC promulgated thereunder; and

(b) DE-Carolinas may not include in its North Carolina cost of service or rates the value of the transfer, whether or not subject to federal law, except as allowed by the NCUC in accordance with North Carolina law.

SECOND AMENDED AND RESTATED SERVICE COMPANY NONUTILITY SERVICE AGREEMENT

This Second Amended and Restated Service Company Nonutility Service Agreement (this "Second Amended and Restated Service Agreement" or "Agreement"), dated September 1, 2008 (the "Effective Date") by and among Duke Energy Corporation, a Delaware corporation ("Duke"), Cinergy Corp., a Delaware corporation ("Cinergy"), and Duke Energy Business Services LLC, a Delaware limited liability company, on its own behalf and as successor in interest to Duke Energy Shared Services, Inc., (the "Service Company"), and the other companies listed on the signature pages hereto (each such other company, together with Duke and Cinergy, a "Client Company", and collectively, the "Client Companies"), supersedes and restates in its entirety the Amended and Restated Service Company Nonutility Service Agreement entered into by the parties dated January 2, 2007 (the "Amended and Restated Service Agreement").

WITNESSETH

WHEREAS, the terms of this Agreement are substantially similar to the Amended and Restated Service Agreement and the purpose of this Second Amended and Restated Service Agreement is to clarify the parties' intentions regarding the scope of services.

WHEREAS, the Service Company and each of the Client Companies (other than Duke itself) is a subsidiary of Duke; and

WHEREAS, the Service Company and the Client Companies have entered into this Agreement whereby the Service Company agrees to provide and the Client Companies agree to accept and pay for various services as provided herein; and

NOW, THEREFORE, in consideration of the premises and the mutual agreements herein contained, the parties to this Agreement covenant and agree as follows:

ARTICLE I - SERVICES

Section 1.1 The Service Company shall furnish to a Client Company, as requested by a Client Company, upon the terms and conditions hereinafter set forth, such of the services described in Appendix A hereto, at such times, for such periods and in such manner as the Client Company may from time to time request and which the Service Company concludes it is equipped to perform. The Service Company shall also provide a Client Company with such special services, including without limitation cost management services, in addition to those services described in Appendix A hereto, as may be requested by a Client Company and which the Service Company concludes it is equipped to perform. In supplying such services, the Service Company may (i) arrange, where it deems appropriate, for the services of such experts, consultants, advisers and other persons with necessary qualifications as are required for or pertinent to the rendition of such services, and (ii) tender payments to third parties as agent for and on behalf of Client Companies, with such charges being passed through to the appropriate Client Companies.

Section 1.2 Each Client Company shall take from the Service Company such of the services described in Section 1.1, and such additional general or special services, whether or not now contemplated, as are requested from time to time by such Client Company and which the Service Company concludes it is equipped to perform.

Section 1.3 The services described herein shall be directly assigned, distributed or allocated by activity, process, project, responsibility center, work order or other appropriate basis. A Client Company shall have the right from time to time to amend, alter or rescind any activity, process, project, responsibility center or work order provided that (i) any such amendment or alteration which results in a material change in the scope of the services to be performed or equipment to be provided is agreed to by the Service Company, (ii) the cost for the services covered by the activity, process, project, responsibility center or work order shall include any expense incurred by the Service Company as a direct result of such amendment, alteration or rescission of the activity, process, project, responsibility center or work order, and (iii) no amendment, alteration or rescission of an activity, process, project, responsibility center or work order shall release a Client Company from liability for all costs already incurred by or contracted for by the Service Company pursuant to the activity, process, project, responsibility process, project, responsibility center or work order, regardless of whether the services associated with such costs have been completed.

ARTICLE II - COMPENSATION

Section 2.1 As compensation for the services to be rendered hereunder, (a) each Client Company (other than subsidiaries of Duke that derive substantially all of their operating revenues from businesses conducted outside of the United States of America (such subsidiaries, "Duke Foreign Companies")) shall pay to the Service Company the cost of such services, except to the extent otherwise required by Section 482 of the Internal Revenue Code, and (b) each Duke Foreign Company shall pay to the Service Company the fair market value of such services, but in any event no less than the cost of such services. Where more than one Client Company is involved in or has received benefits from a service performed, costs will be directly assigned, distributed or allocated, as set forth in Appendix A hereto, between or among such companies on a basis reasonably related to the service performed to the extent reasonably practicable.

Section 2.2 The method of assignment, distribution or allocation of costs described in Appendix A shall be subject to review annually, or more frequently if appropriate. Such method of assignment, distribution or allocation of costs may be modified or changed by the Service Company without the necessity of an amendment to this Agreement provided that in each instance, costs of all services rendered hereunder shall be fairly and equitably assigned, distributed or allocated.

allocated. The Service Company shall advise the Client Companies from time to time of any material changes in such method of assignment, distribution or allocation.

Section 2.3 The Service Company shall render a monthly statement to each Client Company which shall reflect the billing information necessary to identify the costs charged for that month. By the last day of each month, each Client Company shall remit to the Service Company all charges billed to it. For avoidance of doubt, the Service Company and each Client Company may satisfy the foregoing requirement by recording billings and payments required hereunder in their common accounting systems without rendering paper or electronic monthly statements or remitting cash payments.

Section 2.4 It is the intent of this Agreement that, except as otherwise required by Section 482 of the Internal Revenue Code, the payment for services rendered by the Service Company to the Client Companies under this Agreement shall cover all the costs of its doing business (less the cost of services provided to affiliated companies not a party to this Agreement and to other non-affiliated companies, and credits for miscellaneous income items), including, but not limited to, salaries and wages, office supplies and expenses, outside services employed, property insurance, injuries and damages, employee pensions and benefits, miscellaneous general expenses, rents, maintenance of structures and equipment, depreciation and amortization, profit and compensation for use of compensation for use of capital. Without limitation of the foregoing, "cost," as used in this Agreement, means fully embedded cost, namely, the sum of (1) direct costs, (2) indirect costs and (3) costs of capital.

ARTICLE III - TERM

Section 3.1 This Agreement is entered into as of the Effective Date and shall continue in force with respect to a Client Company until terminated by the Service Company and Client Company with respect to such Client Company (provided that no such termination with respect to less than all of the Client Companies shall thereby affect the term of this Agreement or any of the provisions hereof) or until terminated by unanimous agreement of all the parties then signatory to this Agreement.

ARTICLE IV - ACCOUNTS AND RECORDS; NEW CLIENT COMPANIES

Section 4.1 The Service Company shall utilize the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission.

Section 4.2 The Service Company shall permit each Client Company access to its accounts and records, including the basis and computation of allocations.

Section 4.3 Nonutility subsidiaries of Duke organized or acquired after the Effective Date may become additional Client Companies subject to this

Agreement (each, a "New Client Company") by executing an additional original signature page to this Agreement or otherwise agreeing to be bound by the terms and provisions hereof (it being understood that such execution or other agreement to be bound hereby shall be deemed fully satisfied to the extent that any direct or indirect parent company, other than Duke or Cinergy, owning all of the outstanding voting securities of such New Client Company executes such additional original signature page or otherwise agrees to be bound by the terms and provisions hereof on behalf of such New Client Company). For the avoidance of doubt, the mere addition of any New Client Company as a party to this Agreement, without more, shall not be deemed to amend or other modify any of the terms and provisions of this Agreement.

ARTICLE V – MISCELLANEOUS

Section 5.1 Counterparts. This Agreement may be executed in one or more counterparts, all of which shall be considered one and the same agreement and shall become effective when one or more counterparts have been signed by each party and delivered to the other parties.

Section 5.2 Entire Agreement; No Third Party Beneficiaries. This Agreement (including Appendix A and any other appendices or exhibits or schedules hereto) (i) constitutes the entire agreement, and supersedes all prior agreements and understandings, both written and oral, among the parties with respect to the subject matter of this Agreement (including without limitation the

Amended and Restated Service Agreement; and (ii) is not intended to confer upon any person other than the parties hereto any rights or remedies.

Section 5.3 Governing Law. This Agreement shall be governed by, and construed in accordance with, the laws of the State of New York, regardless of the laws that might otherwise govern under applicable principles of conflict of laws.

Section 5.4 Assignment. Neither this Agreement nor any of the rights, interests or obligations under this Agreement shall be assigned, in whole or in part, by operation of law or otherwise by any of the parties hereto without the prior written consent of the other parties. Any attempted or purported assignment in violation of the preceding sentence shall be null and void and of no effect whatsoever. Subject to the preceding two sentences, this Agreement shall be binding upon, inure to the benefit of, and be enforceable by, the parties and their respective successors and assigns.

Section 5.5 Amendments. This Agreement may not be amended except by an instrument in writing signed on behalf of each of the parties.

Section 5.6 Interpretation. When a reference is made in this Agreement to an Article, Section or Appendix or other Exhibit, such reference shall be to an Article or Section of, or an Appendix or other Exhibit to, this Agreement unless otherwise indicated. The headings contained in this Agreement are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement. Whenever the words "include", "includes" or "including" are used in this Agreement, they shall be deemed to be followed by the words "without limitation". The words "hereof", "herein" and "hereunder" and words of similar import when used in this Agreement shall refer to this Agreement as a whole and not to any particular provision of this Agreement. The definitions contained in this Agreement are applicable to the singular as well as the plural forms of such terms and to the masculine as well as to the feminine and neuter genders of such term. References to a person are also to its permitted successors and assigns.

[REMAINDER OF PAGE INTENTIONALLY LEFT BLANK]

IN WITNESS WHEREOF, the parties hereto have caused this Second Amended and Restated Service Agreement to be executed as of the date and year first above written.

DUKE ENERGY CORPORATION

By:____________________
Richard G. Beach
Assistant Corporate Secretary

CINERGY CORP.

By:____________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY BUSINESS SERVICES LLC

By:____________________
Richard G. Beach
Assistant Secretary

APOG, LLC
(by Duke Energy Carolinas, LLC its Managing Member)

By:____________________
Richard G. Beach
Assistant Secretary

BISON INSURANCE COMPANY LIMITED

By:____________________
Edwin Keith Bone
Senior Vice President

BSPE, L.P.

By:____________________
Wouter T. van Kempen
Authorized Representative

IN WITNESS WHEREOF, the parties hereto have caused this Second Amended and Restated Service Agreement to be executed as of the date and year first above written.

DUKE ENERGY CORPORATION

By:____________________________
Richard G. Beach
Assistant Corporate Secretary

CINERGY CORP.

By:____________________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY BUSINESS SERVICES LLC

By:____________________________
Richard G. Beach
Assistant Secretary

APOG, LLC
(by Duke Energy Carolinas, LLC its Managing Member)

By:____________________________
Richard G. Beach
Assistant Secretary

BISON INSURANCE COMPANY LIMITED

By: George V. Brown
George V. Brown
President and Chief Executive Officer

BSPE, L.P.

By:____________________________
Wouter T. van Kempen
Authorized Representative

IN WITNESS WHEREOF, the parties hereto have caused this Second Amended and Restated Service Agreement to be executed as of the date and year first above written.

DUKE ENERGY CORPORATION

By:______________________________
Richard G. Beach
Assistant Corporate Secretary

CINERGY CORP.

By:______________________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY BUSINESS SERVICES LLC

By:______________________________
Richard G. Beach
Assistant Secretary

APOG, LLC
(by Duke Energy Carolinas, LLC its Managing Member)

By:______________________________
Richard G. Beach
Assistant Secretary

BISON INSURANCE COMPANY LIMITED

By:______________________________
Edwin Keith Bone
Senior Vice President

BSPE, L.P.

By:______________________________
Wouter T. van Kempen
Authorized Representative

BSPE GENERAL, LLC

By:________________________________

Wouter T. van Kempen
Authorized Representative

BSPE HOLDINGS, LLC

By:________________________________

Wouter T. van Kempen
Authorized Representative

BSPE LIMITED, LLC

By:________________________________

Wouter T. van Kempen
Authorized Representative

CINCAP IV, LLC
(by Cinergy Capital & Trading, Inc. its Managing Member)

By:________________________________

George Dwight, II
Assistant Secretary

CINCAP V, LLC
(by Cinergy Capital & Trading, Inc. its Managing Member)

By:________________________________

George Dwight, II
Assistant Secretary

CINERGY-CENTRUS, INC.

By:________________________________

Richard G. Beach
Assistant Secretary

CINERGY-CENTRUS COMMUNICATIONS, INC.

By:________________________________

Richard G. Beach
Assistant Secretary

BSPE GENERAL, LLC

By:______________________________
Wouter T. van Kempen
Authorized Representative

BSPE HOLDINGS, LLC

By:______________________________
Wouter T. van Kempen
Authorized Representative

BSPE LIMITED, LLC

By:______________________________
Wouter T. van Kempen
Authorized Representative

CINCAP IV, LLC
(by Cinergy Capital & Trading, Inc. its Managing Member)

By: George Dwight II
George Dwight, II
Assistant Secretary

CINCAP V, LLC
(by Cinergy Capital & Trading, Inc. its Managing Member)

By: George Dwight II
George Dwight, II
Assistant Secretary

CINERGY-CENTRUS, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY-CENTRUS COMMUNICATIONS, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

BSPE GENERAL, LLC

By:______________________________
Wouter T. van Kempen
Authorized Representative

BSPE HOLDINGS, LLC

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Wouter T. van Kempen
Authorized Representative

BSPE LIMITED, LLC

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George Dwight, II
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CINCAP V, LLC
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By:______________________________
George Dwight, II
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By:______________________________
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Assistant Secretary

CINERGY CLIMATE CHANGE INVESTMENTS, LLC

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Julia S. Janson
Secretary

CINERGY GLOBAL ELY, INC.

By:______________________________
James D. Duncan, Jr.
Vice President

CINERGY GLOBAL HOLDINGS, INC.

By:______________________________
James D. Duncan, Jr.
Vice President

CINERGY GLOBAL POWER, INC.

By:______________________________
Joseph E. Lentz, Jr.
Vice President

CINERGY GLOBAL RESOURCES, INC.

By:______________________________
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CINERGY GENERAL HOLDINGS, LLC

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Julia S. Janson
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By:______________________________
Greer E. Mendelow
Assistant Secretary

CINERGY ORIGINATION & TRADE, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY POWER GENERATION SERVICES, LLC

By:______________________________
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Vice President

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By:______________________________
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Vice President

CINERGY RECEIVABLES COMPANY LLC

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Secretary

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By:______________________________
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Secretary

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By: George Dwight, II
George Dwight, II
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CINERGY RETAIL POWER GENERAL, INC.

By:______________________________
Joseph E. Lentz, Jr.
Vice President

CINERGY RETAIL POWER LIMITED, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY RETAIL POWER, L.P.
(by Cinergy Retail Power General, Inc. its General Partner)

By:______________________________
Joseph E. Lentz, Jr.
Vice President

CINERGY SOLUTIONS – UTILITY, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY SOLUTIONS PARTNERS, LLC
(by Duke Energy Generation Services, Inc. its Managing Member)

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George Dwight, II
Assistant Secretary

CINERGY TECHNOLOGY, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY TWO, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY RETAIL POWER GENERAL, INC.

By:________________________________
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George Dwight, II
Assistant Secretary

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By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY TWO, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY UK, INC.

By:______________________________
Richard G. Beach
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CINERGY WHOLESALE ENERGY, INC.

By:______________________________
Joseph E. Lentz, Jr.
Vice President

CINFUEL RESOURCES, INC.

By:______________________________
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Assistant Secretary

CINPOWER I, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

CRESCENT RESOURCES, LLC

By:______________________________
Kay H. Arnette
Assistant Secretary

CSGP GENERAL, LLC

By:______________________________
George Dwight, II
Assistant Secretary

CSGP LIMITED, LLC

By:______________________________
George Dwight, II
Assistant Secretary

CINERGY UK, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY WHOLESALE ENERGY, INC.

By:______________________________
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Vice President

CINFUEL RESOURCES, INC.

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Assistant Secretary

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Assistant Secretary

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George Dwight, II
Assistant Secretary

CSGP LIMITED, LLC

By:______________________________
George Dwight, II
Assistant Secretary

CINERGY UK, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

CINERGY WHOLESALE ENERGY, INC.

By:______________________________
Joseph E. Lentz, Jr.
Vice President

CINFUEL RESOURCES, INC.

By: George Dwight
George Dwight, II
Assistant Secretary

CINPOWER I, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

CRESCENT RESOURCES, LLC

By:______________________________
Kay H. Arnette
Assistant Secretary

CSGP GENERAL, LLC

By: George Dwight
George Dwight, II
Assistant Secretary

CSGP LIMITED, LLC

By: George Dwight
George Dwight, II
Assistant Secretary

CSGP OF SOUTHEAST TEXAS, LLC

By:____________________________
George Dwight, II
Assistant Secretary

CSGP SERVICES, L.P.
(by CSGP General, LLC its General Partner)

By:____________________________
George Dwight, II
Assistant Secretary

CST GENERAL, LLC

By:____________________________
George Dwight, II
Assistant Secretary

CST GREEN POWER, L.P.
(by CST General, LLC its General Partner)

By:____________________________
George Dwight, II
Assistant Secretary

CST LIMITED, LLC

By:____________________________
George Dwight, II
Assistant Secretary

DEGS BIOGAS, INC.

By:____________________________
George Dwight, II
Assistant Secretary

DEGS EPCOM COLLEGE PARK, LLC

By:________________________
George Dwight, II
Assistant Secretary

DEGS GASCO, LLC

By:________________________
George Dwight, II
Assistant Secretary

DEGS O&M, LLC

By:________________________
George Dwight, II
Assistant Secretary

DEGS OF BOCA RATON, LLC

By:________________________
George Dwight, II
Assistant Secretary

DEGS OF CINCINNATI, LLC

By:________________________
George Dwight, II
Assistant Secretary

DEGS OF DELTA TOWNSHIP, LLC

By:________________________
George Dwight, II
Assistant Secretary

DEGS OF LANSING, LLC

By:________________________
George Dwight, II
Assistant Secretary

DEGS OF MONACA, LLC

By:______________________
George Dwight, II
Assistant Secretary

DEGS OF NARROWS, LLC

By:______________________
George Dwight, II
Assistant Secretary

DEGS OF OKLAHOMA, LLC

By:______________________
George Dwight, II
Assistant Secretary

DEGS OF PARLIN, LLC

By:______________________
George Dwight, II
Assistant Secretary

DEGS OF PHILADELPHIA, LLC

By:______________________
George Dwight, II
Assistant Secretary

DEGS OF ROCK HILL, LLC

By:______________________
George Dwight, II
Assistant Secretary

DEGS OF SAN DIEGO, INC.

By:______________________
George Dwight, II
Assistant Secretary

DEGS OF SHREVEPORT, LLC

By:______________________________
George Dwight, II
Assistant Secretary

DEGS OF SOUTH CHARLESTON, LLC

By:______________________________
George Dwight, II
Assistant Secretary

DEGS OF ST. BERNARD, LLC

By:______________________________
George Dwight, II
Assistant Secretary

DEGS OF ST. PAUL, LLC

By:______________________________
George Dwight, II
Assistant Secretary

DEGS OF TUSCOLA, INC

By:______________________________
George Dwight, II
Assistant Secretary

DEGS WIND I, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

DEGS WIND SUPPLY, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

DEGS OF SHREVEPORT, LLC

By:______________________________
George Dwight, II
Assistant Secretary

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DEGS WIND I, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

DEGS WIND SUPPLY, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

DELTA TOWNSHIP UTILITIES, LLC

By: George Dwight
George Dwight, II
Assistant Secretary

DELTA TOWNSHIP UTILITIES II, LLC

By: George Dwight
George Dwight, II
Assistant Secretary

DETMI MANAGEMENT, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

DUKE-CADENCE, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

DUKE-RELIANT RESOURCES, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

DELTA TOWNSHIP UTILITIES, LLC

By:______________________________
George Dwight, II
Assistant Secretary

DELTA TOWNSHIP UTILITIES II, LLC

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DUKE-RELIANT RESOURCES, INC.

By:______________________________
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DUKE BROADBAND, LLC

By:____________________________
Richard G. Beach
Assistant Secretary

DUKE COMMUNICATIONS HOLDINGS, INC.

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DUKE ENERGY AMERICAS, LLC

By:____________________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY ENGINEERING, INC.

By:____________________________
George Dwight, II
Assistant Secretary

DUKE ENERGY GENERATION SERVICES, INC.

By:____________________________
George Dwight, II
Assistant Secretary

DUKE ENERGY GENERATION SERVICES HOLDING COMPANY, INC.

By:____________________________
George Dwight, II
Assistant Secretary

DUKE ENERGY GLOBAL MARKETS, INC.

By:____________________________
Richard G. Beach
Assistant Secretary

DUKE BROADBAND, LLC

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George Dwight, II
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DUKE ENERGY GLOBAL MARKETS, INC.

By:____________________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY INDUSTRIAL SALES, LLC

By: R. G. Beach
Richard G. Beach
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DUKE ENERGY INTERNATIONAL, LLC

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Javier Gonzalez
Assistant Secretary

DUKE ENERGY INTERNATIONAL GROUP, LTD.

By:______________________________
Javier Gonzalez
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DUKE ENERGY INTERNATIONAL HOLDING, LTD.

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DUKE ENERGY MARKETING AMERICA, LLC

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Assistant Secretary

DUKE ENERGY MERCHANTS, LLC

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Richard G. Beach
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DUKE ENERGY NORTH AMERICA, LLC

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Richard G. Beach
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DUKE ENERGY NORTH AMERICA, LLC

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DUKE ENERGY ONE, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

DUKE ENERGY RECEIVABLES FINANCE COMPANY, LLC

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Richard G. Beach
Assistant Secretary

DUKE ENERGY RETAIL SALES, LLC

By:______________________________
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Assistant Secretary

DUKE ENERGY ROYAL, LLC

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DUKE ENERGY TRADING AND MARKETING, L.L.C.

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DUKE PROJECT SERVICES, INC.

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Richard G. Beach
Assistant Secretary

DUKE VENTURES, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

DUKE VENTURES II, LLC

By:______________________________
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Assistant Secretary

DUKENET COMMUNICATIONS, LLC

By:______________________________
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Assistant Secretary

DUKENET COMMUNICATION SERVICES, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

DUKETEC, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

DUKETEC I, LLC

By:______________________________
Richard G. Beach
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DUKETEC II, LLC

By:______________________________
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ENERGY EQUIPMENT LEASING LLC

By:______________________________
George Dwight, II
Assistant Secretary

ENVIRONMENTAL WOOD SUPPLY, LLC

By:______________________________
David A. Ledonne
Vice President

EVENT RESOURCES I LLC

By:______________________________
Richard G. Beach
Assistant Secretary

DUKETEC I, LLC

By:________________________________
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GREEN POWER G.P., LLC

By:________________________________

Wouter T. van Kempen
Authorized Representative

GREEN POWER HOLDINGS, LLC

By:________________________________

Wouter T. van Kempen
Authorized Representative

GREEN POWER LIMITED, LLC

By:________________________________

Wouter T. van Kempen
Authorized Representative

HAPPY JACK WINDPOWER, LLC

By:________________________________

Richard G. Beach
Assistant Secretary

KO TRANSMISSION COMPANY

By:________________________________

Richard G. Beach
Assistant Secretary

LANSING GRAND RIVER UTILITIES, LLC

By:________________________________

George Dwight, II
Assistant Secretary

LH1, LLC

By:________________________________

George Dwight, II
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LH1, LLC

By: George Dwight II
George Dwight, II
Assistant Secretary

MIAMI POWER CORPORATION

By:__________________________________
Richard G. Beach
Assistant Secretary

NOTREES WINDPOWER, LP
(by TE Notrees, LLC its General Partner)

By:__________________________________
Richard G. Beach
Assistant Secretary

OAK MOUNTAIN PRODUCTS, LLC

By:__________________________________
George Dwight, II
Assistant Secretary

OCOTILLO WINDPOWER, LP
(by TE Ocotillo, LLC its General Partner)

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Richard G. Beach
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OHIO RIVER VALLEY PROPANE, LLC

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Julia S. Janson
Secretary

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Assistant Secretary

SOUTH CONSTRUCTION COMPANY, INC.

By:______________________________
Richard G. Beach
Assistant Secretary

SOUTH HOUSTON GREEN POWER, L.P.

By:______________________________
Wouter T. van Kempen
Authorized Representative

SPRUCE MOUNTAIN PRODUCTS, LLC
(by Spruce Mountain Investments, LLC its Managing Member)

By:______________________________
Richard G. Beach
Assistant Secretary

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Richard G. Beach
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Richard G. Beach
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ST PAUL COGENERATION, LLC

By: ______________________
David A. Ledonne
President

SUEZ-DEGS, LLC

By: ______________________
David A. Ledonne
Vice President

SUEZ-DEGS OF ASHTABULA, LLC

By: ______________________
George Dwight, II
Assistant Secretary

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SUEZ-DEGS OF SILVER GROVE, LLC

By:______________________________
George Dwight, II
Assistant Secretary

SUEZ-DEGS OF TUSCOLA, LLC

By:______________________________
George Dwight, II
Assistant Secretary

SUEZ/VWNA/DEGS OF LANSING, LLC

By:______________________________
George Dwight, II
Assistant Secretary

SYNCAP II, LLC

By:______________________________
George Dwight, II
Assistant Secretary

TE HAPPY JACK, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

TE NOTREES, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

TE OCOTILLO, LLC

By:______________________________
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By:______________________________
Richard G. Beach
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TEAK MOUNTAIN PRODUCTS, LLC

By:______________________________
Richard G. Beach
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TRI-STATE IMPROVEMENT COMPANY

By:______________________________
Richard G. Beach
Assistant Secretary

WILLOW MOUNTAIN PRODUCTS, LLC

By:______________________________
Richard G. Beach
Assistant Secretary

**Appendix A to
Second Amended and Restated
Service Company
Nonutility Service Agreement**

DESCRIPTION OF SERVICES AND DETERMINATION OF CHARGES FOR SERVICES

I. The Service Company will maintain an accounting system for accumulating all costs on an activity, process, project, responsibility center, work order or other appropriate basis. To the extent practicable, time records of hours worked by Service Company employees will be kept by activity, process, project, responsibility center or work order. Charges for salaries will be determined from such time records and will be computed on the basis of employees' labor costs, including the cost of fringe benefits, indirect labor costs and payroll taxes. Records of employee-related expenses and other indirect costs will be maintained for each functional group (a "Function") within the Service Company. Where identifiable to a particular activity, process, project, responsibility center or work order, such indirect costs will be directly assigned to such activity, process, project, responsibility center or work order. Where not identifiable to a particular activity, process, project, responsibility center or work order, such indirect costs within a Function will be allocated in relationship to the directly assigned costs of the Function. For purposes of this Appendix A, any costs not directly assigned by the Service Company will be allocated monthly.

II. Service Company costs accumulated for each activity, process, project, responsibility center or work order will be directly assigned, distributed or allocated to the Client Companies or other Functions within the Service Company as follows:

1. Costs accumulated in an activity, process, project, responsibility center or work order for services specifically performed for a single Client Company or Function will be directly assigned and charged to such Client Company or Function.

2. Costs accumulated in an activity, process, project, responsibility center or work order for services specifically performed for two or more Client Companies or Functions will be distributed among and charged to such Client Companies or Functions. The appropriate method of distribution will be determined by the Service Company on a case-by-case basis consistent with the nature of the work performed and will be based on the application of one or more of the methods described in Section IV and V of this Appendix A. The distribution method will be provided to each such affected Client Company or Function.

3. Costs accumulated in an activity, process, project, responsibility center or

or work order for services of a general nature which are applicable to all Client Companies or Functions or to a class or classes of Client Companies or Functions will be allocated among and charged to such Client Companies or Functions by application of one or more of the methods enumerated in Section III.

III. For purposes of this Appendix A, the following definitions or methodologies shall be utilized:

1. "Gross margin" refers to revenues as defined by Generally Accepted Accounting Principles, less cost of sales, including but not limited to fuel, purchased power, emission allowances and other cost of sales.

2. The weights utilized in the weighted average ratios in paragraph V of this Appendix A shall represent the percentage relationship of the activities associated with the function for which costs are to be allocated. For example, if an expense item is to be allocated on the weighted average of the Gross Margin Ratio, the Labor Dollars Ratio and the Total Property, Plant and Equipment ("PP&E") Ratio, and the activity to be allocated is one-third gross margin related, one-third labor related and one-third PP&E related, 33 percent of the Gross Margin Ratio would be utilized, 33 percent of the Labor Dollars Ratio and 34 percent of the PP&E Ratio would be utilized. To illustrate this application, assuming that the Gross Margin Ratio were 53.75 percent for Company A and 46.25 percent for Company B, the Labor Dollars Ratio were 25 percent for Company A and 75 percent for Company B, and the Total PP&E Ratio were 60 percent for Company A and 40 percent for Company B, the following weighted average ratio would be computed:

		Company A		Company B	
Activity	Weight	Ratio	Weighted	Ratio	Weighted
Gross Margin Ratio	33%	53.75%	17.74%	46.25%	15.26%
Labor Dollars Ratio	33%	25.00%	8.25%	75.00%	24.75%
Total Property, Plant and Equipment Ratio	34%	60.00%	20.40%	40.00%	13.60%
	100%		46.39%		53.61%

IV. Costs accumulated in an activity, process, project, responsibility center or work order for services of a general nature which are applicable to all Client Companies or Functions or to a class or classes of Client Companies or Functions will be allocated and/or distributed among and charged to such Client Companies or Functions by application of one or more of the following allocation methods:

1. Revenues Ratio. A ratio based on the total applicable revenues for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable). This ratio will be determined annually or at such time as may be required due to a significant change.

2. Number of Employees Ratio. A ratio based on the applicable number of employees at the end of a recent month in the preceding twelve consecutive month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

3. Construction-Expenditures Ratio. A ratio based on the applicable projected total construction expenditures for the following twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable). Separate ratios will be computed, where applicable, for total construction expenditures and appropriate functional plant classifications. This ratio will be determined annually or at such time as may be required due to a significant change.

4. Number of Central Processing Unit (CPU) Seconds Ratio. A ratio based on the sum of the applicable number of central processing unit seconds expended to execute mainframe computer software applications for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

5. Sales Ratio. A ratio, based on the applicable domestic firm kilowatt-hour electric sales (and/or the equivalent cubic feet of gas sales, where applicable), excluding intra-system sales, for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all utility Client Companies

Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable), This ratio will be determined annually, or at such time as may be required due to a significant change.

6. Electric Peak Load Ratio. A ratio, based on the sum of the applicable monthly domestic firm electric maximum system demands for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable). This ratio will be determined annually, or at such time as may be required due to a significant change.

7. Number of Customers Ratio. A ratio, based on the applicable number of customers at the end of a recent month in the preceding twelve consecutive month period, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable). This ratio will be determined annually, or at such time as may be required due to a significant change.

8. Inventory Ratio. A ratio based on the total applicable inventory balance for the preceding year, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable). Separate ratios will be computed for total inventory and the appropriate functional plant classifications. This ratio will be determined annually or at such time as may be required due to a significant change.

9. Procurement Spending Ratio. A ratio based on the total amount of applicable procurement spending for the preceding year, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable) and/or the Service Company. Separate ratios will be computed for total procurement spending and appropriate functional plant classifications. This ratio will be determined annually or at such time as may be required due to a significant change.

10. Square Footage Ratio. A ratio based on the total amount of applicable square footage occupied in a recent month in the preceding twelve consecutive month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

11. Gross Margin Ratio. A ratio based on the total applicable gross margin for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company and the denominator of which is for all

which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable). This ratio will be determined annually or at such time as may be required due to a significant change.

12. Labor Dollars Ratio. A ratio based on the total applicable labor dollars for a preceding twelve consecutive calendar month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

13. Number of Personal Computer Work Stations Ratio. A ratio based on the total number of applicable personal computer work stations at the end of a recent month in the preceding twelve consecutive month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

14. Number of Information Systems Servers Ratio. A ratio based on the total number of applicable servers at the end of a recent month in the preceding twelve consecutive month period, the numerator of which is for a Client Company or Service Company Function and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable) and/or the Service Company. This ratio will be determined annually or at such time as may be required due to a significant change.

15. Total Property, Plant and Equipment Ratio. A ratio based on the total applicable Property, Plant and Equipment balance (net of accumulated depreciation and amortization) for the preceding year, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable). This ratio will be determined annually or at such time as may be required due to a significant change.

16. Generating Unit MW Capability Ratio. A ratio, based on the total applicable installed megawatt capability for the preceding year, the numerator of which is for a Client Company and the denominator of which is for all Client Companies (and Duke Energy Corporation's domestic utility affiliates, where applicable). This ratio will be determined annually or at such time as may be required due to a significant change.

IV. A general description of each Function's activities is set forth below.

1. INFORMATION SYSTEMS

Provides communications and electronic data processing services. Examples of activities include development and support of mainframe computer software applications; procurement and support of personal computers and related network and software applications; development and support of distributed computer software applications (e.g., servers); installation and operation of communications systems; and management and support services.

2. METERS

Procures and maintains meters, similar equipment for Client Companies. Assists Client Companies in rendering purchasing, construction, installation, inspection, maintenance, repair and related services for customer-owned meters and similar equipment.

3. TRANSPORTATION

Procures and maintains vehicles, aircraft and similar equipment for Client Companies. Assists Client Companies in rendering purchasing, construction, installation, inspection, maintenance, repair and related services with respect to vehicle fleets, aircraft and similar equipment.

4. HUMAN RESOURCES

Establishes and administers policies and supervises compliance with legal requirements in areas of employment, compensation, benefits and employee health and safety. Processes payroll and employee benefit payments. Supervises contract negotiations and relations with labor unions.

5. FACILITIES

Operates and maintains office and service buildings. Provides security and housekeeping services for such buildings and procures office furniture and equipment.

6. ACCOUNTING

Maintains books and records of Duke Energy Corporation and its affiliates, prepares financial and statistical reports, processes payments to vendors, prepares tax filings and supervises compliance with tax and other similar laws and regulations.

7. PUBLIC AFFAIRS

Prepares and disseminates information to employees, customers, government officials, communities and media. Provides graphics, reproduction lithography, photography and video services.

8. LEGAL

Renders services relating to labor and employment law, litigation, contracts, rates and regulatory affairs, environmental matters, financing, financial reporting, real estate and other legal matters.

9. FINANCE

Renders services to Client Companies with respect to investments, financing, cash management, risk management, insurance, claims, etc. Prepares budgets, financial forecasts, economic analyses and other similar finance-related documents and/or reports. Assists Client Companies in rendering financial-related services to customers, such as development and implementation of "shared savings" arrangements, and in providing financing options to customers (loans, leases, etc.) principally in connection with sales of Client Company goods and services.

10. INTERNAL AUDIT

Reviews internal controls and procedures to ensure that assets are safeguarded and that transactions are properly authorized and recorded.

11. INVESTOR RELATIONS

Provides communications to investors and financial community, performs transfer agent and shareholder record-keeping functions, administers stock plans and performs stock-related regulatory reporting.

12. PLANNING

Assists in development of business plans; monitoring of trends; gathering and evaluation of information with respect to competitors and customers; evaluation of business opportunities; related strategic matters.

13. EXECUTIVE

Provides general administrative and executive management services.

14. ENERGY-RELATED FACILITY MAINTENANCE

Assists Client Companies in rendering maintenance and related consulting services for customer-owned utility assets (generation, transmission/transportation and distribution facilities) and other energy-related facilities and equipment, such as cogeneration facilities, fuel systems, chilled/hot water systems, fiber optic/telecommunications facilities, outdoor and street lighting systems, etc. To the extent Client Companies themselves own any such facilities and equipment, such maintenance services may also be provided to any such Client Company.

15. ENGINEERING AND CONSTRUCTION

Assists Client Companies in rendering engineering and construction and related consulting services for customer-owned utility assets (generation, transmission/transportation and distribution facilities) and other energy-related facilities and equipment, such as cogeneration facilities, fuel systems, chilled/hot water systems, fiber optic/telecommunications facilities, outdoor and street lighting systems, etc. To the extent Client Companies themselves own any such facilities and equipment, such engineering and construction services may also be provided to any such Client Company.

16. MARKETING AND CUSTOMER RELATIONS

Assists Client Companies in designing, implementing and promoting products and services to potential customers and in administering business relationships with existing customers. Activities include assisting Client Companies in connection with (1) advertising, (2) making initial contacts with and designing specific proposals for potential customers; (3) administering business relationships with customers including bill processing and payment collection; and (4) operation of telephone call centers with respect to foregoing matters.

17. MATERIALS MANAGEMENT

Provides services in connection with procurement of materials and contract services, processes payments to vendors, and provides management of materials and supply inventories.

18. FUELS

Assists Client Companies in procuring fuel supplies (coal, steam, fuel oil, gas, etc.) for customers and, where applicable, Client Companies themselves.

19. ENVIRONMENTAL, HEALTH AND SAFETY

Assists Client Companies in providing environmental, health and safety services (compliance, studies, testing, licensing, monitoring, employee training, etc.) to customers. Where applicable, such services also provided to Client Companies themselves.

20. RATES

Assists Client Companies in connection with customer rate negotiations and risk analysis with respect to utility service.

21. RIGHTS OF WAY

Assists in purchase/sale, surveying and recording of interests in real estate, both for Client Companies themselves and customers thereof.

22. ENERGY-RELATED SYSTEM OPERATIONS

Assists Client Companies in rendering operational and related consulting services for customer-owned utility assets (generation, transmission/transportation and distribution facilities) and other energy-related facilities and equipment, such as cogeneration facilities, fuel systems, chilled/hot water systems, fiber optic/telecommunications facilities, outdoor and street lighting systems, etc. To the extent Client Companies themselves own any such facilities and equipment, such operational services may also be provided to any such Client Company. This function also includes assistance with respect to matters relating to disposal of associated by-products.

Duke Energy®

FRANCHISED ELECTRIC & GAS (FE&G)
SERVICE COMPANY ALLOCATIONS
AUDIT # 306026
DECEMBER 13, 2006

To: Carol E. Shrum, Vice President, Finance Shared Services

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James L. Turner
Steven K. Young

FE&G – Service Company Allocations – Summary Report
Audit # 306026
December 13, 2006

Project Scope	The scope of this audit was an evaluation of the processes within FE&G for service company allocations after April 3, 2006 (post-merger).
Objective(s)	The objectives of this audit were to evaluate whether: • Allocations are in compliance with applicable Service Agreements • Allocations are accurately calculated and based on approved allocation methods and rates • All appropriate costs have been allocated in a timely manner Additionally, SOX management retesting was performed to the extent possible.
Project Timing	September – November 2006

Summary Results

Priority	Total # of Issues	# of SOX Issues
Critical	-	-
High	-	-
Moderate	-	-
Low	1	-

Primary Risks Addressed

Strategic	Business Environment	
Financial	Operational	
Fraud	EH&S	Technology

Detail Audit Report
FE&G – Service Company Allocations
December 13, 2006

Observation and Management Response

Observation

BDMS Allocation Rate Discrepancies

Allocation rates for two Duke Energy Shared Services cost pools within the Business Data Management System (BDMS) did not agree to the allocation rates prescribed by the Cost Allocation Manual (CAM) as summarized below.

- The Mainframe Services – Enterprise allocation pool for the North American Non-Regulated Generation (NANRG) and "Other" business unit were under-allocated .47% and .02%, respectively. Meanwhile, the Duke Power, Cincinnati Gas & Electric, Duke Energy Gas Transmission, and PSI Energy units were over-allocated by .34%, .08%, .01%, and .06%, respectively.
- The Human Resources (HR) Services – Governance pool for the NANRG business unit was under-allocated by .85% while the "Other" business unit was over-allocated by .85%.

Additionally, BDMS rates are reviewed and approved annually rather than quarterly.

It should be noted that out of $828 million allocable costs, the impact of the items listed above is less than $5,000 since April 3, 2006.

Management Response

Management agrees with this finding. Given the immateriality of this difference, we will assure these allocation percentages in 2007 agree to the 2007 CAM and will implement a quarterly review process to ensure allocations in BDMS remain consistent with the CAM. The 1st quarter 2007 review will coincide with the scheduled March 31, 2007 filing of the CAM with the North Carolina Utilities Commission. The remaining quarterly reviews will be scheduled the last week of each closing quarter.

Business Risk	Priority	Implementation Date	SOX Reference
Financial	Low	March 31, 2007	N/A

Duke Energy®

U.S. FRANCHISED ELECTRIC & GAS (FE&G)
STATE AFFILIATE CODE OF CONDUCT (KENTUCKY)
AUDIT # 107001
MAY 18, 2007

To: John J. Finnigan, Jr., U.S. FE&G Regulatory Counsel
Paul G. Smith, Vice President Rates – Ohio and Kentucky

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FE&G - State Affiliate Code of Conduct (Kentucky) – Summary Report
Audit # 107001
May 18, 2007

Project Scope	The scope of this audit was to review compliance with Kentucky law relating to transactions between Duke Energy Kentucky (DE-Kentucky) and affiliates of DE-Kentucky during the period from April 3, 2006 (post-merger) through December 31, 2006. Transactions with service companies were excluded from the audit scope.
Objective(s)	The primary objective of this audit was to evaluate whether the processes for affiliate transaction pricing and regulatory reporting practices are sufficient to comply with the applicable provisions of Kentucky law.
Project Timing	February – March 2007

Summary Results

Priority	Total # of Issues	# of SOX Issues
Critical	-	N/A
High	2	N/A
Moderate	4	N/A
Low	-	N/A

Primary Risks Addressed

Strategic	Business Environment	
Financial	Operational	
Fraud	EH&S	Technology

Detail Audit Report
FE&G – State Affiliate Code of Conduct (Kentucky)
May 18, 2007

Observation and Management Response

Observation

Filing Roles and Responsibilities

Processes that include responsibilities of Legal, Regulatory, and Accounting were not clearly defined or adequately communicated to facilitate the ongoing complete and accurate filing of the annual DE-Kentucky Cost Allocation Manual (CAM).

Additionally, the initial CAM filing by DE-Kentucky in May 2006 referenced a listing of transactions and services between the company and its affiliates. The listing provided as attachment E-4 to the CAM was not complete for all transactions during the reporting period and included estimates rather than actual amounts.

Management Response

Representatives from Legal, Regulatory, and Accounting met to discuss responsibilities and gathered the information required to timely file the CAM by March 31, 2007. To complete this filing for the current year, Legal prepared a summary of documents required and distributed it to responsible parties, who provided the information. Accounting provided the comprehensive summary of transactions and services between the company and its affiliates.

Although the CAM was correctly filed by March 31, 2007, there remains a need for management to identify the individual responsible for sponsoring this annual filing and to clearly communicate the accountabilities for providing information. We expect to complete these actions for future filings by July 31, 2007.

By May 31, 2007, Legal, Regulatory, and Accounting representatives will determine if it is practicable to amend the CAM filed in May 2006. If practicable, the revised CAM will be filed by July 31, 2007.

Business Risk	Priority	Implementation Date	SOX Reference
Financial	High	July 31, 2007	N/A

Detail Audit Report
FE&G – State Affiliate Code of Conduct (Kentucky)
May 18, 2007

Observation and Management Response

Observation

Affiliate Transactions

Processes to monitor transactions between DE-Kentucky (DEK) and its affiliates are not fully defined in the following areas:

- Responsibilities and procedures to extract the complete population of DEK's affiliate transactions.
- Procedures to verify that services and products provided between DEK and its affiliates are priced at the fully embedded cost, as defined in the Service Agreements.
- Responsibilities to verify that recorded affiliate direct charges for services have been authorized.

Management Response

- Once BDMS is converted to FMIS, FE&G Midwest accounting will be responsible for extracting the DEK affiliate transaction information monthly from the Midwest general ledger (BDMS). Subsequent to the conversion, reports developed from FMIS (PeopleSoft) will be maintained by Accounting. These reports will be sent to Regulatory Accounting & Compliance on a monthly basis.

- Fully embedded cost rates are being developed by Regulatory Accounting & Compliance. These rates will be distributed to Rates, Accounting and the Business Support Groups during the 2nd quarter 2007. Once rates are developed, DEK Rates, Regulatory Accounting & Compliance, Midwest Accounting, and the Business Support Group will meet to discuss procedures for ensuring the proper pricing, including the Carolinas requirements for asymmetrical pricing.

- Regulatory Accounting & Compliance will initiate meetings with the Business Support Group to create processes and documentation 1) to validate transactions on the affiliate transaction reports and 2) to confirm that the transactions are authorized with a valid approval record maintained in the Service Request Database.

We expect that these processes will be in place by December 31, 2007.

Business Risk	Priority	Implementation Date	SOX Reference
Financial	High	December 31, 2007	N/A

Detail Audit Report
FE&G – State Affiliate Code of Conduct (Kentucky)
May 18, 2007

Observation and Management Response

Observation

Service Request Database (SRD)

The SRD is maintained by Rates & Regulatory Accounting to summarize authorized services provided between DEK and its affiliates. Observations related to the SRD include the following:

- The SRD does not include a complete population of 2006 transactions and should not be utilized as the sole source of information for filing of the CAM. Transactions with certain affiliates are not included in the database including, but not limited to, transactions with Cinergy Receivables Company LLC, Cinergy Marketing & Trading LP, DukeNet Communications LLC, and Duke Energy Ohio for transactions related to the Miami Fort plant operations.
- The Midwest general ledger system (BDMS) inter-company validation routines used to prevent unauthorized affiliate transactions from being recorded are not reconciled to the SRD. Many BDMS validations currently indicate 12/31/2050 as the ending date, allowing transactions to be posted in BDMS between these affiliates until that time without requiring further entry to the Service Request Database.
- Six of eleven individuals with access to the Service Request Database do not require access to the database. Three of these employees are no longer with the company and the remaining three do not require access.

Management Response

- The data included in the SRD database will no longer be utilized as the sole source for affiliate transaction information to be included with the CAM (it was for the initial filing in 2006). The information gathered by DEK Rates as described in the response to the Affiliate Transactions observation in bullet point one will be used for future CAM filings. No further actions required.
- The BDMS validation routines are a preventative control to avoid unauthorized entry to the general ledger. Management sees value in reviewing the stop-dates for these combinations and to remove those that are no longer authorized. However, the impending conversion to PeopleSoft 8.9 will cause these validation routines to become meaningless and the response to the Affiliate Transactions observation in bullet point three will mitigate any risk of unauthorized transactions. No further actions required.
- The IT group revoked access to the employees who no longer require it. Regulatory Accounting & Compliance will assume the responsibility of maintaining the SRD database and access will be restricted going forward to only those individuals requiring it to perform their jobs.

Business Risk	Priority	Implementation Date	SOX Reference
Financial	Moderate	Implemented	N/A

Detail Audit Report
FE&G – State Affiliate Code of Conduct (Kentucky)
May 18, 2007

Observation and Management Response

Observation

Term Definitions Consistency

The method to price services between affiliates is not consistently defined in various agreements. The Service Agreements describe the price for services as "the fully embedded cost," defined as the sum of (i) direct costs, (ii) indirect costs, and (iii) costs of capital. Certain affiliate contracts describe services to be priced at "the fully allocated cost", which is not defined. The Kentucky Statute 278.2207 defines the price of services and products provided to the utility by an affiliate as "fully distributed cost but in no event greater than market."

Management Response

For future contracts and filings, Legal will use consistent language. For purposes of employee training, employees will be advised that the terms "fully embedded cost," "fully allocated cost," and "fully distributed cost" have the same meaning as the definition of "fully embedded cost" shown above. This construction will also be conveyed to regulators. Future CAM filings will include a statement that the terms "embedded cost", "fully allocated cost", and "fully distributed cost" are synonymous terms to describe the method to price services between affiliates as defined by (i) direct costs, (ii) indirect costs, and (iii) costs of capital.

Language clarification in future CAM filings and communication with non-employee interested parties will be handled on an as-needed basis. We expect to complete the communication to employees by June 30, 2007.

Business Risk	Priority	Implementation Date	SOX Reference
Financial	Moderate	June 30, 2007	N/A

Detail Audit Report
FE&G – State Affiliate Code of Conduct (Kentucky)
May 18, 2007

Observation and Management Response

Observation

Training

Training materials and attendance history of employees (e.g. shared service employees) receiving training of how to charge time directly assignable to a utility or non-utility company is not adequately documented. Training is required to improve employee awareness in preventing time that should be directly billed to an entity versus being subject to a standard allocation.

Management Response

This observation has impacts across FE&G and requires coordination with additional groups. Recent change in the organization and increased numbers of Service Company employees magnify the importance of individuals to understand the concept of allocations and how to record exceptions to those allocations. There are different jurisdictional requirements for charging time which must also be understood.

Regulatory Accounting & Compliance will work with the various state Rate Departments, FRE, Business Support Group, Corporate Ethics and Compliance, Service Company Accounting & Reporting, and others to begin the development of training materials which will ultimately be communicated to employees to provide awareness of the jurisdictional requirements.

We expect a training plan will be developed by the responsible parties by December 31, 2007.

Business Risk	Priority	Implementation Date	SOX Reference
Financial	Moderate	December 31, 2007	N/A

Detail Audit Report
FE&G – State Affiliate Code of Conduct (Kentucky)
May 18, 2007

Observation and Management Response

Observation

Billing Statements ▶ Billing statements are not produced for affiliate transactions as required by the Service Agreements.

Management Response

Management is aware that the Operating Companies Service Agreement and the Operating Company/Non-Utility Companies Service Agreement refer in Article 3 that a statement shall be rendered "reflecting the billing information necessary to identify the costs charged for that month" and all charges billed will be remitted by the last day of each month. However, to the extent amounts are owed from one consolidated entity to another, intercompany payables and receivables are recorded and the balances are directly charged (offset). The settlement of these intercompany balances is managed by the Treasury group.

Although it is understood that the language in the Service Agreement describing a "billing statement" could be misinterpreted, management deems the process described above as appropriate to settle affiliate transactions for consolidated entities.

Business Risk	Priority	Implementation Date	SOX Reference
Financial	Moderate	N/A	N/A

Final Report
Audit of Merger-Related Agreements
Duke Energy Kentucky

Public Version

Presented to:

The
Kentucky Public Service Commission

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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:
    - Whether the account contains costs attributable to regulated operations and non-regulated operations
    - Whether the costs are joint costs that cannot be directly identified
    - 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]

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

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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]

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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.

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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]

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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]
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[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
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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.

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

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]	

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]
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[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]	[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]			

[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]

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]

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.

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

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.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF AN ADJUSTMENT	)	
OF GAS RATES OF	)	CASE NO. 2009-00202
DUKE ENERGY KENTUCKY, INC.	)	

DIRECT TESTIMONY OF

GARY J. HEBBELER

ON BEHALF OF

DUKE ENERGY KENTUCKY, INC.

July 1, 2009

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I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Gary J. Hebbeler. My business address is 139 East Fourth Street, Cincinnati, Ohio 45202.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Duke Energy Business Services, Inc., an affiliate service company of Duke Energy Kentucky, Inc. (Duke Energy Kentucky or the Company), as General Manager, Gas Engineering.

Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS.

A. I am a graduate of the University of Kentucky where I obtained my Bachelor of Science in Civil Engineering. In 1994, I obtained my license as a Professional Engineer in the Commonwealth of Kentucky and by reciprocity later in the State of Ohio.

Q. PLEASE SUMMARIZE YOUR BUSINESS EXPERIENCE.

A. I began working for The Cincinnati Gas & Electric Company (CG&E), now known as Duke Energy Ohio, Inc. (Duke Energy Ohio), in 1987, as an engineer in the Gas Engineering Department. I initially worked as a project engineer. I was responsible for designing gas mains and water lines; coordinating projects with governmental agencies and consulting firms; calculating pipe capacity and stress calculations on pipes; and evaluating company paving standards and designs. I worked for CG&E, and later for Cinergy Services, Inc., until 1998. I was Vice

President for Michels Concrete Construction, Inc. during 1998 and returned to Cinergy Corp.'s Gas Engineering Department in 1999. In 2000, I was promoted to Manager, Contractor Construction. In this position, I helped design the Accelerated Main Replacement Program (AMRP). I also managed the construction activities for replacing the cast iron/bare steel pipe under the AMRP. In 2002, I was promoted to Manager, Gas Engineering. I am responsible for managing the engineering activities and the capital expenditures for Gas Operations in Duke Energy Ohio's and Duke Energy Kentucky's gas distribution systems. In 2006, I was promoted to my current position of General Manager, Gas Engineering. In addition to my responsibilities for gas engineering activities and capital expenditures, I am responsible for construction activities for the AMRP, street improvements, pressure improvements and major projects for Gas Operations in Duke Energy Ohio's and Duke Energy Kentucky's gas distribution systems.

Q. **HAVE YOU EVER TESTIFIED BEFORE THE KENTUCKY PUBLIC SERVICE COMMISSION?**

A. Yes. I have previously testified before this and other state commissions.

Q. **WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

A. The purpose of my testimony is to provide an overview of the Company's natural gas business. I also discuss the Gas Operations Department's major safety, reliability and efficiency initiatives. I explain major changes in Duke Energy Kentucky's Gas Operations business since the Company's last general gas rate case. I support the operation and maintenance (O&M), purchased fuel mixture information and purchased gas expense for the base period and the forecasted test period. I discuss Duke Energy Kentucky's AMRP, and I support Duke Energy Kentucky's request to discontinue the AMRP and place all of the associated investment into rate base. I also discuss the progress of and changes to Duke Energy Kentucky's safety initiatives: the Integrity Management Program, the Distribution Integrity Management Program and the Accelerated Riser Replacement Program. I discuss how the gas capital expenditure budget is prepared and I support the gas capital budget, including retirements, which I supplied to Stephen R. Lee, Duke Energy Kentucky witness. I also sponsor and support Schedule B-4.1 and Filing Requirements (FR) 10(9)(b), FR 10(9)(f) and FR 10(9)(g). Finally, I sponsor Filing Requirement (FR) 10(9)(h)(8), which provides the mix of gas supply utilized in the financial forecast, and the O&M information relied on by Mr. Lee.

II. GAS OPERATIONS BUSINESS

Q. PLEASE DESCRIBE DUKE ENERGY KENTUCKY'S GAS BUSINESS.

A. Duke Energy Kentucky serves a relatively densely-populated territory that, though not heavily industrialized, consists of a fairly diverse mix of industrial customers. Duke Energy Kentucky currently provides natural gas distribution service to approximately 96,000 customers in Boone, Campbell, Gallatin, Grant, Kenton and Pendleton counties in Northern Kentucky. Duke Energy Kentucky has approximately 1,425 miles of gas mains on its natural gas distribution system. There are approximately 340 employees in Duke Energy Kentucky's and Duke

Energy Ohio's Gas Operations Department, many of whom perform services for Duke Energy Kentucky. The capital expenditures for Duke Energy Kentucky's Gas Operations in 2008 were approximately $32 million.

Gas Operations is organized by the following functional groups: Gas Commercial Operations, Gas Engineering, Gas Field and Gas System Operations, and Gas Performance Support, which I will further discuss.

A. GAS COMMERCIAL OPERATIONS

Q. PLEASE DISCUSS THE GAS COMMERCIAL OPERATIONS FUNCTION.

A. Gas Commercial Operations is responsible for obtaining adequate natural gas supplies and interstate pipeline transportation services at a reasonable cost for Duke Energy Kentucky to supply to customers. Duke Energy Kentucky purchases and delivers natural gas to approximately 96,000 gas sales customers, and delivers customer-owned gas supplies to another 104 customers under firm and interruptible transportation service tariffs.

During the 2008 winter period, Duke Energy Kentucky purchased nearly all of its gas supply under firm supply contracts with established marketers and producers, who manage diversified natural gas supply and energy portfolios. These firm agreements are composed of a base supply component, which assures a continuous supply designed to meet minimum customer demands, and a swing supply component. Swing supply provides Duke Energy Kentucky flexibility to accommodate daily temperature-sensitive fluctuations in customer demand. Duke Energy Kentucky sources its gas through a competitive bidding process to enable it to obtain the optimal mix of suppliers and prices for its customers. The small remaining portion of Duke Energy Kentucky's 2008 gas supply was obtained from the daily and monthly markets.

Duke Energy Kentucky contracts with interstate pipelines for firm transportation and storage services. During 2008, Duke Energy Kentucky contracted for firm transportation and storage services with Columbia Gas Transmission Corporation (Columbia Gas). Duke Energy Kentucky also contracted for firm transportation service from Tennessee Gas Pipeline Company (Tennessee Pipeline), Columbia Gulf Transmission Corporation (Columbia Gulf), Texas Gas Transmission Company and KO Transmission Corporation. This diverse group of interstate pipeline companies allows Duke Energy Kentucky to negotiate lower transportation rates than it otherwise would be able to obtain from a smaller group of transportation providers.

The Company's gas procurement policies and practices have traditionally resulted in some of the most competitive gas cost adjustment (GCA) rates in the Commonwealth. Notwithstanding recent increased wholesale prices, Duke Energy Kentucky's actual gas costs continue to rank favorably among Kentucky's gas utilities. Using techniques such as "expected value analysis" and *Monte Carlo* simulation, Duke Energy Kentucky has successfully made the transition from being a pre-Order 636[1] pipeline-supply dependent customer to an

[1] Docket No. RD91-11-000 In Re Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations. (FERC Order No. 636).

independent, aggressive buyer managing a diversified gas commodity and pipeline services portfolio.

Duke Energy Kentucky's gas rates compare favorably with the rates of other Kentucky local distribution companies (LDCs) in part due to Duke Energy Kentucky's efficient management practices. For example, we recently executed new agreements with Columbia Gas and Columbia Gulf for new interstate pipeline transportation agreements through which Duke Energy Kentucky will obtain significant seasonal volume and rate discounts from the pipelines' maximum tariff transportation rates.

Duke Energy Kentucky has used asset management agreements, where the Company has contracted with a third-party, British Petroleum (BP) to manage Duke Energy Kentucky's gas supply contracts, interstate pipeline transportation contracts and storage gas in exchange for a monthly fee which the asset manager credits to Duke Energy Kentucky. This fee, which Duke Energy Kentucky flows through 100% to customers through the monthly GCA, allows Duke Energy Kentucky to optimize the value of these assets. Duke Energy Kentucky also manages its gas prices through the use of a hedging program, utilizing fixed or capped collared prices for physical delivery, which the Commission most recently approved in an order dated August 19, 2008, in Case No. 2008-175. Additionally, Duke Energy Kentucky revises its GCA price monthly in order to send accurate price signals to its customers, which the Commission approved in an order dated November 6, 2003, in Case No. 2003-00386.

Q. WHAT STEPS HAS DUKE ENERGY KENTUCKY TAKEN TO HELP MITIGATE THE IMPACT OF HIGH NATURAL GAS COSTS?

A. In a July 17, 2001, order in Administrative Case No. 384, the Commission specified certain practices for LDCs to follow with respect to mitigating the impact of high natural gas prices on customers. Duke Energy Kentucky complied with these directives by reporting on its gas procurement activities, developing a formal hedging program, and undergoing an audit by Liberty Consulting Group. Duke Energy Kentucky has completed all eleven recommendations that resulted from Liberty's audit of Duke Energy Kentucky.

Additionally, the Company offers various bill management and payment options, which Company witness Ms. Julia S. Janson describes in detail. If special payment plans alone do not suffice to avoid disconnection, Duke Energy Kentucky, on the basis of a written statement signed by a physician, registered nurse, or a public health officer stating that disconnection of service would aggravate a debilitating illness or infirmity, postpones disconnection of service.

Duke Energy Kentucky also offers Demand Side Management (DSM) programs which provide energy efficiency services to residential gas and electric customers. There are currently four programs that provide both gas and electric benefits. Although there are additional DSM programs included in the Company's current DSM portfolio of programs, as well as in its Application for a new DSM recovery mechanism in Case No 2008-495, those programs primarily focus on energy efficiency for electric customers or are pending Commission approval. The four current programs providing benefits for gas customers are: the

Residential Conservation and Energy Education (RCEE) (Low-Income Weatherization) program, the Residential Home Energy House Call (HEHC) program, Energy Efficient Web Site program, and the Residential Comprehensive Energy Education program (NEED).

RCEE helps the Company's income-qualified customers reduce their energy consumption and lower their energy costs. This program specifically focuses on Low Income Home Energy Assistance Program (LIHEAP) customers that meet the income qualification level of 150% of federal poverty level. This program uses the LIHEAP intake process as well as other community outreach to improve participation. The RCEE program provides direct installation of weatherization and energy-efficiency measures and educates Duke Energy Kentucky's income-qualified customers about their energy usage and other opportunities to reduce energy consumption and lower their costs.

Under the HEHC program, a qualified home energy specialist visits the home to gather information about household energy usage. A questionnaire about the energy usage, including appliance efficiencies, is completed. The specialist performs a walk-through audit and checks the home for air infiltration, inspects the HVAC filter, and surveys the insulation levels in different areas of the home. A detailed report is generated on site that explains how energy is used each month and a list of prioritized action items is compiled based on energy savings and costs. The customer is also provided with free samples of energy efficiency products.

The Duke Energy Kentucky's Energy Efficiency Web Site program offers opportunities for customers to assess their energy usage and obtain recommendations for more efficient use of energy in their homes. This on-line service provides energy efficiency information, tips, and bill analysis. As an incentive to encourage customers to use the website, a free Energy Efficiency Starter Kit is offered. The kit is mailed directly to the customer's service address and provides the customer with several easy to install measures including a low-flow showerhead, CFL light bulbs, and faucet aerators. In addition, all customers who use Duke Energy Kentucky's on-line services to pay bills or view their accounts can access the Home Profile tool. The Home Profile is a short energy audit that gives the customer an immediate personalized energy report on their energy usage and helps the customer identify additional energy saving measures.

The Residential Comprehensive Energy Education program is operated under subcontract by Kentucky National Energy Education Development (NEED). NEED was launched in 1980 to promote student understanding of the scientific, economic, and environmental impacts of energy. The program provides educational information on all energy sources, with an emphasis on the efficient use of energy. Energy education materials and Leadership Training workshops are designed to address students of all aptitudes and have been provided for students and teachers in grades K through 12. In addition, the program provides an energy savings "kit" as a tool that enables teachers to have actual in-home measures implemented. This program has demonstrated that measures are being installed in the home. These kits include CFL bulbs, low-flow shower heads, faucet aerators, water temperature gauge, and outlet insulation pads. The Kentucky NEED program follows national guidelines for materials used in teaching, but also offers additional services such as: hosting teacher/student workshops, sponsoring teacher attendance at summer training conferences, sponsoring attendance at a National Youth Awards Conference for award-winning teachers and students, and providing curricula, free of charge, to teachers.

Due to efforts of the Kentucky NEED program, energy and facility managers with the Kenton County School District implemented a voluntary program that garnered national recognition around their energy management plans; it incorporated student participation and education curriculum. This led to the construction project of an additional efficiency (LEED) certified school building.

Duke Energy Kentucky also has a customer communications program in which it advises customers about steps they can take to reduce their natural gas usage, weatherize their homes, and take advantage of these different payment options.

B. <u>GAS ENGINEERING</u>

Q. PLEASE DISCUSS THE GAS ENGINEERING FUNCTION.

A. Gas Engineering's primary responsibilities are to provide engineering services, including policies, procedures, job design, and budgeting for the installation, operation and maintenance of gas facilities to ensure system reliability and compliance with applicable laws. These responsibilities also include developing and managing the capital budget and the integrity management system. In addition, Gas Engineering has the responsibility for the AMRP planning, design, bidding, budgeting, tracking and resource acquisition.

Gas Engineering includes the Systems Engineering and Construction Drafting group, which performs system pressure and flow modeling, analysis and design, including city gate stations, distribution stations, and customer facilities. In addition, this section provides drawings for construction projects. They evaluate and select construction materials and determine the best installation practices; and they design and program the gas Supervisory Control and Data Acquisition Systems (SCADA). SCADA is a software tool that enables the Company's engineers to monitor the status to the distribution system and to develop optimal distribution system design plans.

Gas Engineering also includes the Pipeline Engineering, Mapping and Records group, which provides engineering expertise for the construction, operation, and maintenance of gas pipelines. In addition, this section collects and retains records necessary for compliance with regulations, for U.S. Department of Transportation (DOT) audits, and for performance of subsequent work on the gas system. They manage procurement of contractor services for engineering and drafting work for the installation of mains and services, and coordinate projects with governmental and private authorities.

Gas Engineering also includes Corrosion Engineering and Control. The Corrosion Engineering and Control group manages a cathodic protection program for approximately 3,345 miles of coated steel pipeline and appurtenances for both Duke Energy Kentucky and Duke Energy Ohio.

Gas Engineering also includes Contractor Construction Management. The Contractor Construction management group's primary responsibility is the AMRP. They are also responsible for the inspection, supervision and construction of gas facility installation, replacement and street improvement projects that are completed by outside contractors. Duke Energy Kentucky has used outside contractors to install new mains in the AMRP. We select these outside contractors through a competitive bidding process which helps control costs. The AMRP has provided $3,840,701 million in maintenance savings through reduced maintenance costs since inception of the program.

C. GAS FIELD AND GAS SYSTEM OPERATIONS

Q. PLEASE DISCUSS THE GAS FIELD AND GAS SYSTEM OPERATIONS FUNCTION.

A. Gas Field Operations has the primary responsibility to install, operate, and maintain transmission and distribution facilities for the delivery of gas from the supplier and/or Company's propane/air plant to the customer in a safe, reliable and economical manner. Gas Field Operations is also responsible for emergency response and for monitoring and maintenance work on Duke Energy Kentucky's system, including but not limited to, leak surveys, valve inspections, regulator inspections, pipeline patrol, and leak tracking and repair. Additionally, Gas Field Operations participates in the American Gas Association's (AGA) benchmarking program to gain lessons learned from other utilities for a better means of providing safe, adequate and reliable service to customers at a reasonable cost.

Gas System Operations is responsible for maintaining and ensuring proper operation of all propane plants and propane storage facilities and compliance programs such as regulator/relief valve, control valve inspection. Gas System Operations assists with collecting corrosion compliance data. Gas System Operations also maintains and assists in operating all pressure regulating facilities as well as maintaining system integrity of all pressures throughout our natural gas distribution system.

D. GAS PERFORMANCE SUPPORT

Q. PLEASE DISCUSS THE GAS PERFORMANCE SUPPORT FUNCTION.

A. Gas Performance Support is responsible for the development and verification of qualifications of personnel to comply with the U.S. DOT's Operator Qualification training requirements. Gas Performance Support maintains training records and develops and conducts public awareness and safety programs. Gas Performance Support also ensures compliance with codes and regulations promulgated by the U.S. DOT and the Ohio and Kentucky state Regulatory/Office of Pipeline Safety entities. Finally, Gas Performance Support develops process improvement programs and provides financial support for all areas of Gas Operations.

III. SAFETY, RELIABILITY AND EFFICIENCY INITIATIVES

A. OVERVIEW

Q. PLEASE BRIEFLY DESCRIBE GAS OPERATIONS' MAJOR PUBLIC SAFETY PROGRAMS AND RELIABILITY INITIATIVES.

A. All of our activities incorporate safety and reliability considerations. For example, Gas Commercial Operations purchases gas that meets industry quality standards in terms of BTU content. Gas Engineering designs and installs the distribution system in accordance with applicable safety codes promulgated in Title 49 of the Code of Federal Regulations and by the American Society of Testing Materials. Gas Field Operations follows U.S. DOT safety regulations and Commission safety regulations in installing, operating, and maintaining transmission and distribution facilities. The same can be said of our other functional groups.

In addition to these daily safety measures, we have five major programs that focus on safety and reliability. First, the Company has undertaken an initiative to conduct camera inspections of legacy AMRP installations prior to May 2006 that present a high risk of breaches to sewer laterals and mains. Second, Duke Energy Kentucky has initiated an Accelerated Riser Replacement Program (RRP) (formerly the Riser Optimization Program) that is designed to replace certain types of service head adapter risers which have been associated with riser leaks. Since Duke Energy Kentucky's last gas rate case, the Company began replacing these risers on an accelerated basis to ensure the safety and reliability of its gas delivery system and customers. This program is set up to mirror a similar program for Duke Energy Ohio in order to optimize the use of resources in an economic manner.

Third, the Integrity Management Program is a comprehensive systematic approach to maintain and improve safety of Duke Energy Kentucky's hazardous liquid and gas transmission pipeline system in compliance with federal legislation.

Fourth, Duke Energy Kentucky is anticipating the approval of the new Distribution Integrity Management Program (DIMP) rule to be released in the near future. Three programs that have already been developed and mentioned that will be incorporated into this program are the AMRP, RRP and the legacy sewer work.

Finally, the AMRP is designed to replace Duke Energy Kentucky's aged cast iron and bare steel mains and associated metallic services on an accelerated basis. The AMRP program has significantly reduced leak repairs and Account 887 "Maintenance of Mains" expense on Duke Energy Kentucky's gas distribution system. Duke Energy Kentucky will complete its AMRP program in 2010.

B. CAMERA INSPECTIONS

Q. WHY IS DUKE ENERGY KENTUCKY PERFORMING CAMERA INSPECTIONS ON SOME OF THE AMRP INSTALLAIONS PRIOR TO 2006?

A. Unfortunately, through experience, the Company has come to learn that many local sewer districts do not maintain accurate records of the location and depths of their systems nor do they own the sewer laterals. Despite Duke Energy Kentucky's best efforts to properly install its gas mains, the inaccurate sewer records and field markings of sewer districts have caused some AMRP installations to breach sewer lines. Therefore, the Company has undertaken the initiative to inspect what has been determined to be the most likely installations that may have a sewer breach. Since May 2006, Duke Energy Kentucky has included the underground camera inspections as part of its AMRP installation so going forward there is no issue. This program is designed to check potential high risk installations that are likely to have experienced a breach based upon premises structure elevation and main line sewer location and depth in relation to the street.

C. ACCELERATED RISER REPLACEMENT PROGRAM

Q. PLEASE EXPLAIN THE DUKE ENERGY KENTUCKY'S PREVIOUS RISER OPTIMIZATION PROGRAM.

A. The flexible riser is a fitting that connects the service line to the meter assembly. Flexible riser fittings are used for outside meters. One type of flexible riser fitting is known as a service head adapter (SHA) style riser. Both Duke Energy Kentucky and Duke Energy Ohio followed the Riser Optimization Program which was developed as a proactive program to target those factors on SHA risers that have a high propensity for leaks. As discussed in Duke Energy Kentucky's last gas rate case, the Company had approximately 25,000 SHA style risers on its distribution system. Duke Energy Kentucky and Duke Energy Ohio designed a formal program known as the Riser Optimization Program to target for replacement those SHA style risers with certain characteristics associated with a high propensity for leaks.

The resulting Riser Optimization Program is similar to the Cast Iron Maintenance Optimization System (CIMOS) and Bare Steel Maintenance

Optimization System (BSMOS) programs in that both programs identify criteria associated with past activities to develop a replacement program. In fact, some of the criteria, such as operating pressure, type of pipe material and year of installation, are the same for all of the programs. Under that program, Duke Energy Kentucky annually evaluates the activities associated with field assembled SHA risers and determines the number to be replaced. Duke Energy Kentucky selects for replacement those field assembled SHA risers that have similar factors to risers associated with a high incidence of leaks.

Q. WHY DID DUKE ENERGY KENTUCKY INITIATE AN ACCELERATED RISER REPLACEMENT PROGRAM?

A. The Accelerated Riser Replacement Program is an extension of the Riser Optimization Program discussed above and in the Company's last gas rate case. Duke Energy Kentucky plans to accelerate its riser replacement program to complete SHA riser replacement in 2012. This coincides with our schedule for completing the Riser Replacement Program in Ohio. This will allow us to coordinate the work activity of our outside contractors, and schedule the work more efficiently. This should reduce the overall costs of the riser replacement program.

Q. WHAT COSTS DOES DUKE ENERGY KENTUCKY EXPECT TO INCUR FOR THE ACCELERATED RISER REPLACEMENT PROGRAM?

A. Duke Energy Kentucky is planning on spending approximately $2 million per year for 2009, 2010, and 2011, and $1 million for 2012, for a total of $7 million in total capital expenditures for the replacement of field assembled SHA style risers.

The budget for this program for 2009 through 2012 was developed by estimating the replacement cost for all SHA risers over a four-year period.

D. <u>INTEGRITY MANAGEMENT PROGRAM</u>

Q. PLEASE EXPLAIN THE INTEGRITY MANAGEMENT PROGRAM.

A. The Integrity Management Program was created in response to new federal legislation in 2002 and accompanying regulations issued by the United States Department of Transportation Office of Pipeline Safety. These new regulations require operators of hazardous liquid pipelines and natural gas transmission pipelines to provide enhanced pipeline safety inspection and testing activities for their facilities. These regulations required the hazardous liquid pipeline and natural gas transmission pipeline operators to develop a program to identify all heavily populated areas traversed by their pipelines; develop a baseline assessment plan; conduct periodic risk assessments; and implement certain maintenance procedures.

In response to these new regulations, Duke Energy Kentucky developed its Integrity Management Program in 2004, which is a comprehensive systematic approach to maintain and improve safety of our hazardous liquid and transmission pipeline system. The Integrity Management Program is comprised of five separate plans – Integrity Management Plan, Performance Plan, Communication Plan, Management of Change Plan, and Quality Control Plan – that provide the foundation for the program and includes the processes and procedures necessary to comply with the new regulations.

The ongoing integrity activities for 2010 include + identification of high consequence areas, evaluating pipeline threats and conducting risk assessments for each covered pipeline segment, identifying and implementing additional preventive and mitigation measures, conducting integrity assessments through pressure testing or direct assessment methods, and remediating conditions found during integrity assessments.

Duke Energy Kentucky notes that it did not request cost recovery under the Rider AMRP, but simply wanted to explain the Integrity Management Program because it accounts for significant O&M expenditures in the test year.

E. DISTRIBUTION INTEGRITY MANAGEMENT PROGRAM

Q. PLEASE EXPLAIN THE DISTRIBUTION INTEGRITY MANAGEMENT PROGRAM.

A. The Pipeline and Hazardous Material Safety Administration (PHMSA) has issued a Notice of Proposed Rulemaking (NOPR) that will require operators of gas distribution pipeline systems to develop and implement a Distribution Integrity Management Program (DIMP) to enhance the operator's pipeline safety by identifying and reducing pipeline integrity risks and improving public safety. As proposed, a gas distribution pipeline operator will have 18 months to develop and implement a written integrity management program once the final rule is published, which is expected sometime in 2009.

The required elements within DIMP are: knowing the gas distribution system; identifying threats; evaluating and prioritizing risk; identifying and implementing measures to address risks; measuring performance; monitoring results and evaluating effectiveness; making periodic evaluations and improvements; and reporting results. Duke Energy Kentucky is to identify and implement risk reduction strategies with an emphasis on an effective leak management program and "enhanced" damage prevention program.

F. DUKE ENERGY KENTUCKY'S AMRP

Q. PLEASE PROVIDE AN OVERVIEW OF THE AMRP.

A. Duke Energy Kentucky instituted the AMRP in 2000 to accelerate its replacement rate of cast iron and bare steel mains in order to improve the safety and reliability of its natural gas distribution system.

When Duke Energy Kentucky adopted this program, some of its cast iron pipe in service dated back to 1887 and some of its bare steel pipe in service dated back to 1906. Cast iron and bare steel pipe, however, are more prone to leaks than plastic and coated, cathodically protected steel which are now the material of choice for main construction throughout the United States. In 1971, the U.S. Department of Transportation adopted regulations removing cast iron from its list of approved materials for new pipe construction.

Duke Energy Kentucky adopted formal cast iron and bare steel main replacement programs in 1988 and 1989, respectively. An in-house developed program was used in conjunction with two commercially available programs, known respectively as CIMOS® and BSMOS®, respectively. These programs identified certain factors associated with cast iron and bare steel main activities, such as year installed, operating pressure, length of pipe and number of prior activities. The programs then developed a ranking system that Duke Energy

Kentucky used to determine which sections of cast iron and bare steel main to replace. The in-house program is still being used to target these types of pipe replacement projects.

Under the CIMOS® and BSMOS® programs, Duke Energy Kentucky was replacing the cast iron and bare steel mains at a replacement rate that would have taken approximately 50 years to complete. By that time, the mains that Duke Energy Kentucky would have been replacing would have been over 150 years old.

Duke Energy Kentucky performed a detailed review of its own operation and maintenance practices, including the leak rates for the different types of pipe materials. The Company also retained Stone & Webster in 2000 to independently review the background, operation and maintenance of Duke Energy Kentucky's cast iron and bare steel mains, including the Company's CIMOS® and BSMOS® programs, as well as the proposed AMRP.

Stone & Webster's ultimate recommendation was that Duke Energy Kentucky should "become much more aggressive in replacing both cast iron and bare steel mains for safety and risk considerations." Stone & Webster based this conclusion on the leak rates for the various types of pipe and on Duke Energy Kentucky's then-existing rate of cast iron and bare steel main replacement.

Q. DID DUKE ENERGY KENTUCKY ADOPT THE AMRP?

A. Yes, as I mentioned previously, Duke Energy Kentucky started the AMRP in 2000. The Commission approved a tracking mechanism known as Rider AMRP in its January 31, 2002, order in Case No. 2001-00092, which permitted Duke Energy Kentucky to timely recover the costs related to the AMRP.

Q. HOW DOES DUKE ENERGY KENTUCKY PLAN FOR CAST IRON AND BARE STEEL MAIN REPLACEMENT UNDER THE AMRP?

A. The AMRP is designed to replace the cast iron and bare steel in the system that is 12-inches in diameter or smaller. For larger diameters, the pipe is either coated, protected steel or contains only a small amount of cast iron and bare steel. The hubs on most of the larger diameter cast iron pipe have been repaired and the pipe is in an acceptable condition. These pipes will be monitored and replaced if necessary in conjunction with other improvement projects.

The AMRP consist of four types of projects: Modules, CIMOS®, BSMOS® and Street Improvements. The Module work encompasses two- to five-mile replacement segments and is a proactive program to replace cast iron and bare steel. CIMOS® and BSMOS® work is a responsive program to replace the cast iron and bare steel in the system with the highest possibility of developing future incidents and leaks. Street Improvement work involves replacing cast iron and bare steel pipe as a result of projects initiated by governmental entities.

Q. PLEASE DISCUSS THE RESULTS OF THE AMRP TO DATE.

A. The AMRP has been quite successful in allowing Duke Energy Kentucky to reduce the amount of cast iron and bare steel mains in its distribution system. This has resulted in substantial benefits to the Company's customers and to the public at large.

Duke Energy Kentucky's gas distribution system consists of approximately 1,345 miles of distribution mains. As of December 31, 2008, Duke Energy Kentucky has replaced approximately 172 miles of cast iron and bare steel mains. Duke Energy Kentucky estimates that it has 31 remaining miles of cast iron and bare steel mains. Duke Energy Kentucky will complete its AMRP installations in 2010 on schedule as submitted originally in 2000. In addition, the program is projected to be completed on budget as submitted originally in 2000 using the Handy-Whitman index converting the annual spend to 2000 dollars excluding the cost associated with camera inspections. The procedure for installing facilities changed in 2006 and the cost associated with camera inspections was not submitted as part of the original estimate.

Customers and the public at large benefit from the improved safety and reliability of Duke Energy Kentucky's natural gas distribution service. One key safety measure of the AMRP's success is the leak rate for Duke Energy Kentucky's gas distribution system. The incidence of leaks repaired has decreased 34% from a peak in 2002 to 2008.

This reduced incidence of leaks has caused Duke Energy Kentucky's Account 887 "Maintenance of Mains" expense to decline from approximately $1.5 million in 1999 to $585,000 in 2008. These maintenance savings were returned to customers through the Rider AMRP tracking mechanism while it was active.

Q. WILL DUKE ENERGY KENTUCKY COMPLETE THE AMRP PROGRAM ON SCHEDULE?

A. Yes. Duke Energy Kentucky will complete its AMRP installation in 2010, which is within the forecasted test year in this proceeding. The program will be complete and all plant will be in service and considered used and useful. And therefore, re-approval of the AMRP Rider is not necessary.

Despite the suspension of Rider AMRP, Duke Energy Kentucky has efficiently executed the program. Prior to suspension, Duke Energy Kentucky's annual Rider AMRP filings included the necessary cost information to allow the Commission to process these cases efficiently. Additionally, Duke Energy Kentucky operated the program such that it is on schedule. Duke Energy Kentucky maintained a replacement rate that allowed it to complete the program by 2010, as originally anticipated. Additionally, Duke Energy Kentucky has efficiently managed the program by awarding the construction contracts for the AMRP through an annual bidding process. This has allowed Duke Energy Kentucky to reduce the program costs. I previously discussed the customer benefits resulting from the AMRP. Duke Energy Kentucky therefore requests that the Commission allow Duke Energy Kentucky to eliminate Rider AMRP and that the plant installed since the Company's last gas rate case and through the test year in this proceeding be placed into rate base to allow for recovery of the remaining capital expenditures associated with the AMRP

G. OTHER MAJOR INFRASTRUCTURE INVESTMENTS

Q. SINCE THE COMPANY'S LAST GENERAL RATE CASE, HAS DUKE ENERGY KENTUCKY MADE ANY MAJOR INVESTMENTS IN INFRASTRUCTURE BESIDES THE AMRP?

A. Yes. In 2007 Duke Energy Kentucky installed a feederline bypass around Walton, Kentucky. This pipeline is a 2.2 mile six-inch diameter, protected steel pipeline. The pipeline was constructed cross country to bypass Walton which provided a 75 mile loop for the Kentucky system beginning at AM7 in Latonia and ending at the Erlanger Gas Plant. Customers benefitted from this projected inasmuch as it enhanced system integrity by providing pressures to the southern locations of the system and providing duel feeds around the system.

H. SAFETY AND RELIABILITY PERFORMANCE

Q. HOW HAS GAS OPERATIONS PERFORMED ON ITS MAJOR SAFETY AND RELIABILITY MEASURES?

A. Gas Operations' major safety and reliability measures are leaks repaired for its gas distribution system and the duration of customer outages. Duke Energy Kentucky's leak repairs have declined significantly, from a peak in 2002 to a 26% reduction in 2004, 33% in 2005, 47% in 2006, and 40% in 2007 compared to 2002 as a direct result of the AMRP.

Currently, the most accepted reliability standard utilized within the gas industry is Outages per 1,000 Customers. In an AGA Benchmarking Study on Outages per 1,000 Customers during 2007, Duke Energy's Gas Operations was in the first quartile for U.S. companies participating in the study.

Q. HAS THE COMPANY EFFICIENTLY AND COST EFFECTIVELY MANAGED ITS GAS OPERATIONS BUSINESS?

A. Yes. Duke Energy Kentucky has aggressively investigated and implemented where justified, new products, technologies, and work methods to increase its productivity. Duke Energy Kentucky also participates in the AGA's Best Practices Benchmarking Program. In this program, approximately 80 United States and Canadian gas utilities routinely benchmark five operations each year. Duke Energy Kentucky has implemented process improvements and utilized new technology, materials and equipment as a result of what it has learned through participating in this program. Similarly, Duke Energy Kentucky shares its practices with the other participating members of the AGA and, in 1999, was recognized by its peers for "Best Practice for Leak Survey."

In 2007, Duke Energy was selected to present at the AGA's 2007 Distribution Best Practices Roundtable for Leak Management, based on Duke Energy's top quartile performance in repairing leaks in 2006. Also, Duke Energy was selected to present at the AGA's 2007 Safety Summit based on the constructions practices for mitigating sewer issues when using trenchless technology. In addition, Duke Energy Kentucky participates in a Peer Panel benchmarking conducted by Public Service Gas & Electric of New Jersey and has participated in a best practices exchange with Washington Gas, Baltimore Gas & Electric and Citizens Gas.

IV. OPERATIONS AND MAINTENANCE BUDGET

Q. PLEASE DISCUSS HOW DUKE ENERGY KENTUCKY'S RESPONSIBILITY BUDGET WAS PREPARED FOR USE IN THE COMPANY'S FORECASTED TEST PERIOD DATA.

A. The responsibility budget is prepared by Gas Operations. Gas Operations prepares a detailed monthly budget every year for Operations and Maintenance

(O&M) costs. Duke Energy Kentucky reviews every aspect of Gas Operations' O&M activities by individual Federal Energy Regulatory Commission (FERC) account. The Company performs a historical analysis of the O&M accounts and uses this as a starting point. The Company analyzes whether any unusual conditions caused any category of O&M costs to be higher than normal and adjusts estimates accordingly. Gas Operations also analyzes whether there are any new O&M activities that will occur in future years that are not reflected in previous years' costs. For example, the Legacy Camera inspections discussed in my testimony is a program Duke Energy Kentucky developed that will involve significant new O&M costs. For such programs, we estimate the costs required for that particular new O&M activity for the budget period, and we adjust our estimate of O&M costs accordingly. We prepared these detailed estimates of O&M costs for the 2009 annual budget, which served to provide the last six months of the base period in this proceeding. The results were then given to Mr. Lee for use in the preparation of the financial forecasts for the base period and the forecasted test period.

V. <u>CAPITAL EXPENDITURE BUDGET PROCESS</u>

Q. PLEASE GENERALLY DESCRIBE THE PROCESS FOLLOWED TO DEVELOP DUKE ENRGY KENTUCKY'S GAS OPERATIONS CAPITAL BUDGET FOR THE NEXT FIVE YEARS.

A. The capital budget consists of three major categories: Blanket Projects, Specific Projects and the module portion of the AMRP. We use different methods to forecast the capital expenditures for each type of construction work.

Blanket Projects consist of load growth projects, equipment replacement projects, government mandated projects and capital expenditures associated with capital tools and building upgrades. Load growth projects involve new main installations related to general growth in Duke Energy Kentucky's customer load. Government mandated projects consist of street improvement projects and other construction projects Duke Energy Kentucky is required to undertake by permit.

We develop the blanket capital expenditure budget for these projects through a qualitative review of historical data. We compare the previous three-year average installation footage to the historical trend to determine whether any unusual factors existed during any year for the historical data, such that the data for that year should be discounted or a forecasted footage for the current year should be used. We then prepare a three-year average cost. The average cost is multiplied by the projected footage to develop the budget. We use specific cost projections related to a particular project, to the extent that such information is available. For example, government entities notify us about many street improvement projects well in advance, and we prepare the capital budget for these items by incorporating the projected cost for the known parameters of these projects.

Specific Projects are larger projects that Duke Energy Kentucky can identify in advance which are needed to maintain system integrity, or are initiated by governmental entities for public improvements. System integrity projects are projected by computer modeling when areas of the distribution system have deficient minimum pressure levels. We budget for Specific Projects based on engineering cost estimating methods for labor and material costs, based on the known scope for each project. The costs are generated by historical costing data based on past projects and adjusting to current resource and material trends.

The module portion of the AMRP is a proactive program to replace the cast iron and bare steel in the system that is twelve-inches in diameter or less. We use a rating system to select mains for replacement based on the likelihood of future incidents and based on a ten-year schedule for completing the AMRP. We prepare the budget for the module projects by using average unit prices to complete the AMRP program on a ten-year schedule.

We prepare a five-year forecast for these capital expenditures, including retirements, each year. This information is used for the annual budget and the five-year forecasts discussed by Mr. Lee. Gas Operations is responsible for preparing the capital expenditures budget (except for gas meters, information technology and corporate initiatives) used by Mr. Lee to develop the forecasted test period financial data. I am also responsible for preparing the capital expenditure budget (except for gas meters, information technology and corporate initiatives) for 2009, 2010 and 2011. I do not apply future loadings for construction overhead costs when developing the capital budget. Instead, these loadings are added after I supply the capital expenditures, in the course of preparing the Gas Operations' budget.

VI. SCHEDULES SPONSORED BY WITNESS

Q. WHAT PORTIONS OF THE COMPANY'S FILING REQUIREMENTS 10(9)(d) AND 10(9)(h)(8) DO YOU SPONSOR?

A. I sponsor the O&M information used in filing requirement (FR) 10(9)(d), which is the annual and monthly budget for the twelve months preceding the filing date, and the monthly budget detail used in the preparation of the base and the forecasted test period. I also sponsor the information on mix of gas supply and the purchased gas expense in FR 10(9)(h)(8) and supplied it to Mr. Lee.

Q. HOW WAS THE MIX OF GAS SUPPLY AND PURCHASED GAS EXPENSE DETERMINED FOR BUDGETING PURPOSES?

A. Duke Energy Kentucky meets its natural gas supply requirements through natural gas purchases, withdrawals from interstate pipeline storage, and output from its Erlanger Propane/Air Plant. Forecasted storage withdrawals are determined based on the pipeline tariff requirements regarding minimum and maximum monthly withdrawal rights, seasonal storage balance requirements and historic withdrawal rates. Propane/air utilization is forecasted based on historic averages. All remaining forecasted natural gas requirements are met with purchases. Assuming normal weather, purchases make up 89.9% of annual gas supply, storage withdrawals 9.9% and propane/air 0.2%. The purchased gas expense was determined by applying the projected cost for these components.

Q. PLEASE DESCRIBE SCHEDULE B-4.1.

A. Schedule B-4.1 is a list of projects that have a budget estimate in excess of $100,000 that are projected in Construction Work in Progress (CWIP) as of January 31, 2011. This schedule presents the percent complete for each project as of January 31, 2011, based on both elapsed time and total expenditures. For the projects on lines 1 and 2, the amount in column H is not the CWIP balance at

January 31, 2011. Portions of these projects will have been placed in service during the year but there will be a balance in CWIP at that date.

Q. PLEASE EXPLAIN FR 10(9)(b).

A. FR 10(9)(b) provides the budget for Duke Energy Kentucky's gas capital expenditures for 2009, 2010 and 2011. I provided the underlying information for this filing requirement to Mr. Lee, using the methodology I discussed earlier in my testimony. Mr. Lee used this information to prepare Duke Energy Kentucky's forecasted test period financial data.

Q. PLEASE EXPLAIN FR 10(9)(f).

A. FR 10(9)(f) requires the applicant to list all major construction projects, defined as projects five percent or more of the annual construction budget within the three-year forecast. Although Duke Energy Kentucky does not have any individual projects meeting this criterion, projects have been grouped by category and these categories are listed on FR 10(9)(f).

Q. PLEASE EXPLAIN FR 10(9)(g).

A. FR 10(9)(g) requires the applicant to list certain cost information, in aggregate form, for all other construction projects not listed on FR 10(9)(f) within the three-year forecast. I prepared this information for these projects, using the methodology I discussed earlier in my testimony for preparing the Gas Operations capital expenditure budget.

VII. CONCLUSION

Q. WERE SCHEDULES B-4.1, (FR) 10(9)(d), (FR) 10(9)(h)(8) (FR) 10(9)(b), FR 10(9)(f) AND FR 10(9)(g) OBTAINED OR PREPARED BY YOU OR UNDER YOUR DIRECTION AND CONTROL?

A. Yes.

Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?

A. Yes.

VERIFICATION

State of Ohio)
)
County of Hamilton)

The undersigned, Gary J. Hebbeler, being duly sworn, deposes and says that he is General Manager, Gas Engineering for Duke Energy Business Services, Inc., and he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.

Gary J. Hebbeler
Gary J. Hebbeler, Affiant

Subscribed and sworn to before me by Gary J. Hebbeler on this 15th day of June, 2009.

Anita M. Schafer
NOTARY PUBLIC

My Commission Expires:

NOTARY PUBLIC STATE OF OHIO

ANITA M. SCH...
Notary Public, State ...
My Commission Ex...
November 4, 20...

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