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Executive Director Robert Gruber
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Subject: Need for your action regarding Duke Energy's "catch us if you can" approach to rate cases

Dear Gentlemen,

NC WARN's review of documents from Duke Energy Carolinas' 2009 and 2011 rate cases indicates a troubling pattern of recurring errors or deliberate actions that are likely reaping undue profits for Duke by effectively overcharging North Carolina electricity customers many millions of dollars annually.

North Carolina law (G.S. 62-133) authorizes the NC Utilities Commission to set electric rates that include the utility's "reasonable operating expenses." It is the responsibility of the Commission to ensure that customers pay only Duke's "reasonable operating expenses." In every rate case, Duke submits thousands of pages of evidence which supposedly documents the total "reasonable operating expenses" to be charged to NC customers.

In 2009 and 2011, Duke attempted – apparently with some success that no one can quantify – to improperly add many unallowable operating expense predictions into electricity rates. Many expenses discovered and rejected by the N.C. Utilities Commission's Public Staff during its limited review in 2009 were again included by Duke in 2011.

We are concerned that this is a systemic and multi-faceted problem. There is a deeply inadequate system to prevent Duke from overstating operating expenses; there is no potential penalty when Duke does get caught overstating expenses, and; resource constraints and time limitations leave the Public Staff pressured to settle rate cases instead of fully examining and challenging Duke's overcharges – or allowing other parties to do so – during open, evidentiary hearings.

Based on our review and complaints by the Public Staff, it appears that Duke has created an accounting scheme that makes entire sections of the rate case record unintelligible and untraceable for the Public Staff and other interveners. Furthermore, it appears that regulatory practices in various states provide for little if any oversight to prevent Duke from charging ratepayers in other states for the very same expense items it is charging NC customers.

All of this leaves Duke positioned to repeat the pattern of overcharging customers in the serial rate cases it plans to file, beginning this year, in both the Progress and Duke service areas in North Carolina. There seems to be only two possible explanations for the pattern of overstating expenses, particularly since Duke repeated many of the overcharges in both rate cases:

1. Either Duke Energy has suffered severe competency problems within its corporate accounting and legal departments for at least the past three years, or

2. Duke Energy is padding its profits by deliberately gouging ratepayers.

Operating expenses are very important because Duke is allowed to pass directly to customers 100 percent of these *predicted* expenses – not just a mark-up as it receives on investments such as power plants – and because there is no year-end reconciliation between predicted and actual operating expenses. Such a system provides a questionable incentive to control costs, and we are concerned by the potential for padding predicted expenses.

NC WARN once again expresses our concern that the Public Staff felt it had to settle the rate cases in 2009 and 2011, especially before even considering concerns of other intervening parties. Because part of the Public Staff's reason for settling seems to be to avoid protracted legal cases, and because they have been put by the Commission into the role of settling rate cases, the time has come for an open assessment of resource limitations and Commission deadlines in rate cases. We believe such discussions will support our call that the utilities should be required to fund a stronger budget for the Public Staff, and to fund a comprehensive third-party audit of operating expenses included in the 2009 and 2011 rates, along with all subsequent rate cases.

With upcoming rate increase requests by Duke Energy under both its Progress Energy Carolinas and Duke Energy Carolinas service companies, we seek your timely review and appropriate action regarding this indefensible situation.

"CATCH US IF YOU CAN"

NC WARN commends the Public Staff for catching a long list of inappropriate expenses in both rate cases. However, the strong probability exists that, because they were able to review only a small number of the thousands of pages amid a virtual mountain of complex accounting documentation, many more improper expenses would be found during a complete review; instead, those amounts have been included in customer rates.

In 2009 Duke settled for $180 million less than its initial request, and in 2011 it settled for $328 million less. The Commission's position seems to be that Duke's compromise on expense *totals* means the public is being protected. But with the number of egregious expense "errors" resulting from a relative handful of expense items that were reviewed, odds are that Duke is quite satisfied that it has successfully gamed the regulators. A full audit must be required of the thousands of unreviewed expense items in each rate case.

Duke executives seem to treat rate cases as contests: They include a vast (and heretofore unknown) number of unallowable expense items and a total request that is far higher than

allowable, while knowing the Public Staff will be unable to review more than the "limited number of invoices," as testified by Public Staff witness Peedin. Then Duke negotiates with the Public Staff and agrees to a compromise regarding various expense categories, which leaves Duke with millions of profit dollars it never should have requested or been allowed. The Public Staff is forced to yield because the Commission expects it to settle the case and avoid a protracted proceeding.

The compromise settlements add back millions of improper charges. So the more Duke initially pads the expenses, the more the Public Staff has to compromise and the more Duke gets to keep. In subsequent rate cases, Duke is likely to try this scheme again, knowing it will get to keep a large portion of each item following settlement negotiations. Thus, the overcharging is perpetuated.

While the Public Staff might correctly point out that its settlements with Duke in each rate case reduced Duke's initial expense request by many millions, it seems certain that Duke still gains millions in profits it did not deserve.

Such a "catch us if you can" system, where a utility knowingly exaggerates expenses – or through a degree of widespread incompetence that is difficult to imagine – meets neither the spirit nor intent of the laws that strictly prohibit such overcharging.

EVERYTHING BUT THE KITCHEN SINK

Duke's strategy appears to be to include so many expense items, buried amid thousands of pages of documents arranged in a manner difficult to track, that it is impossible for anyone to catch all the improper expenses. The nature of expense items caught by the Public Staff discredits any argument that differences with Duke are merely matters of interpretation, as evidenced by a look at just a few of the expense amounts rejected by the Public Staff in 2009 and 2011:

- $5 million for air travel on Duke's private fleet for political purposes and foreign trips in 2011 not involving NC activities;
- $16 million in 2009 for expenses resulting from Duke's 2006 merger with Cinergy that were explicitly required to be borne by Duke shareholders;
- $5 million in "outside service" including charges for "the Indiana investigation" into wrongdoing at the Edwardsport construction boondoggle that led to felony indictment of the lead regulator, and "numerous other matters" as noted by the Public Staff;
- $10 million in property taxes for property that is exempt from taxes;
- $2 million in unallowable lobbying expenses in 2009;
- $4 million in compensation to Duke executives in 2011, some serving in other states; as noted in pre-filed testimony by Public Staff witness Peedin, "It is not appropriate for Duke's ratepayers to compensate officers of affiliates that have little or nothing to do with the operations of Duke Energy Carolinas customers." (Duke attempted to charge NC for almost half the compensation of corporate officers of Duke Energy Ohio, Duke Energy Indiana and Duke Energy Kentucky);

- $3 million in 2009 for compensation to Duke executives whose functions are linked with meeting stockholder demands;
- $750,000 in storm clean-up expenses in 2011 that Duke did not incur,

After being caught including improper expenses in 2009, Duke attempted to include many of them again in 2011, as noted in the testimony by the Public Staff's lead accountant Peedin, including $10 million in Duke-Cinergy merger expenses and related severance packages.

The Cinergy merger expenses raise particular concern because in the Duke-Progress merger, the utilities originally planned to charge ratepayers hundreds of millions of dollars in similar expenses including employee severance. Even though Duke finally agreed that shareholders must bear those costs, Duke or Progress could attempt to place merger expenses into rates during upcoming rate cases after all – as in the Cinergy merger – and could wind up gaining at least partial recovery if a settlement is reached.

The Public Staff's chief accountant referred to "numerous inappropriate charges" within just one expense account, and said the "Public Staff is concerned that there may be a systematic problem with costs for outside services being improperly charged," while calling for an outside audit of that account. The settlement agreement, however, allowed Duke to conduct an in-house audit of the outside services account.

NOT EVEN A WRISTSLAP

NC WARN and other watchdog groups across the United States have long complained that many polluters deliberately skirt regulations by rationalizing internally that, if and when they get caught, the resulting penalty is a cost of doing business that is outmatched by the savings reaped by breaking the law over time.

For Duke Energy, however, there appears to be no downside in its gaming of the system by including unallowable expenses in rate cases. There is no penalty whatsoever. The only repercussion for getting caught inflating expenses is having to negotiate those items downward. Duke has every reason to continue including expenses of other companies or otherwise clearly disallowable or unreasonable expenses because, the higher Duke's initial demand for a rate increase, the higher the final compromise Duke will likely secure. Moreover, repeatedly making the same errors or deliberately claiming the same types of unallowable expenses consumes the Public Staff's time and makes the Public Staff less able to verify that Duke's overall operating expenses of almost $4 billion are "reasonable" as required by law.

Such impunity leaves Duke's primary calculation to be how high to make the initial rate hike request without causing massive public outrage.

OUR REQUESTS

1. We ask that you join NC WARN in requesting the Commission to order a comprehensive, third-party audit of total, overall operating expenses filed by Duke Energy Carolinas as filed in the 2009 and 2011 rate cases, to be paid for by Duke shareholders, and for refunds to the extent the public was overcharged.

2. We ask that you support a requirement that comprehensive, third-party audits of all operating expenses, to be paid for by the applicant, in all subsequent rate cases in North

Carolina, as part of the general proceeding. Not only would this protect ratepayers, it would relieve the Public Staff of being placed in an unfair and "outgunned" position that serves the interest of the utilities to the great disadvantage of the public. In addition, independent audits would likely force the utilities to reduce the number of unallowable expenses in forthcoming rate cases.

3. We urge the Public Staff not to settle any issues in future rate cases until third-party audits of predicted operating expenses are completed.

4. If, as seems apparent, there is no penalty or good-faith requirement to keep Duke from submitting expenses that are clearly improper and thereby increase pressure on the Public Staff to settle for an unduly high rate increase, we ask that the Attorney General and Public Staff work together to institute a strict penalty.

5. We request that the Attorney General's office and Public Staff clarify who has jurisdiction over potential "double-dipping" of expenses in states where Duke Energy operates, and whether any regulators in Duke's states monitor filings in other states to eliminate double-dipping.

We appreciate that Mr. Gruber and his staff have discussed and corresponded with us several times on these matters, but now believe Mr. Cooper's office must become involved. Therefore, we request a meeting with both of you at your earliest convenience.

We look forward to any clarification of our understanding of the facts, interpretation of events, or your thoughts and plans for the two upcoming rate cases.

I look forward to your earliest possible reply, and would be happy to meet with you on this matter.

Sincerely,

Jim Warren
Executive Director