PLACE: Dobbs Building, Raleigh, North Carolina

DATE: Monday, March 23, 2009

DOCKET NO.: E-7, Sub 856

TIME IN SESSION: 2:00 P.M. - 4:23 P.M.

BEFORE: Commissioner Lorinzo L. Joyner, Presiding
Chairman Edward S. Finley, Jr.
Commissioner Robert V. Owens, Jr.
Commissioner Howard N. Lee
Commissioner William T. Culpepper, III

IN THE MATTER OF:

Duke Energy Carolinas, LLC: Application for Approval of a Solar Photovoltaic Distributed Generation Program and for Approval of the Proposed Method of Recovery of Associated Costs

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P R O C E E D I N G S

COMMISSIONER JOYNER: Good afternoon. We're ready to come on the record. I am Commissioner Lorinzo Joyner and with me today are Chairman Edward S. Finley, Jr. and Commissioners Robert V. Owens, Jr., Howard N. Lee and Commissioner William T. Culpepper, III.

I now call for hearing, for further hearing Docket No. E-7, Sub 856, which is an application by Duke Energy for approval of solar photovoltaic distributed generation program.

On June 6, 2008, Duke Energy filed an application for a certificate of public convenience and necessity in this docket. The matter was heard on October 23, 2008, and the Commission issued its Order Granting Certificate of Public Convenience and Necessity with Conditions, I believe, on December 31st, 2008.

On January 29, 2009, Duke filed a motion for reconsideration along with the affidavit of Melisa B. Johns seeking expedited reconsideration of the Commission's December 31st Order. On February 2, 2009, the Commission issued an Order allowing briefs on the motion for reconsideration and scheduling an oral argument.

On February 10, 2009, the Attorney General filed a motion to reschedule the oral argument and to extend the filing date for briefs. By Order dated February 13, 2009, the Commission granted the motion and rescheduled the oral argument to this time and at this place.

On March 4, 2009, briefs were filed by Duke Energy, the Attorney General, the North Carolina Sustainable Energy Association, The Solar Alliance and the Southern Alliance for Clean Energy. On that date the Public Staff filed its initial brief with a proposed revised order granting certificate of public convenience and necessity with conditions.

On March 18, 2009, reply briefs were filed by Duke Energy, the Public Staff and the North Carolina Sustainable Energy Association. Attached to Duke's reply brief was a revised proposed order granting certificate with conditions.

Finally, on March 18, 2009, Carolina Utility Customers Association, Inc., filed a letter in lieu of reply brief in response to Duke's motion for reconsideration.

In compliance with the requirements of Chapter 138A of the State Government Ethics Act, I remind all members of the Commission of their responsibility to avoid conflicts of interest and inquire now whether any member has a conflict of interest with respect to the matter before us this afternoon?

(No Response.)

Let the record reflect that no such conflict has been identified. We'll now have appearances of counsel, beginning with counsel for Duke.

MR. KAYLOR: Thank you, Madam Chair, members of the Commission. Robert Kaylor appearing on behalf of Duke Energy Carolinas.

MS. NICHOLS: Lara Nichols also appearing on behalf of Duke Energy Carolinas. And with me today is Jim Warren of the law firm of Winston & Strawn. Mr. Warren has been admitted pro hac vice for the purposes of this hearing. And I just wanted to tell you a little bit about him because he will be arguing the tax normalization argument that's raised by the Company.

Mr. Warren has an LL.M. and also is a CPA. His practice specializes in the legal accounting and regulatory aspects of utility taxation. He represents clients before the IRS and also has served as expert tax witness in proceedings before 15 different states, public utility commissions and FERC, and specifically has assisted utilities and their commissions, their regulating commissions in addressing tax normalization issues, most recently in Oregon and Connecticut.

COMMISSIONER JOYNER: Thank you. Nice to have you with us today, Mr. Warren. Intervenors?

MS. COMPTON: Sarah Compton on behalf of The Solar Alliance.

MR. GREEN: Good afternoon. I'm Len Green with the North Carolina Attorney General's office appearing on behalf of the consumers.

MR. GILLAM: Bob Gillam with the Legal Division of the Public Staff appearing on behalf of the Using and Consuming Public.

COMMISSIONER JOYNER: Thank you. Ladies and gentlemen, prior to convening this docket, at a conference at the bench it was agreed that, I believe, the Attorney General and the Public Staff were the only intervenors who wished to be heard this afternoon and that you would do so in that order. We are here on Duke's motion for reconsideration, so they of course will have the first and last word.

Are there any preliminary matters that we need to address before hearing from Duke?

(No Response.)

There appearing to be none, we'll hear from you two, Mr. Warren or Ms. Nichols, in whichever order works for you.

MS. NICHOLS: Mr. Warren will go first with the tax argument and then I'll follow with the remainder of the Company's argument.

MR. WARREN: Thank you, Commissioners. I'm going to start off by spending a little time speaking about the investment tax credit normalization rules and the implications of those rules for our -- the situation in which we all find ourselves now.

I'm not going to spend a lot of time revisiting the history of the normalization rules or all of the mechanics of the normalization rules. The briefs speak to that in some substantial detail. And I don't believe that there really is any disagreement about what these rules are, what they say or importantly that the cost of violating them is likely to increase the Company's revenue requirement by somewhere in the order of $300 million.

It is probably a -- let me provide a quick example, which is probably grossly oversimplified, but will make the point. To assume that a company, a regulated utility places in service a thousand dollar asset and is able to clean with respect to that asset a $100 tax credit. Assuming that that asset is depreciated for regulatory purposes over ten years, the normalization rules limit the benefit that can be passed through to customers to a $10 reduction in tax expense each year for the ten years. That's the limit.

Now, one can look at that and say, well, if you compare the first-year benefit that can be passed through to customers, the $10, to the total amount of the benefit, $100, that there is a cost associated with being subject to the investment tax credit normalization rules. And that cost in year one would be $90.

If the regulators that are setting rates for that company were to disallow $90 of tax expense, the effect of doing that would be to place the company from a revenue requirement perspective in the same position they would be in had they flowed through the entire $100 of credit.

Now, I go through this mechanic, the simplified mechanic just to demonstrate that the disallowance of a normalization compliance cost, which is the $90, clearly is the same as a -- well, it constitutes a violation of those rules. You've done what the normalization rules say you can't do, you've provided customers with more than the $10 benefit, which is the limit that the normalization rules permit.

If instead of disallowing $90, you were

disallowed even just another $5, the effect would not be that you flowed through the entire $100 of benefit, but you still would have flowed through more than the $10 that the normalization rules permit you to flow through. This is sort of a long-handed way of saying that disallowance of a normalization compliance cost represents a violation of the underlying normalization rules.

And whether you flow through or you disallow the $90 or the $5, if in either case you have a violation of those rules, the entire $300 million penalty applies. It's not scalable; it is -- there is no sense of relationship between the sin and the punishment if you assume there is only one punishment.

So disallowing the cost of normalization compliance is really not an option as far as the Company is concerned. And if there is a possibility that the normalization compliance cost would be disallowed, then the Company really can't proceed with its program.

Now, in the context in which we find ourselves now, it is clouded to some extent by some -- what I'll refer to as extraneous material. Not extraneous to the program, but it's extraneous to the normalization analysis. And what I'm talking about are other costs like distributed generation, any costs that could be attributed to the acquisition of additional important knowledge base of various types and some other what I'll refer to as broader benefits that are embedded in the program, but really have nothing to do with the normalization analysis. They just complicate the arguments. And I think that what I would like to do is present you with a clean -- what I'll refer to as a clean hypothetical that will strip those out and demonstrate where we are and where we need to go.

To do this, I would ask you to assume that we have a nonregulated solar provider who has agreed to construct a 10-megawatt facility. And let's assume that it's a centralized photovoltaic facility. And let's -- so -- and let's further assume that there is no O&M because that really complicates things too a little bit. So all we have are equipment costs. We have the solar provider that is expending funds to purchase sufficient equipment to construct a 10-megawatt non-distributed generation centralized photovoltaic facility. And it gets in its cost, its price, it's willing to sell -- commit to a contract to sell at X dollars a megawatt hour. Doesn't matter what X dollars is, but it's just at a specified price.

Now, we know a couple of things about this provider. Number one, it's not a regulated utility. So we know that it is not subject to the tax normalization rules. But there's more that we don't know about this provider. We don't know what tax benefits it thinks it's flowing through that's been incorporated in its bid of X dollars. It may flow through everything; it may flow through nothing. We have no way of knowing. We don't know what its return, its equity return is that's built into its bid. We don't know if it's one percent; we don't know if it's 20 percent. We have no way of knowing.

We don't even know if that nonregulated bidder has decided to buy the contract it wants to make -- it wants to get into the business and has agreed to sell solar power at a loss. We have no way of knowing that. All we know is that it offered a bid at X dollars per megawatt hour.

Now, let's flip over and look at a utility that would do the same thing. We have a utility, regulated utility that will pay precisely the same price for precisely the same equipment to produce precisely the same quantity of electricity. But this utility has to earn a regulated return. It must comply with the normalization rules. It will have a -- an assigned depreciable life associated with its assets. And let's assume having considered all those variables it needs to charge 1.5 times X. So one and a half times X it needs to charge. And that is -- actually represents the least it can charge. It can't do anything differently. That's what it has to charge.

Now, if that utility is granted a CPCN with the proviso that only X dollars of its costs is the prudent and reasonable cost of providing solar, then it's -- it should be confused, and I think it is.

If further the regulator were to designate the extra half of X to include the cost of normalization compliance, and we know that a disallowance of normalization compliance costs is a significant normalization problem, then the question becomes should the company bet $300 million on the probable recovery of that .5 X dollars in a subsequent proceeding or not. Well, that's essentially where the Company finds itself at this point.

Now, the Public Staff offers a solution, its solution or its proposed solution to this quandary. And what it suggests is that we change some labels. Instead of the one-half X -- going back to the example. Instead of the one-half X including normalization compliance costs, we'll take back that language that said that and we'll say that we really didn't mean that. What we'll do instead is we'll take our plant costs, those costs of the photovoltaic panels, and we will divvy them up two-thirds going to the X portion and one-third going to the half X -- the half X portion, if you recall the example.

So we can at that point take the half X portion, which I'll refer to as kind of the noncritical solar plant; that there's the critical solar plant for the one X and the non-critical for the half X. We can then disallow a portion or all of the noncritical solar plant without creating the normalization problem.

Now, let's talk for a second about -- of plant disallowances. We know you can't disallow normalization compliance costs without creating a problem under the normalization rules. However, you can disallow plant costs without creating a normalization violation or problem so long as the tax benefits associated with the disallowed costs follow those costs. And I'll give you the simple example.

If you disallow $10 million of plant costs for whatever reason, imprudency, not used and useful, whatever the rational is, and if you assume that that $10 million of plant costs produced a million dollars of credit, then your shareholders absorb the $10 million of costs.

However, the normalization rules do require that the million dollars of credits that were generated by those costs also accompany the absorption. They actually since the -- since the shareholders absorbed the $10 million of disallowed costs, then they are entitled and must be entitled to the million dollars of credits that were generated by those costs. So basically you get -- whoever absorbs the cost gets the tax benefits. It's as simple as that.

Now, there was mention in the Public Staff's brief of the CP&L Harris Nuclear Plant disallowance as being a representation of a disallowed cost where there wasn't a normalization problem. And there wasn't a normalization problem and there shouldn't have been because it was a straight disallowed plant cost situation.

What you can't do is you can't disallow plant costs as a means to negate the impact of the normalization compliance costs. You can disallow plant costs, but you can't disallow them if the intent is merely to finesse the normalization rules.

CHAIRMAN FINLEY: Now, Mr. Warren, is that how you read this Order, that we are suggesting that there may be an imprudency disallowance because the choice Duke makes with the self-built generation rather than third-party generation is to finesse, not -- of disallowing taxes? Is that the way you read this Order?

MR. WARREN: No. What I'm referring to, I guess, right now is the Public Staff's proposal now. I mean, Duke really has no option but to comply with the normalization rules. And to the extent that the Commission disallows normalization compliance costs, you know, I think it's fairly direct the Commission has already identified those costs as being part of, if you will, the .5 X. They're in there under the existing Order. They're not -- they're not part of the base case, the 1X. They're the extra costs. They're considered the non-REPS, non-REPS recovery costs.

CHAIRMAN FINLEY: Now, where in the Order -- what are you pointing to in the Order that leads you to that conclusion exactly?

MR. WARREN: Well, because the -- excuse me for just a second.

CHAIRMAN FINLEY: Mr. Warren, the way I read the Commission's Order, and it is relatively simple, it is that Duke has two choices, potentially at least. It has the one choice, the Duke-built option and the price is dear. It has a second choice, the third-party option, and the price is cheap. And we're suggesting here that it needs to be careful because if it proves the expensive option rather than the cheap option, it runs a risk of an imprudency disallowance because of a choice it made. That's between the two options, one dear and one cheap, it picked the dear one.

And we don't really care, the way I read our Order, what composes Duke's costs, whether they be higher labor costs, higher materials costs, tax normalization, it's the bottom line that we're interested in and those are two comparisons that the Commission is drawing attention to. And it's saying if you make a wrong choice, you run the risk of being imprudent in that choice because you picked the cost that is higher than you could otherwise get and you're trying to pass that through to the ratepayer.

Do you read our Order differently than that?

MR. WARREN: Well, I would say that Duke can't produce electricity for any less money -- again, taking out the -- and this is why I'm trying to give you a clean -- a clean example. In that example, the utility can't produce that electricity for any less than 1.5 X. It can't do it.

Now, if what you're saying is then it's imprudent for it to try to do it, then that's a different issue and that goes to perhaps to whether the CPCN is appropriate or not. I mean, if it can't produce the electricity -- I mean, if you grant a certificate to construct a facility and then say but if you actually construct it you would be imprudent, that seems to be -- that's at the very least a mixed message and maybe needs to be clarified in terms of what you mean. But it seems to me that's what you're essentially saying.

CHAIRMAN FINLEY: Well, I think you can't really clean away all the other factors that we have here other than the tax implications. As I understand Duke's case, they're saying, well, Commission, those are apples and oranges and we have other benefits by self-generation that the third party can't provide and furthermore the third party is -- we can't determine -- our history with third parties is we can't depend on them; they miss their deadlines; we don't know whether they can get their financing and so what you're really talking about is apples and oranges here and so you can't really compare the dear price with the cheap price.

So even if we went with the expensive price, in the long run that's the best price because the two comparisons aren't fair; isn't that part of Duke's argument?

MR. WARREN: Well, part of Duke's argument is that there are -- there are -- there are these other differences, which is, again, why I tried to strip them out and give you a very simplistic example without all of those other differences.

But even if there were no other differences, we would still be in this situation where we have to determine if you want -- if you believe that Duke should be a participant in the provision of solar through its ownership of solar facilities, there are certain ratemaking consequences that come with that. And, you know, at this point --

CHAIRMAN FINLEY: Explain to me how this is different than the Carolina Power & Light Harris Plant. Carolina Power & Light built the Harris Plant. They took investment tax credits; they took accelerated depreciation; they built the plant; they took advantage of those credits and accelerated depreciation and they flowed them through rateably and afterwards when the plant was online they came in here for a prudency case and the Commission said, sorry, some of the decisions that you made, Carolina Power & Light, are imprudent and we're going to disallow part of those costs.

Well, if you looked at it on a prorated basis, if you looked at every dollar that was disallowed, you could say ten percent of each dollar was flowed through investment tax credits or tax normalization, but that's not really what -- but the imprudency was based on the decisions that the company made and there was no argument there that they ran afoul of the tax law.

MR. WARREN: But -- you're right, but the decisions that Duke made in that -- or Duke made. The decisions that Carolina Power & Light made related to the construction of the process. And the imprudency related to the consequences, the cost consequences of those decisions.

In Duke's situation, the consequences, compliance with the normalization rules, is not a decision that Duke made. And frankly it has no real practical choice in whether it attempts to comply with the normalization rules or not.

Merely being in a position where the tax law says you have to treat a credit in a certain way I don't believe is -- should be viewed as a choice that Duke made. It's subject to an evaluation for imprudency. It's -- again, the whole notion of prudency is there has to be choice and there isn't choice in this situation.

CHAIRMAN FINLEY: But are you telling me, Mr.

Warren, that if you've got the same -- let's -- if you had two plants exactly the same, one is Duke built and is twice as expensive as the third-party built plant and the reason that Duke's plant is twice as expensive is because Duke has to use tax normalization, then the Commission can't say, sorry, the choice that you made is imprudent because you picked the one that's twice as expensive and Duke says but I'm sorry, it's twice as expensive because we had to pay tax normalization and therefore you can't disallow anything for imprudency; is that what you're telling me?

MR. WARREN: No. You -- I think what has -- the choice in that instance that you would have a problem with is that Duke went ahead to build the thing in the first place knowing that it was subject to the tax normalization rules. Everybody knows that it's subject to the tax normalization rules. That's not a surprise to anybody and it's not a choice that Duke makes.

So, I mean, it may be a subtle difference, but the decision that would trigger your review shouldn't be whether you comply with the normalization rules or not. That's not an option. It's whether you go ahead with the program or not.

And the question is if they shouldn't be going ahead with the program, then what are the consequences of having been issued a certificate and knowing -- with the Commission knowing that they were subject to the normalization rules.

And even then, I mean, when you talk about whether a regulated utility should be -- should go ahead and do something even if it doesn't happen to be the cheapest right now, who knows whether it's going to in the long run be the cheapest option. There are lots of states who believed that up until the last few years that the market would drive generation costs down to the benefit of customers and that proved to be erroneous. That turned out that with a regulated plant you know what the cost is going to be, it's going to diminish over time, aside from fuel costs, but the plant costs are diminished over time, but if -- with the market, you never know.

CHAIRMAN FINLEY: And isn't that a pretty strong argument that Duke has made up until it filed its motion for reconsideration which was that, hey look, we're experienced in this; we build plants; we can put this on line; we can bring it on line within the time allowed; we're looking at some bids over here; we don't know anything much about the people who are filing these bids and so you can't compare this price that Duke is talking about to the price of this bid? Isn't that part of the argument?

MR. WARREN: Correct. That's right. I think that's right. But I think what the point is and the difference, the difference that matters between the Duke situation and the CP&L situation is the decision in the CP&L case related to the incurrence of nontax costs. The focus on the tax cost and the dis -- the potential disallowance only on normalization compliance that creates the problem in the Duke case.

Now, if we were writing on a clean slate and there was no -- and the record that exists did not exist and there were some question such as the question you raised would be appropriately addressed. And if it were decided that Duke's costs were too high -- well, the capital costs were too high -- I guess the answer is they -- it's really a question of going ahead with the project in the first place knowing that you're subject to all of these rules, including not only the normalization rules, but the requirement that you earn a return, that you use designated depreciation length, et cetera, none of which applies. I mean, the non-regulated companies are totally unfettered by any of that.

CHAIRMAN FINLEY: But if the fact that those unregulated companies are unfettered by these requirements and that gives them a substantial competitive benefit over the bottom line price that they can charge for this solar power, can't the Commission look at that and determine whether Duke was prudent to proceed and they went ahead for the solar power and the self-generated plant? Are we just to ignore that?

MR. WARREN: No. I think the Commission can consider that. I just don't think that the Commission -- that the tax law would permit the Commission to isolate the cost of normalization compliance as a cost that should be disallowable without invoking the penalties of the normalization provisions.

CHAIRMAN FINLEY: And where in our Order do we do that?

(Brief Pause.)

I tell you what, why don't you finish your argument. I didn't mean to --

MR. WARREN: Oh, okay.

CHAIRMAN FINLEY: And you all maybe can look at that while Mr. Gillam is talking.

MR. WARREN: Surely, surely. All right. Now, I guess where I was was something that was reemphasized I guess during our discussion, which was that you can disallow plant costs, you just can't disallow tax costs. And you can't put -- disallow plant costs as a way to get to the same position through to the end had you disallowed plant -- tax costs. You can't do indirectly what you can't do directly.

And that seems to me to be the thrust of Public Staff's proposal. And really that was what I was referring to is the Public Staff proposal to reconstitute, to rejigger (sic) the cost labeling. And if we were to apply the Public Staff's proposal to that -- again, that hypothetical with the X and the half X, I guess what we would do is we'd take two-thirds of the plant costs and associate them with the REPS rider piece and we'd take half -- excuse me, one-third of the plant costs and say those were the excess costs that we would subject to a prudency evaluation in a subsequent case.

Now, there are a couple of things wrong with that. Number one, it's not really logical in the sense that if you think about -- the simplified example, all of the plant -- all of the plant is required to produce the ten megawatts. So I'm not sure on what basis -- and you also paid -- the utility paid precisely the same amount for that plant as did the non-regulated company. So I don't know on what basis you would disallow one-third of the plant costs or any portion of it. It's precisely the same plant in either case and precisely the same cost in either case, so any disallowance logically has to -- can't really be related to plant. Something else has to be going on.

And in fact what is going on is it's a backdoor way of getting at the normalization impact. And so by disallowing what are extensively plant costs, and they are extensively plant costs because up until the Order was revised they weren't plant costs, but now they are, then after the new Order is issued, they become disallowable. But there's really no substance behind that.

If you look at the -- we have the same graphic that's embedded in the reply brief that might be helpful. Okay. So what we have is a graphic with four representations here. The first on the left, far left being the -- just a representation of the third lowest RFP. That's the 1X that I was talking about. And that included all of the costs associated with the nonregulated company bidding in for the provision of solar power.

The next depiction to the right, which is labeled "The Order," is our view of what the Order does. The Order takes those same costs and treats those as not at risk, the bottom square. Then it isolates costs that are at risk. And the not-at-risk piece is recoverable under the REPS rider.

And then above -- over and above that we have distributed generation costs, any other costs associated with the acquisition of these different elements of knowledge.

And the other broad -- broaden benefits. And those are not necessary or the Commission has determined them not necessary in acquiring the solar power. And then also included in that same category are the costs of normalization compliance.

So those two categories of costs are not recoverable through the REPS rider, but are subject to a subsequent proceeding in which the Company would try to make the case in a base rate proceeding that those would be recoverable.

Public Staff's proposal is depicted as the third item over. And what it does in our view is it moves some of the normalization costs down basically into the REP rider and moves some of the capital costs that were embedded in the REP rider piece above to the "at risk" portion.

There's only a certain quantity of costs that can be supported by the revenues that are produced in the

REP rider. So if you are moving some normalization costs into there, you have to be moving some capital costs out -- it's simple math -- so that we have the same amount of dollars in the REP rider and the same amount of dollars in the "at risk" category, it's just that we have relabeled them.

It is the -- when the Company looks at this, they say what's changed or have we magically transmuted ourself into a CP&L situation? We have precisely the same dollars in the REPS' portion of the diagram. We have precisely the same dollars in the at risk portion, the ones that are subject to a prudency evaluation and a base rate. No party as far as we can tell is better off than they were under the Order; no party is worse off than they were under the Order.

And ultimately in the Company's view we have rearranged the deck chairs, but we're still on the Titanic. There is no underlying economics to what's transpired here. And as a result, if some of the capital costs in the at risk portion are disallowed, we think that is a fairly -- it is not much of a leap to recognize that what's happened is that that disallowance has transpired in order to offset the implications of the normalization rules. That would be an indirect -- impermissible, indirect -- indirect reduction in cost of service, which the regulations and specifically those portions of the tax regulations that are cited in both the initial brief and the reply brief do not allow.

So what we did, the Company provided initially two solutions to this. The solutions being that all of the costs of the program be encompassed in the REPS rider recovery mechanism. The alternative being that all of the costs of the program be provided with assurance of eventual recovery. The premise being, and I think it's an indisputable premise, that if there's no risk of a disallowance, then there's no risk of a normalization violation. If we recover all our costs, there is no normalization problem.

In our reply brief we thought about it a little bit and identified a third possibility. And that is that the Commission incorporate into the Order, the new Order, a finding and an ordering provision in which it found and held that the normalization compliance costs are reasonable and prudent. And we don't think that's really very much of a stretch or shouldn't be very much of a stretch for a couple of reasons.

By avoiding a violation of the normalization rules, the Company pays the least possible tax that it can. If it does not violate the normalization rules, it -- in a perverse way it doesn't -- it saves on taxes. Obviously if it violates, it pays taxes. It pays a lot of taxes.

And I guess if the Company were to knowingly violate the normalization rules and trigger all of the adverse consequences associated with violating the normalization rules and then were to come to the Commission and ask for recovery of those tax costs, no doubt the Commission would deny recovery and hold that it would be imprudent for the Company to knowingly violate the normalization rules. If that's so, then it seems to me that it follows logically that compliance with the normalization rules must be prudent and reasonable, just as compliance with all other aspects of the tax law should be inherently reasonable and prudent.

If the -- if a new order provides for the prudency and reasonableness of compliance with the normalization rules, whatever those are, whatever those costs are, then the Company's view that we will have -- we will have avoided a problem under the normalization rules. And then the costs that will be at issue, remain at risk, will be these broader costs, the cost of distributed generation, knowledge acquisition, et cetera, the ones that make this program different. And the Company can then make its case that those differences are worth the incremental revenues that are required to support it.

Okay. With regard to, Commissioner, your question about the Order. Yeah, I think -- we would turn to Page 15 of the Order. And it's the second full paragraph where it says, "Duke asserts, through the testimony of witness McManeus, that its federal tax normalization obligations provide a valid justification to the high cost of the program. The Commission disagrees. If the federal tax code treats self-generation of solar energy by a public utility less favorably than the purchase of solar energy from a third party, then prudence points in the direction of not self-generating, but instead purchasing the needed solar energy." And I think that's what you were getting to.

CHAIRMAN FINLEY: But to me that is saying that the choice that Duke makes in picking self-generation as opposed to third-party generation may be imprudent unless there are other reasons for doing so because the price is higher than the alternative, not to indirectly cause you to lose your tax normalization.

It just so happens that one of the factors that causes Duke's price to be higher than the hypothetical third-party price is tax requirements that it must follow. The outcome would be the same if it were labor costs, if it were materials costs or any costs. It's the bottom line that gets Duke in trouble in the hypothetical because the price of their alternative is higher than the price of the third party.

And the disallowance is due to the choice it makes. And there's no intent here to cause you to indirectly pass through more tax benefits to the customer than you would in another situation. The intent is not to cause you to violate tax laws.

MR. WARREN: I understand. But the problem is the tax law restricts the Company's options. It has no choice. It's not as though it could buy or not buy a piece of equipment or employ labor or not employ labor or employ labor at different costs. It must comply with the normalization rules. And under the tax law -- whereas you can disallow an excess of labor costs or an excess of equipment costs without a normalization problem, under the tax laws you can't disallow a tax cost without creating this whole problem.

And I understand your perspective, but the normalization rules are, you know, pretty much what they are. They don't give you the flexibility to do other than follow the regulatory format.

CHAIRMAN FINLEY: And I understand your perspective, too. But let me ask you this. This issue of the tax normalization was raised in the testimony; it was raised in the Public Staff's proposed order. Why are we hearing about this now after the Order has been issued? Did it not occur to anybody that this risks all these tax disallowances?

MS. NICHOLS: I can answer that. At the time that the Company was proceeding with its case, originally when it filed the application, it was not eligible for these tax credits. And so in the course of the proceeding the law was changed and the Company reran its numbers for purposes of determining what its rebuttal testimony would be and was responding to discovery and doing all this and it was very fluid.

And so in the process of going through and determining -- we truly thought once we were eligible for this tax credit our numbers really should come down and be very close in line with those bid prices. And we determined that they were not because of these normalization issues.

In our mind if the Commission does indeed think it's appropriate for Duke to self-generate, these should be reasonable and prudent costs. That's a decision on the front end. Unlike how you execute your construction program and what choices you make about how to deal with a subsequent change in the law or a subsequent change in your demand or who you hire to do your EPC contract, this is a fact that's known now. And if it's reasonable for us to move forward to self-generate for the reasons that we've argued that it is, then those costs should be prudent; we should know that today.

And all this was fluid. It was an explanation for why our costs -- originally our costs were higher because we weren't eligible for this credit. Now that we're eligible, well, why is it still such a differential? Well, this is the reason: After the Commission's Order came out and we started looking at, well, can we proceed; can we proceed with recovering this certain amount through the REPS rider and then risking the rest for recovery in the base rate case is when this concern about the fact that not only are your tax credits that you're granted for this project at risk, but if you violate these rules, that all your subsequent -- you know, other tax credits that you're eligible for also become at risk.

That's when that issue became apparent to us. So it all had to do with the timing of the change in the law.

CHAIRMAN FINLEY: But you knew about the timing of the change in the law by the time of the testimony because it was discussed in some length, that you had advantage of the investment tax credits --

MS. NICHOLS: We knew that --

CHAIRMAN FINLEY: -- and you had to normalize it.

MS. NICHOLS: I don't think we were aware of the extent to which the penalty for violation could cause problems outside of this program.

CHAIRMAN FINLEY: And when did you become aware of that, after the Commission's Order?

MS. NICHOLS: After the Commission's Order when we were looking at how to proceed is when we consulted with our tax department and became aware of the risks outside -- to the other program -- to the other projects.

CHAIRMAN FINLEY: Do you have any revenue rulings? Do you have any tax court rulings? Do you have any authority for the position?

MS. NICHOLS: Well, I can let Mr. Warren speak to other precedents, but our intention once this proceeding is resolved would be to go to seek a private letter ruling to determine with whatever the Commission chooses to do here, is that going to subject us to a violation or not.

CHAIRMAN FINLEY: Okay. Thanks.

MR. WARREN: No, I'm done. Thank you.

MS. NICHOLS: And I think we can -- any other questions about the -- specific to the tax normalization questions I think would be appropriate here or I can proceed with the second piece of our argument.

COMMISSIONER JOYNER: I have a question based on the illustration that was distributed, particularly the section to the far right, Duke Energy Carolina's third alternative.

MR. WARREN: Yes, ma'am.

COMMISSIONER JOYNER: And I'm not sure who is in the best position to help me out with this, but it is my recollection and it was my understanding when we heard this case that Duke took the position that the cost of this program were inseparable, indivisible; that you could not isolate costs associated solely with REPS compliance with the costs that would be incurred for the other broader purposes.

And this illustration and something you said, Mr. Warren, makes me question my understanding in that regard because I thought what I heard you say was that this third alternative poses a scenario where only the broader costs, DG costs, et cetera, that first column, remain at risk.

Now, is that inconsistent with what I've just said my earlier understanding --

MS. NICHOLS: Well, I think -- our position in the case is that they should be treated as a unitary cost because we would not be doing this program absent the REPS requirements.

But what we've done here is the Commission in its Order has decided that the reasonable and prudent costs of complying with the REPS standard should be pegged at that third place bid. Now, we disagree with that. But taking that as the assumption that the costs for the pure solar value of the plant should be pegged at that third place bid, what we've attempted to do is instead of doing this pro rata recommendation of the Public Staff, which really compresses the amount of capital costs you can recover through the REPS rider if you're going to associate the normalization costs with it, it really drives down the amount of capital that you're assured of recovering through the REPS rider.

Instead we've said, well, let's utilize that third place bid amount to capture the capital costs associated with the equipment and call that the REPS compliance costs, then associate -- then give -- provide assurance that in a base rate case the normalization costs associated with that capital cost would be recoverable and it would be the remaining costs that -- of whatever our true cost is at the end of the day that we would have to come in and demonstrate that these other benefits that we sought to achieve were worthwhile and worth that cost.

So we really took the Commission's view of what the solar value should be and worked backwards from there.

COMMISSIONER JOYNER: Okay. That's useful. Thank you. If there are no other questions at this time with respect to Mr. Warren's argument with respect to the tax normalization issue, Ms. Nichols, you can proceed however you wish.

MS. NICHOLS: Thank you. And I think this is a good point to pick up on where I had planned to go in terms of thinking about the analogy to the CP&L Harris Plant case.

In the Company's view, this is not a typical CPCN type proceeding in the way it has played out. Even if we didn't have this issue of what amount should flow through the REPS rider or not, this program would require a CPCN because it's building generation. And in a typical

CPCN proceeding, the Company makes application and the Commission in granting a certificate would find the Company has a need and that the facility that the Company has proposed to build is the appropriate or best type of facility to meet that need.

And as the Commission did in our recent Buck and Dan River cases looked at did you test the market to compare it to what you're proposing here. And the Commission finds that it's appropriate to build that facility and then it finds that the cost estimate is reasonable. And it is based on those findings that the Company is then -- moves forward with their construction program. And it is then up to the Company to execute on that plan in a reasonable and prudent manner and to deal with things that occur since -- you know, the facts that change over time and to respond to those things in a reasonable and prudent manner.

So in the CP&L Harris case, for example, I believe the disallowance was related in part to should you have built the fuel handling facility at the size that you did once you knew you were not going to build all four units. And should you have taken steps more quickly to address some of the changes that came out of the NRC requirements after Three Mile Island.

Those are all facts that happened after the granting the CPCN. The Commission found this was the right facility. You had a need and this was the right facility to build. And then it was later up to the Company to go forth and execute prudently.

Here we have presented facts about the broader benefits that we think this program offers. We've presented facts about why we think it's appropriate for the -- us to comply with the REPS standard and with a mixed portfolio of utility-owned assets, third-party PPA assets and REC purchases. And the cost associated with doing so or the cost that the Company has no choice but to bear as a result of the tax normalization laws is a known fact now.

So in my mind this is very different because on one hand the Commission has granted the Company a CPCN, but in its Order granting the certificate, the Commission itself raises questions about whether it's appropriate for the Company to move forward with the program. The quotation that Mr. Warren just read about the prudence pointing in the direction of not self-generating is, I think, the most striking and the most worrisome provision in the Order for the Company.

In addition, the Commission questions the evidence that the Company put into the record regarding these broader benefits. It says that it's not persuaded by Duke's arguments that purchases from third parties are unreliable and would place Duke at risk of noncompliance. It tells Duke that, well, if you -- you risk noncompliance with the solar obligation, however, if you rely in good faith on a third party, then you have -- and through not fault of your own you fail to meet the requirement, you have an out.

The Order doesn't actually find the program's cost estimate to be reasonable. It instead finds that -- finds facts in accordance with Duke's witnesses' testimony, but makes it clear that the Commission's approval of the estimate does not amount to approval of cost in excess to the third place bid.

So the Company in this case truly is placed in a quandary of understanding whether the Commission does truly believe that this program is the right program to put in place to meet the need that has been identified.

CHAIRMAN FINLEY: Ms. Nichols, I can completely understand that argument. That makes lots of sense, but what does it have to do with tax normalization?

MS. NICHOLS: Well, I think what it has to do with tax normalization is that the Order as written, as I think our briefs provide, shows that there's a -- that -- the Order has numerous references to the tax normalization rules that an IRS auditor could point to and say -- if there's a subsequent disallowance and say, aha, you're costs were high because of tax costs and they were disallowed and that's a violation.

And trying to fix this after the fact is a bit like trying to unring a bell. And in our view if the Commission does not choose to lift the restriction on what can pass through the REPS rider, which I'll speak to in a minute, then if it truly does believe that this is a -- this program makes sense based on the facts presented before it, then similar to in the Lee nuclear development case, it could grant assurance. It could issue a declaratory order that says that we believe that seeking -- spending this money to seek these benefits is reasonable and appropriate and then it will be up to Duke to demonstrate through its execution of the program that it did so in a reasonable and prudent manner.

And so --

COMMISSIONER CULPEPPER: Ms. Nichols, it's okay from my standpoint of view if what your argument is doesn't have anything to do about a tax normalization. Isn't it true that the main crux of this motion is the fact that the Company feels like the Commission has sent several signals in its Order that kind of indicate that it's already made a determination that any costs above the third place bidder is not going to be -- eventually found to be prudent?

MS. NICHOLS: That is correct. And in addition to that, in doing so in the manner that the Order -- how the Order came out, the risk that the Company has to take is not just that it won't recover that amount above the third place bid, but that it will also lose these tax benefits on its other projects.

So the Company believes that it's presented uncontradicted evidence of the benefits of distributed generation. It is true that those were qualitative arguments and evidence as opposed to quantitative evidence, but this is the second such program proposed in the country. There's no such program yet operating. It's very difficult to tell on the front end what to quantify those benefits.

We also believe that we've presented uncontradicted evidence of the benefits of utility ownership of solar. I think the Public Staff made an argument that was adopted by the Commission in its Order that because solar generation technology is not as complex as nuclear generation technology that utility ownership of solar generation would not provide any greater reliability of REPS compliance.

I think this argument misses the point. The evidence that the Company has presented shows that the challenges are entirely different. They have to do with working with entities that are in a less mature and evolving industry without the benefit of time tested and often repeated protocols for negotiation, project development and financing. And I think the financing issue is the one in our current economic condition is one of the most critical. And I'm going to try to avoid getting into any confidential information unless the Commission should seek to ask questions here, but I think that evidence is all controverted.

And then the third place bid in and of itself, we think that clearly the bid prices are informative in comparing the relative cost estimates of the Company's program, which is indeed an estimate as well, however, they're simply not definitive enough for establishing an inflexible maximum recovery amount.

And again, there's uncontradicted evidence in the record from the Company about all of the contingencies that are involved in the bid process from finding acceptable site, performing due diligence, achieving interconnection, tax credits and expected tax payments that the bidder would have to receive and pay, financing and establishing credit and then pass-through costs associated with the contracts, that all of those make the bid prices not firm enough for saying, Duke, this is how much solar should be worth.

And the Public Staff made statements regarding the ability to secure solar energy at the bid prices or lower, but really it's the Company's evidence that -- where employees are involved in that activity that is uncontroverted in the record.

And then lastly I would say that we do see this as similar to the Lee nuclear situation where, you know, the Company is in the unique position of having these risks that are within the program itself and exterior to the program in connection with the tax credits available to the Cliffside project and other projects.

That if it is -- in that case the Commission made a finding that it was in the public interest for the Commission to declare -- to issue a declaratory ruling that gives Duke a general assurance that its activities in assessing the development of the proposed Lee Nuclear Station are appropriate activities. And here in the alternative to lifting the restriction placed with a third place bid, if the Commission does believe that this program has merits and we should pursue it, that the Commission issue a similar declaratory ruling giving general assurance that proceeding with the program as proposed is reasonable and the Company would then be at risk for demonstrating that it does so in a reasonable and prudent manner. Thank you.

CHAIRMAN FINLEY: Ms. Nichols, what if the Commission said we're going to look at the third place bidder for the sole purpose of determining how much of the cost Duke incurs and its distributed generation project is passed through the REPS rider and as to the rest of those costs based on the evidence and testimony that Duke presented, we think that based on what we know now that their decision to move forward with the project is reasonable and prudent?

MS. NICHOLS: I think that's what our alternative form of relief is.

CHAIRMAN FINLEY: You would like that?

MS. NICHOLS: Yes. That's all for Duke at this point.

COMMISSIONER JOYNER: Any questions from Commissioners at this point for Duke?

(No Response.)

MS. NICHOLS: Thank you.

COMMISSIONER JOYNER: Thank you very much Mr. Warren, Ms. Nichols. Mr. Green, we're ready to hear from you.

MR. GREEN: Thank you, Commissioner Joyner, members of the Commission. I would like to make three points. And in all three of those points I think there are two pivotal facts that the Commission needs to focus on. First is that the cost of tax normalization is a cost of the public utility's self-built project, just like any other costs, as Chairman Finley I think was getting to in his questions earlier.

It's entitled to no special treatment and any sort of advance declaratory judgment about whether it's reasonable or prudent, it's a cost that the Commission should review later in a rate case to determine whether the activities that actually produce that cost and the reasonableness of that cost are within prudence and reasonableness tests of the statute.

Second point is that -- and I'll use -- for the third place bid I'll just call that company X. Secondly, Duke asserts that its utility-owned solar project has certain broader benefits that make it more valuable than the project that company X proposes to do.

If Duke's assertion that its project has those broader benefits proves to be true, then I think the Commission in a later general rate case could approve and find prudent and reasonable the extra costs of Duke's self-built project. If Duke's assertion that its broader benefits have value and will come to fruition proves not to be true, then I think the Commission will find that the extra costs -- should find that the extra costs of Duke's project were not prudent or reasonable.

However, under no conditions, I don't believe, and there's no authority under the Public Utilities Act, that the Commission today can decide that any of those extra costs that Duke has identified in its self-built project are today declared to be reasonable and prudent and that includes the tax normalization cost.

The second point is in relation to Duke's argument with regard to the Lee Nuclear Plant development docket, the E-7, Sub 819, we believe that what the Commission said in that Order in March of 2007 is exactly the same assurance that the Commission has given in its Order of December 31st in this docket.

And there seems to be some dispute about what the Sub 819 Order said, so if you'll bear with me, I'm going to read the first -- or the two what I would say are the definitive paragraphs from that Order. This is on Page 22 of the Sub 819 Order issued in March of 2007. States "With regard to the specific language of the declaratory ruling, the Commission's declaratory ruling is as follows:

"a) It is appropriate in general for Duke to pursue preliminary siting, design and licensing of the proposed William States Lee II Nuclear Station (Development Work) through December 31, 2007, to ensure that nuclear generation remains an available resource option for Duke's customers. And such development work is generally consistent with the promotion of adequate, reliable and economical utility service to the citizens of North Carolina and the policies expressed in G.S. 62-2."

Subparagraph B, "To the extent the Commission finds in a future general rate case proceeding the specific activities involved in and the cost of pursuing such development work to be prudent and reasonable, Duke may recover in rates the North Carolina allocable portion of Duke's share of such costs at the times and in the manner determined to be appropriate by the Commission and otherwise as allowed by North Carolina law."

So the Commission made two declarations; one that was a general assurance to say, yes, Duke's pursuit of the nuclear option looking at the Lee Station and whether or not to continue looking at whether to develop that station is reasonable and prudent at this stage, but as far as any specific development work costs, or any amount of those costs, the Commission declined to say any particular costs were reasonable or prudent and said that decision will be made later in a general rate case.

CHAIRMAN FINLEY: Mr. Green, isn't this a bit different than that situation because there's language in this Order that tends to call into question Duke's decision to move forward with self-built distributed generation?

And we were saying in the Lee -- in the Lee cost Order, well, your decision, it's prudent to move forward to incur those development costs. What we're telling them now is well, that might not be prudent because you're looking at another bid here that's at a lower cost. So isn't there a distinction there between the two situations?

MR. GREEN: I think there is some difference, Chairman Finley, because there is a -- this is a CPCN that was actually issued by the Commission. There is some difference there. But I think within the bounds of what the Commission can do in the issuance of a CPCN, that still the Commission doesn't have the authority to go forward now and say that the tax normalization costs are reasonable and prudent costs of this project not knowing at this stage whether or not the broader benefits are going to come to fruition.

And that was my second pivotal fact, I think. That it really depends on -- whether the tax normalization costs end up being reasonable and prudent really depends on whether those broader benefits come to fruition. And we can't know that today until the project is built.

But I will say that I think the general -- excuse me.

CHAIRMAN FINLEY: Go ahead.

MR. GREEN: Okay. I will say that I think the general assurance that the Commission has given Duke in its present Order in this docket is comparable to what the Commission gave in the nuclear development document or Order.

And I'll point to paragraph four in which the Commission says "In order to meet the solar and set-aside requirements of the North Carolina Renewable Energy and Energy Efficiency Portfolio Standard, the REPS, G.S. 62-133.8(d), there is a need for Duke to acquire solar energy. Duke's proposed construction of 10 megawatts of solar PV generating facilities is an appropriate method for meeting a portion of this statutory requirement."

I think that is the assurance that that project is an appropriate means of meeting their solar set-aside requirement under the REPS statute. Again, not -- the Commission not trying to go down the road to say future costs will be deemed prudent and reasonable and can be recovered in a future proceeding.

And I'd like to also point out that under the provisions of SB 3 which added G.S. 62-110.7 on project development costs for nuclear plants, that the Commission still does not have the authority to in the process of looking at project development costs declare that certain costs are reasonable and prudent, future costs are reasonable and prudent and will be recovered in a later case.

The statute says, quote, "The Commission shall prove the public utility's decision to incur project development costs," and then later in that same section, "however, the Commission shall not rule on the reasonableness or prudence of specific project development activities or recoverability of specific items of cost."

So even with the addition of that review by the

Commission and giving some assurance of project development costs being in the statute now, it is still not authority for the Commission to actually review and determine that certain costs are reasonable and prudent at this stage.

And then the third point in our brief we discuss very briefly the role and prudence review section of the -- granted by SB 3, which is G.S. 62-110.1(f) and (f1) which allows a company that holds a CPCN to come in each year, show what its costs have been, ask the Commission to find that those costs are reasonable and prudent. And if the Commission does so, then they are found to be recoverable in a later general rate case.

And I understand from Duke's reply brief that this is not the 100 percent answer to their concern about what this -- they have in this case and all -- I understand that. It is not. Didn't found it is as being such. But I think the point is that it's all the Act provides right now for a pre-rate case determination of reasonable and prudence as far as costs on a CPCN project.

Thank you. I'd be glad to answer any questions.

COMMISSIONER JOYNER: There appearing that there are no questions, Mr. Green, thank you very much. Mr. Gillam, we are ready to hear from the Public Staff.

MR. GILLAM: Thank you, Madam Chair. As we discussed in the conference at the bench, I would like to move down to the opposite end of the table so that I can use the easel.

COMMISSIONER JOYNER: And that's fine, but what we need to do is to make sure that a working mike is at that end. Well, I see the mike, but the adjective was a working mike is at that end so that the court reporter can accurately transcribe your argument. And we need to make sure that counsel on the other side of the room can see as well as we. With that and as soon as you are settled, you may begin.

MR. GILLAM: With regard to the mike, can you hear me?

COMMISSIONER JOYNER: I can hear you now.

MR. GILLAM: And I will do the best I can with the easel. I'm clearly not an artist, but if someone cannot see it, please let me know.

Well, good afternoon, Madam Chairman and Commissioners. First of all, the North Carolina Sustainable Energy Association has authorized me to state that they are unable to take part in the oral argument today and that they support the Public Staff's position.

Throughout this case the Public Staff has tried to be straightforward with the Commission and all of the parties. We included in our proposed order last fall some discussion on normalization, which may have been overly broad, but in any case was not critical to our argument.

And that discussion unfortunately made its way into the Commission's December 31st Order. And when Duke pointed out the problems with that language, we immediately acknowledged them. And when the Commission called for briefs, we filed with the Commission a proposed revised order eliminating the questionable language.

Our effort to correct the questionable language has been labeled by Duke as slight of hand and a transparent, even flimsy solution based on an obvious desire to do less rather than more and an insufficient respect for the IRS regulations.

Duke argues that the only way to correct the problems in the December 31st Order and avoid the risk of a massive forfeiture of tax credits is to go beyond correcting the stated language and to substantively reverse the outcome of the Order.

Well, we considered Duke's argument and we stand behind our filing. It was an effort to correct the problem Duke has identified and in our view it did correct the problem. What Duke is proposing on the other hand in our view is not necessary and it's not desirable.

I think it's important to begin by reviewing just what it seems clear to us the Commission did in its December 31st Order. And as Duke has developed their argument through some boxed diagrams in their reply brief and in their handout, I'd like to draw some boxed diagrams on the easel.

The top line of this boxed diagram represents Duke's total per megawatt hour cost per its solar program. That's a confidential number and I won't say the numerical amount, but the Commission knows what it is. The middle line is the maximum amount the Commission set in its Order. Again, the Commission knows the numerical amount.

The cost in the lower box here were found by the Commission to be associated with acquiring solar energy or compliance with the solar carve-out of the renewable energy and energy efficiency portfolio standard at the lowest available cost. To the extent they are incremental costs over and above avoided costs, they can be recovered through the REPS rider under G.S. 62-133.8(h)(1)(a). To the extent they are avoided costs, they can be recovered through base rates. In either event, the Commission has approved they're being recovered by Duke.

The costs in the upper box on the other hand are the costs associated with the so-called broader benefits of the Duke program, benefits such as gaining knowledge of the impact of solar distributed generation on Duke's system, determining what types of distributed generation facilities have the greatest appeal to North Carolina customers, promoting the widespread acceptance of distributed generation to North Carolina and so on.

The Commission did not decide whether these costs will be prudent and recoverable in rates because they are costs that haven't yet been incurred. And this is only a certificate of public convenience and necessity proceeding. That decision about the recoverability, the prudence of those costs will be made in a later case.

If these costs are shown to be reasonable and prudent, they'll be recovered either through the research clause, G.S. 62-133.8(h)(1)(b), or through base rates. Because the Commission hasn't yet decided whether these costs will in fact be recovered, Duke has labeled this upper box "At Risk."

The criteria for whether costs go in the lower or upper box under the Commission's Order is clearly whether the costs are for simply acquiring solar energy to meet the requirements of the REPS or whether they are for the broader benefits of Duke's distributed generation program.

The Commission didn't have the option of just deciding not to have a lower and upper box and not to set a maximum amount and just lumping all the costs in one box. The reason the Commission didn't have that option is the Commission rightly found in its Order that the REPS rider was intended by the General Assembly only for recovering the incremental costs of REPS compliance. The cost of buying or generating renewable energy over and above the utility's avoided costs, the REPS rider wasn't intended for recovering the entire cost of programs with multiple purposes designed partly to recover renewable energy and partly for other purposes.

Now, it was not a simple thing for the Commission to draw the dividing line between the costs attributable to acquiring solar energy for the REPS and the costs of the broader benefits of the program. There wasn't any clear-cut breakdown of program costs between these two categories. The determination of the maximum amount had to be somewhat subjective, but a determination did have to be made and the Commission made its decision based on its judgment and on the testimony of the Public Staff's witnesses at the hearing. Well, I think this discussion provides a reasonably accurate summary of what the Commission did in its Order in this case.

Turning now to the major bone of contention in this motion for reconsideration, some of Duke's program costs in the lower box, the costs of acquiring solar energy for REPS compliance, are associated with normalization of the federal energy investment tax credit. And likewise, some of the costs in the upper box, the costs relating to the broader benefits of the program, are associated with normalization.

Now, Duke in its reply brief has actually drawn two different box diagrams seeking to create a distinction between the Commission's December 31st Order and the Public Staff's proposed revised order. And I think those are diagrams two and three on their handout. In their diagram of the Commission's Order, they show all normalization costs being pushed into the upper at risk box. That's an incorrect --

CHAIRMAN FINLEY: You go any smaller, Mr. Gillam, I'm going to have to get a telescope to see it.

MR. GILLAM: Hard to see them on -- maybe what I can do is to --

CHAIRMAN FINLEY: That's all right. I'm following you. Go ahead.

MR. GILLAM: I'll try. But we do perceive this as an incorrect depiction of the Commission's Order. The Commission's Order is very clear that the criteria for dividing costs between the lower and the upper box is whether they're costs of producing solar energy for REPS compliance or whether they're costs of the broader benefits of Duke's distributed generation program.

In suggesting that the Commission push all of the normalization costs -- in suggesting that the Commission push all of the normalization costs into the at risk box and thereby violating the IRS normalization regulations, Duke hangs its entire argument on a single sentence of the Commission's 20-page Order; the sentence where the Commission stated, following the language of our November proposed order, "If the federal code -- if the federal tax code treats self-generation less favorably than the purchase of solar energy from a third party, then prudence points in the direction of not self-generating." Counsel for Duke's already read that sentence.

CHAIRMAN FINLEY: And that was in the Public Staff's proposed order or did we add that one?

MR. GILLAM: That was -- we are the author of that sentence.

Well, there are several things I would like to say about that. First in that admittedly ill-advised sentence -- and I should go even further and say that I am the author of that sentence -- the Commission did not say that self-generation is imprudent. The Commission did not say we hold self -- Duke's self-generation plan to be imprudent. The Commission was only observing that prudence pointed in the direction of not self-generating.

Second, as soon as the problem in this rhetorical flourish was pointed out to us, we immediately recognized the error and we recommended that the Commission revise its Order and delete this sentence, as well as all the other comments on normalization that we had drafted without giving adequate consideration to the normalization regulations. We don't desire any more than Duke does for Duke to violate the normalization rules or have to forfeit tax credits.

Third, it was not the Public Staff, it was Duke who injected the normalization issue into this case. It first appeared in the rebuttal testimony of Duke Witness McManeus. When we included the offending sentence in the proposed order, in our proposed order, we were attempting to respond to Ms. McManeus' apparent contention that the normalization costs were somehow -- that somehow they represented an attractive feature of Duke's proposed order and a justification for approving immediate recovery of the entire program costs through the REPS rider.

And when our attempt to respond to this contention lead to the problems with the Commission's Order and we tried to correct those problems through our revised proposed order, we were met with the argument that the only way to do that is to allow full recovery of the entire program costs.

Duke did also present what they described in their reply brief as their third alternative proposal, which is the fourth diagram of their handout. This would involve pushing all of the normalization costs out of the upper at risk box into the lower recoverable box along with the maximum amount so that only this, only this little top piece would be at risk. Duke presented this as a compromise because it would allow some portion of the program costs to remain at risk.

We at the Public Staff were interested in working out a compromise if we could do so without sacrificing our clients' interest. So last week we had a conference call with Duke to learn more about this third alternative proposal. And what we learned was that the numerical amount that will remain in the upper at risk box once all the normalization costs have been pushed into the lower box on top of the maximum amount --

MS. NICHOLS: I don't mean to be rude. I just want to make sure we're not going to reveal any confidential information.

COMMISSIONER JOYNER: And I was about to inquire about that same thing.

MR. GILLAM: And I'm confident I will not reveal a confidential --

COMMISSIONER JOYNER: You are confident. Ms. Nichols, Mr. Gillam is confident that he will not reveal any confidential information or numbers. With that assurance and with my admonition that we are relying on your confidence, you can proceed subject to my hearing something to the contrary from counsel table.

MS. NICHOLS: I just have some concern about talking about settlement discussions as a part of the record.

MR. GILLAM: Well, this was an on-the-record settlement proposal.

MS. NICHOLS: I don't understand what that means.

MR. GILLAM: You filed it in your reply brief. I'm sorry to talk directly. Madam Chair, she filed it in her reply brief.

COMMISSIONER JOYNER: I was going to say, we will short circuit this. I am going to -- by accepting your recognition that confidential information is not to be disclosed on the public record during the oral argument and also we don't want to get into any off-the-record discussions, offers or counters with respect to settlement, to the extent that what you were going to allude to is in the filed pleadings in this case, proceed. Does that help or is that at least clear?

MR. GILLAM: Well, let me -- yes, it is. And let me express it this way: I think if the Commission were to inquire, as we did, about the numerical amount that would remain in the upper at risk box once everything else had been stacked in the lower recoverable box, the Commission would find out that the amount up here is extremely small and almost negligible. And so we concluded that the third alternative proposal is essentially equivalent to Duke's base proposal and not a true compromise. And I will not say the actual number because that would be confidential.

Well, finally and by far the most important thing to focus on today, any commonsense reading of the 20 pages of the December 31st Order will lead to the conclusion that regardless of what might have been said in one sentence, the Commission did not single out normalization costs for negative treatment and did not push all normalization costs into the upper box because the consideration was deferred to a future proceeding.

As I've already pointed out and as the Order makes perfectly clear, the Commission's one and only criteria for classifying costs in the lower recoverable box or the upper at risk box was were they the costs of acquiring solar energy for REPS compliance or were they the cost of achieving the broader benefit of distributed generation.

The whole conceptual structure that Duke has developed and placed such great emphasis on to the effect that the Public Staff's position or the Commission's ruling is based on opposition to normalization, that whole conceptual structure is nothing more than a classic red herring. And Duke's drawing here is wrong and I'm going to mark it out.

Now, turning to this drawing, we again see that both the upper box of costs that have not yet been ruled on and are at risk and the lower box of costs that have been approved for recovery, both boxes contain an element of normalization costs. And Duke's basic argument is that because there are some normalization costs in that upper box, because some normalization costs remain at risk, that constitutes an indirect violation of the normalization rules. That is Duke's theory and we contend that it's a mistaken theory and a theory that goes too far.

As we understand it, any state regulatory Commission is free to disallow costs or to defer ruling on costs as long as its decision is based on a criteria unrelated to normalization. The costs that are disallowed or deferred have to be accompanied by and treated in the same way as the tax credits and normalization costs that are associated with them.

What the Commission is not permitted to do is to disallow normalization costs as such or to adopt the old flow-through concept where the benefits of the investment tax credit were flowed through to ratepayers immediately instead of ratably over the life of the asset or to adopt any type of indirect or partial disallowance or flow through whereby normalization costs are treated less favorably than the other plant costs with which they are associated.

The Commission didn't do any of these prohibited things. The Commission simply deferred ruling on the prudence of the costs of achieving the broader benefits of normalization -- I mean, excuse me, the broader benefits of distributed generation, and included the normalization related element of those costs of the broader benefits.

Duke contends that we at the Public Staff misunderstand the normalization rule and that any disallowance or deferral of normalization costs is prohibited, except that deferral is okay if the Commission is willing to make a commitment that recovery of the deferred costs will be allowed at the first opportunity.

The weakness of Duke's theory can be seen by looking at CP&L's Harris Plant case from 1988. Duke dances all around the Harris case trying to distinguish it on various different grounds, but there's no valid basis for distinguishing.

In that case, the Commission disallowed certain costs of the Harris Plant for imprudence. The great majority of plant costs in that case were put in the lower recoverable box, including the normalization related element of those costs.

A small portion of costs were placed in the upper at risk box. In fact, they weren't just put at risk, they were outright disallowed. And again, the normalization related element of those costs was disallowed also.

I know this is small, but I'm trying to make it proportional. This is the normalization related element of the disallowed costs.

The rational for the disallowance was unrelated to normalization. The disallowance was hugely controversial and it went to the -- the case went up to the North Carolina Supreme Court. But CP&L never contended and I don't think they ever even gave any thought to contending that the disallowance violated the normalization regulations.

And certainly the IRS never required CP&L to forfeit any of its investment tax credits. But under Duke's underlying theory in this case, CP&L could have taken the position that by disallowing recovery of these normalization costs, the Commission committed an indirect violation of the IRS normalization regulations.. This shows us the far reaching nature of Duke's theory.

Their underlying theory can most accurately be stated in this way, even though they, of course, haven't chosen to express it this way: Whenever a utility construction project is subject to or qualifies for the federal energy investment tax credit, no portion of the costs of the project may be disallowed by a state regulatory commission for imprudence or otherwise. This in the Public Staff's --

COMMISSIONER JOYNER: Continue, Mr. Gillam.

MR. GILLAM: -- this in the Public Staff's opinion pushes the meaning of the IRS normalization regulations beyond anything the IRS ever intended.

It's important to keep in mind that this Commission is not by any means the only state commission that's disallowed generating plant costs for imprudence. There's been a great many of states in which disallowances have occurred. In most, if not all of those cases, the plant whose costs were partially disallowed was one that qualified for the investment tax credit. And yet Duke has not cited us to a single case in which the IRS has said that by disallowing plant costs or putting them at risk a regulatory commission has violated the normalization regulation, nor to even one case in which the IRS has required a forfeiture of tax credits because of a state regulatory commission's decision to disallow plant costs or delay ruling on costs.

We think, as we stated in our briefs, that the Commission should eliminate any controversy over normalization and any risk of forfeiture of tax credits by rescinding the December 31st Order and replacing it with the new order comparable to our proposed revised order. And, of course, the Commission will need to also issue a separate order disposing of Duke's other requests for relief.

We also think, as we said in our brief, that apart from clearing up the language on normalization, there is no need for any change in the substantive decision reached in the December 31st Order.

That basically ends our argument and I sense that I have based it entirely on normalization. And the Commission may have some questions about anything, but especially about Ms. Nichol's portion of Duke's argument and I'll be happy to respond to any questions.

CHAIRMAN FINLEY: Mr. Gillam, is it your theory there that any dollar allowed or disallowed when there is a case where there's an imprudency disallowance, has it got an equal percentage of tax normalization benefits, labor costs, return, material costs?

MR. GILLAM: Right.

CHAIRMAN FINLEY: I mean if you -- the dollars in either category, the disallowed category or the allowed category, are fungible and are the same dollars?

MR. GILLAM: They have to be -- well, yes, all dollars are fungible. And I also think that the Commission is required whenever it disallows or defers any costs to disallow or defer with them the accompanying tax credits and the accompanying normalization costs, they all have to go together. If you single out normalization costs for unfavorable treatment, that's where we think the regulations would be violated and there would be -- and that would be something -- that would be what the Commission did not do and should not do.

CHAIRMAN FINLEY: So if there's a future general rate case and there's -- and Duke proceeds with this project and the Commission says, well, there's a disallowance of the self-built generation because way back when Duke could have proceeded with a least -- a less costly alternative and that was the reason for the imprudence disallowance, is it your position then that there's -- because that is not singling out tax normalization issues that that's perfectly okay as far as the tax laws?

MR. GILLAM: That is absolutely our position. We think that if in the subsequent case down the road the Commission looks at the costs in the upper box and concludes that the research benefits or whatever other broader benefits may be gained from them are not large enough to justify the costs, then the Commission can appropriately disallow these extra costs in part or in whole.

But whatever costs, if disallowed, the accompanying tax credits and normalization costs will be -- will have to be disallowed with it and whatever costs it approves, the accompanying tax credits and normalization costs will have to be approved with it. There just cannot be any discrimination against or in favor of normalization costs. The basis for decision has to be unrelated to normalization.

But I would agree that the Commission can in the future proceeding disallow and should disallow, if they're not proven to be reasonable and prudent, the costs in this top box. And I think I sense a great degree of concern by Duke because this leaves them in a state of uncertainty.

Well, a CPCN, as I understand it, has never been intended to provide the utility with certainty. It's only intended to provide the utility with permission to get started. And the regulatory theory and regulatory practice from ever since decades ago has been that the utility undertakes the project and then it's ruled on as the prudence or imprudence.

And I know that Duke and other utilities are now more troubled by that than they used to be because of the large expense of a plant, and they have made some efforts to revise the statutes and some revision was made in

Senate Bill 3. We now have the ongoing review so that the utility doesn't have to wait until completion of a project to know whether it's going to be -- to know where it stands in terms of prudence.

But Senate Bill 3 did not change the traditional ratemaking practice to say that a certificate proceeding is the place to rule on the prudency of costs that are as yet only a forecast and hasn't been incurred or spent at all.

CHAIRMAN FINLEY: But Mr. Gillam, most of our certificate cases don't have sentences like this: "If the federal tax code treats self-generation of solar energy by a public utility less favorably than the purchase of solar energy from a third party, the prudence points in the direction of not self-generating, but instead purchasing the needed solar energy." That's sort of a negative signal, isn't it?

MR. GILLAM: That -- well, it is a negative signal. And I think further than that, that sentence is an unwise negative signal. I can say that because I wrote that sentence.

CHAIRMAN FINLEY: Well, if you were Duke and you read that sentence, you would have some pause in proceeding with this project, wouldn't you?

MR. GILLAM: Yes. And we are recommending that because that negative signal has to do with normalization, that the Commission revoke -- rescind its Order and issue a new Order that doesn't include that sentence.

But now that is a different thing from saying that it was in our judgment a bad thing that the Commission sent a negative signal to Duke. I think to send a negative signal about normalization was not a good idea, but I think to send a negative signal about buying dear when you could have bought cheap was entirely appropriate.

I think the Commission could have denied the certificate altogether. And I think -- I obviously don't know, but I can speculate that if Duke had said, Commission, we don't want any order with any kind of signals in it; we want an absolute yes or no answer. So the Commission might have answered no, Duke, you haven't proven to us that this is the best way to go.

I think perhaps the Commission might have thought or I might have thought if I had been in the Commission's shoes that, well, Duke hasn't proved their entire case for all of the costs to us yet, but we have some degree of confidence in Duke. They are pretty good in building plants. This total cost seeker is now just an estimate. By the time they get finished, it might be lower. And furthermore, they might be able to show in the next proceeding that the benefits, the research benefits that they're going to get from their distributed generation program are really good. They might be able to show us what it is that they're going to find and we might think that this is really valuable stuff and so we might find down the road that this is a very prudent thing to do and we might down the road happily put it in rate base.

But -- I'm speaking sort of as an imaginary commissioner here -- I might have said if Duke insists that we say yes or no right now and won't wait and won't prove its case down the road, then I'll be compelled to say no. And so the way to handle this I might have thought is to say, yes, you may have your certificate, but if -- but take note that the Commission is thinking some negative thoughts and accept this certificate only if you're reasonably competent that you'll be able to prove the prudence of these -- of these costs down the road.

COMMISSIONER JOYNER: Commissioner Culpepper.

COMMISSIONER CULPEPPER: Mr. Gillam, you -- a lot of your argument you make the case that the language that you say you suggested on behalf of the Public Staff, and the Commission adopted in its Order, regarding this tax normalization issue, you say we ought to -- and you're suggesting that we amend the prior Order and take out --

MR. GILLAM: Correct.

COMMISSIONER CULPEPPER: -- all that. Yet in the proposed order that you submit on behalf of the Public Staff March 5, you've got a new paragraph Finding of Fact 19 that gets mighty specific about how the Commission ought to treat the tax normalization issue. And I'm just kind of wondering about that. And that obviously is some very new language and you back that finding of fact up with a whole lot of new wording in your proposed order beginning on Page 21 of that proposed order and going on over to the end of Page 22.

And I guess the bottom line of what I want to find out from you is would it -- what would Public Staff's position be about -- if the Commission thought about amending the Order but didn't get into all this stuff on Paragraph 19?

MR. GILLAM: Well, I think that's up to the Commission. I --

COMMISSIONER CULPEPPER: Well, I understand that. I want to know what the recommendation of the Public Staff is in that regard.

MR. GILLAM: And I think our view was that the

Commission would not want us to file a revised proposed order that just ignored the normalization issue because it obviously was there and it really shouldn't be ignored. So we worked with our accounting division, who is up to date on these normalization regulations, and we tried to develop something that's fully consistent with the normalization regulations and --

COMMISSIONER CULPEPPER: Well, how important is that language to what you're proposing on behalf of your client today?

MR. GILLAM: Well, the decision I think is more important than the language. We -- the Commission has a very good staff and if the Commission Staff can develop better language and shorter language, that will be quite fine with us.

We think everybody -- we think there's very little danger now with all that has been said that anyone's going to write something that is -- that treats normalization adversely and violates the regulations. And if the Commission Staff and the Commissioners themselves can say it more briefly and more clearly and concisely than we did, have at it.

COMMISSIONER CULPEPPER: Well, I guess I'm just getting right into -- I mean, my reading of that paragraph, it sort of suggests that we're making a ratemaking decision in this case with respect to that and seems like to me that we could delay -- whatever the issues is regarding this -- and I don't purport to know much about tax normalization, but it seems like to me it is what it is and why talk about it now. Why don't we just delay that till later on in a ratemaking -- a rate case maybe?

MR. GILLAM: I think the potential pitfall would be if you delay addressing -- if you completely delay making any comments on normalization -- because I think then Duke would have the same feeling that they have now, that this may not stand up with the IRS. I think the IRS insists that you not treat normalization unfavorably -- treat normalization costs unfavorably in comparison with the particular costs that they are associated with.

COMMISSIONER CULPEPPER: Well, isn't it going to be the same -- what you just got through saying, isn't that going to exist down the road in the rate case if we don't even address it in this case?

MR. GILLAM: Well, I --

COMMISSIONER CULPEPPER: It is what it is, isn't it?

MR. GILLAM: In every phase now and down the road the Commission will have to comply with the normalization regulations. And I think given what's happened so far, it's a good idea for the Commission to include in its Order assurance that whatever it decides to do either now or down the road will be in compliance with the normalization --

COMMISSIONER CULPEPPER: Well, don't you think the Commission's going to do that without even having to say it? You'd hope so, wouldn't you?

MR. GILLAM: Well, I'm confident in the Commission. I think -- I don't think you ever intended to violate the law and I don't think you intend to now and I don't think you're going to.

COMMISSIONER CULPEPPER: All right. Thank you, Mr. Gillam. I appreciate it.

MR. GILLAM: I think -- like I say, I think -- we never intended to violate the law; you never intended to violate the law. This whole idea of having a lack of respect for the normalization regulations, I consider that a red herring.

COMMISSIONER JOYNER: Does that conclude your argument, Mr. Gillam?

MR. GILLAM: I'll happily conclude if there are no more questions.

COMMISSIONER JOYNER: Okay. Thank you. We're going to go off the record for just a second.

(Discussion held off record.)

Based on an informal conference that we will continue on without any break at all, thank you, Mr. Gillam. Thank you, Mr. Green.

Mr. Warren and Ms. Nichols, you have the last word, so we will hear from you in whichever order you deem appropriate.

MR. WARREN: Thank you, Commissioners. I would like first to just address a couple of points that were raised by both Mr. Green and Mr. Gillam. First and foremost, I want to address the -- the discredited box on the left and the statement that Duke misinterpreted the Order.

I would refer the Commission to Finding of Fact 14. Now, the way in which Mr. Gillam stated that the Company misinterpreted was insofar as the Company believed that all of the normalization costs, all of the costs that comply with the normalization rules were located or should be located under the Order in the upper box. And he took issue with that interpretation.

Well, I would refer you to Finding of Fact 14. About the middle of the finding -- the paragraph -- and

I'll read that. It says, "The cost associated with the broader benefits of Duke's program and with Duke's tax normalization obligations will not be incurred to comply with the requirements of G.S. 62-133.8(b) to (f). Consequently, these costs may not be recovered through the REPS and REPS EMF riders except to the extent that they may be shown in a future proceeding to constitute research and development expenses."

So I do -- I think that that -- there's very little interpretation that that finding of fact requires. I think it's very clear that all of the costs of normalization compliance were squarely placed in the upper box and that's the way Duke understood it and continues to understand it.

Now, on page -- the statement that's been referred to numerous times in this proceeding on Page 15, which talks about the prudence pointing in the direction of non-generating, was really not the basis of Duke's interpretation. That was actually the provision that gave rise to a panic attack in light of Finding of Fact 14. It was the combination of those two, Finding of Fact 14 in conjunction with the statement on Page 15 that caused Duke to be concerned, and in my view rightfully so, about the potential consequences of a normalization violation.

Now, clearly Mr. Green properly points out that the cost of normalization compliance usually aren't identified as a specific cost in a rate case. And his view is that these costs ought to be treated just like every other cost. They should be afforded no special treatment. And I would concur, based on my experience, normalization costs usually aren't a problem. They aren't raised -- or they aren't identified for special treatment just as he points out.

However, there's a difference here and that is the record that we're faced with. We have a record that provides a mechanism for potential disallowance by isolating the normalization costs and identifying them in the top box. They are primed for a potential disallowance. At least they are certainly at risk as a class of costs, which is themselves, which is a situation I've never seen before. And that is what makes this different.

COMMISSIONER CULPEPPER: Well, while you're on that point -- sorry to interrupt you, but that's the way it works around here sometimes -- have you taken a look at Mr. Gillam's suggested paragraph 19 with respect to the March 5 filing that Public Staff made? Have you taken a look at that?

MR. WARREN: I have.

COMMISSIONER CULPEPPER: Well, now he suggests that he's conferred with his staff accountants and that they feel that that is the legal and appropriate way to handle this issue now. And that would change the course of where we are now and take it out all the way from the top box the way I understand it.

Do you have some disagreement with the way this paragraph 19 is worded in Public Staff's proposed revised order or do you disagree with what he said, that this is not a correct way that the law would handle this matter?

MR. WARREN: The latter. I don't believe that the law would -- that would -- I think it is unlikely that the tax law would respect this reclassification.

Mr. Gillam himself has just said that his proposal doesn't make any substantive change in the Order. I believe that fact speaks for itself. There is no substantive change in the Order. You can call it something else. I promised Ms. Nichols I wouldn't do this, but I lied.

Every once in a while you read a tax case that has something in it that, you know, you say to yourself, well, he must -- the judge must have waited for a long time to use that. And within the last year there was the tax decision that was issued by the Fourth Circuit, the circuit that we're in, regarding a -- it was a tax shelter case and involved the characterization of a very complex leasing situation with all kinds of tax benefits flowing different ways and whether the transaction that purported to be a lease was in fact a lease. That's what was at issue.

And this is the chief judge, Chief Judge Williams of the Fourth Circuit, said the following thing: "In closing" -- you never want this in the last paragraph of a tax decision if you're the taxpayer. "In closing, we are reminded of Abe Lincoln's riddle 'How many legs does a dog have if you call a tail a leg?' The answer is four because calling a tail a leg doesn't make it one."

We're talking about taking costs that the minute before were normalization compliance costs and were put in the top box and then by changing the language in I guess it was paragraph -- on Page 19, we're calling it something else. The relabeling of what the instant before were normalization compliance costs as plant costs followed by the subsequent disallowance of those costs because the costs, the aggregate costs were too high leaves open for anybody who cares to look the possibility, if not the probability, that they will associate that disallowance with the cost associated with the normalization compliance, the way it was characterized first.

And it is the Company's belief and position that merely recharacterizing the tail as a leg isn't going to work. And it gives very, very little comfort that merely changing that language without changing any substantive part of this Order would be respected -- would be a viable solution to the problem.

It also -- I also want to point out and I think that the Order itself makes clear that the -- in compliance with the normalization rules is not a broader benefit. It's certainly not distributed generation, it doesn't -- it's not the acquisition of any of these knowledge bases. I guess it's a broader benefit in that you need to do it to keep all the tax benefits, but it's not a broader benefit of the same type as everything else and shouldn't be just lumped in with those other broader benefits.

I think ultimately the question is -- because normalization is a necessary and a critical part of ownership of generation assets or any other assets by a utility, the question is it an appropriate -- well, is self-generation -- is self-generation an appropriate part of a portfolio of solar power, solar power acquisition.

It has this feature and other types of solar procurement have other features. This is not the only way solar power is going to be procured. And again, it has a familiar feature to it. Is it an appropriate way to go about procuring some portion of the solar requirements that are necessary to comply with North Carolina law.

I think the -- going back to the Carolina Power & Light situation, there's a clear difference. There was never -- there was a disallowance of costs. And Mr. Gillam is right, there's been many -- there have been many disallowances by many commissions of plant costs. And there has rarely, if ever, been a normalization problem.

The distinction and the critical distinction here is that we're not just talking -- we're not talking about just a disallowance or a potential disallowance of plant costs. We're talking about the potential disallowance of plant costs after those costs have been renamed, have been transmuted from normalization compliance costs into plant costs and then disallowed. And the question is are we really disallowing plant costs when we go through that process or is it something else. And it's something else that's the troublesome aspect of this.

CHAIRMAN FINLEY: Mr. Warren, are you saying that once the issue of tax normalization was raised in this case and it was mentioned there's a difference between the bottom line price of Duke's in-house generation and the third-party generation, that any talk of disallowance then risks Duke's tax benefits?

MR. WARREN: No. I don't think I'm going that far. What I'm saying is that again the two-step process of identifying compliance -- the normalization compliance costs as an isolated category of costs, taking them out of the REPS rider recovery mechanism and putting them into the base rate proceeding bucket and then indicating that the now infamous sentence that self-generation may itself have been imprudent because the tax cost of self-generation is -- may be more costly than for a regulated company than a non-regulated company, it's the confluence or the combination of those several things happening in conjunction that creates the record.

And what we are suggesting is that we need -- because of the nature of the record, as it exists, we need something affirmative to undo it. We need more than just to get back to the curve. We need to create a bit of a wall and -- because we're dealing with what we have. We have enough evidence for someone to conclude that a disallowance would be a normalization compliance cost and what we need to do is conclusively eliminate that possibility.

CHAIRMAN FINLEY: Let me give you a hypothetical. Let's set aside for the moment this case where we've got an issue of the buckets on -- in which costs to recover -- let's set aside the REPS recovery rider and recovering rates and base rates down the road.

Let's say that we give Duke a certificate of public convenience and necessity. It builds the plant. Five years later we have a general rate case. Somebody says, Duke, you were imprudent in the price that you paid for that plant and the evidence -- because you could have gotten that generation from a third-party plant, same type plant, but it would have been cheaper, and the evidence in the case is that the reason that Duke's self-generation is more expensive is because they had investment tax credits they had to normalize and the third-party generator didn't have that issue, so the third-party generator could do it more cheaply.

And if we say there is a disallowance of the increment in Duke's self-generated plant above that third-party price because of the difference in price and the reason for the difference in price was the tax rule that had to be followed, does that jeopardize Duke's investment tax credits?

MR. WARREN: In my view it would. And I would certainly not want to see a final order from the Commission without some review by the IRS national office to confirm it, but that's my view.

COMMISSIONER JOYNER: You may proceed. I'm not sure, Mr. Warren, whether you had completed your comments.

MR. WARREN: I'm not sure either. Yes, I have.

COMMISSIONER JOYNER: Just kind of for the record, if we go much longer than ten minutes, I'm going to need a break and I think the court reporter is too.

MS. NICHOLS: I won't take ten minutes. I just wanted to make two points. The first is that Duke finds it interesting that the Public Staff and the Attorney General are arguing that the Commission cannot decide the reasonableness and prudence of going forward with this program -- well, specific costs, let alone going forward with this program, and yet the Public Staff argues that the Commission has properly determined the reasonableness and prudent incremental compliance costs were complying with the solar set-aside requirement. That just seems incongruent.

It seems to me that what Commissioner Finley hit upon when you were asking me questions earlier before is precisely like the Lee development case. Is the pursuit of distributed generation reasonable? Is the pursuit of utility-owned solar reasonable? Is the decision to incur utility-owned distributed generation costs reasonable?

Same -- you know, we're in a unique situation with unique risks here as we are in the nuclear arena and we're asking the Commission to decide that it is reasonable for us to pursue these activities. And so I think that the Chairman's proposal is precisely what our second alternative form of relief is in this case. Thank you.

COMMISSIONER JOYNER: Any further questions from the Commission?

(No Response.)

There appearing to be none, I thank you all for your time and attention. The Commission appreciates, as do each of you I believe, the gravity of the issues before us. And we will take them under deliberation and get you a response just as soon as we reasonably can.

If there is nothing else, I bid you good day. We are adjourned.

Whereupon, the hearing was adjourned.

CERTIFICATE

The undersigned Court Reporter certifies that this is the transcription of notes taken by her during this proceeding and that the same is true, accurate and correct.

Candace Covington
Court Reporter II

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