

How much can Duke afford?

By Becky Johnson

What Price to Pay?

This is the second in a two-part series examining Duke Power's regional hydropower network as the company seeks federal approval for continued operations.

n This week: How much can Duke afford? A look at the company's profits and a federal accounting probe.

n Last week: After three years of negotiations, some participants speak out about promised reparations. ([see story](#))

A loose-knit coalition of environmental, political and business leaders allege Duke Power is shortchanging Western North Carolina as the company seeks new operating permits for its regional hydropower network.

Duke's federal permits to operate a system of 11 dams spanning five rivers in as many counties expire over the next two years. To get a new permit, Duke is required to provide recreational and environmental benefits in exchange for profiting off the public's rivers and altering the natural environment with a system of dams and above-ground pipelines.

Duke has proposed a compensation package valued at \$6.5 million in their bid for a 40-year permit. The compensation package was drafted during a four-year process with various stakeholder groups in the region, such as kayakers, fishermen, environmentalists, lake homeowners and government agencies. But opponents say it is not enough, citing the \$20 to \$30 million range as a more appropriate compensation package. They are taking their fight to the Federal Energy Regulatory Commission and say they will go to court if necessary.

Duke officials, however, say the company would have to raise electricity rates to provide that kind of compensation.

"Duke made it sound like anything more was going to bankrupt them," said Roger Turner with the environmental group WNC Alliance, a group which participated in the four-year negotiation process

Turner dubbed Duke's threat to raise rates as the "rate card." According to Turner, Duke played the rate card frequently during the negotiation process whenever someone asked for something that Duke didn't want to provide, like more money for conservation or returning natural water flows to stretches of river currently rerouted through pipelines to powerhouses.

Opponents now see the recurring threat to raise rates as disingenuous.

"It's not legitimate," said Bill Lyons, an economist and fisherman from Jackson County. "They are already making excess profits. There's no way in the world they are going to get a rate increase."

Federal and state accounting probes, as well as rate mandates from the North and South Carolina public utility commissions, indicate Duke is making excessive profits off its customers in the two Carolinas. As a regulated monopoly, Duke's profit margin is limited to 12.5 percent in North Carolina. But profits for the 12-month period ending June 2003 were 14.43 percent.

The public utility commission in October forced Duke to lower its rates in South Carolina because of its high profit margin. North Carolina officials have not taken action to lower rates, but with profits above the allowed rate of return it's not likely the state would grant an increase. In addition, Duke is barred from enacting a rate increase until 2007 because of the Clean Smokestack Act passed two years ago by the state General Assembly.

Duke says the higher-than-allowed profits are due to a cold winter which led to more electricity use.

Duke Power is also the subject of a federal probe into accounting practices that allegedly concealed profits. The state utility commission ordered an independent audit that concluded in 2002 Duke had used improper accounting methods in order to hide profits and thereby avoid a rate decrease.

Profit sharing

Duke officials say that there is no connection between company profits and the proposed compensation package for relicensing its hydropower network.

"Our profits have nothing to do with relicensing of hydros," said Tom Williams, spokesman for Duke. "To correlate the two is disingenuous, to suggest a company's earnings should drive what somebody gets. Mitigation is based on science."

Fred Alexander, the local spokesman for Duke, just last week cited a possible rate increase as why the company couldn't alter its proposed compensation package. Namely, Duke wants to remove the Dillsboro dam as part of its environmental compensation rather than provide other environmental benefits that could cost the company more money, such as an environmental trust fund, Alexander said.

"Our customers are very fortunate that the stakeholder team agencies agreed to removing Dillsboro Dam instead of requiring solutions that would increase power bills more," Alexander said.

But Alexander also said profits have nothing to do with relicensing or what the company should provide. He said some in the region see Duke as a company with deep pockets and simply want "lots of money for nice things, but not related to relicensing."

Alexander said the goal of the four-year negotiation process with stakeholders was to develop a "fair and equitable condition for new licenses that would address environmental concerns and address recreational concerns and also allow us to continue to have the opportunity to operate these plants with flexibility to make energy for these customers."

Andrew Fahlund, with the American Rivers national environmental group, also disagrees with the connection between profits and environmental compensation, but for different reasons.

"At some level, I don't care if you can afford it or not. You've got a responsibility," Fahlund said. Fahlund also questions the idea of quantifying environmental compensation.

"You can very easily quantify the value of the electricity that is traded in the marketplace, but as far as trout habitat, how do you quantify that? How do you assign a value to a beautiful view versus a mountainside spanned by a pipeline?" Fahlund asked.

What are the profits?

Duke's annual profits in North Carolina hover around \$450 million, according to the public utility commission. But that number includes sales to 1.5 million customers and generation from nuclear and coal power plants statewide.

Duke opponents want to know how much Duke makes off the rivers of Western North Carolina to determine whether Duke can afford more compensation. So far, they have not been able to get those numbers.

In an interview last month, Duke spokesman Tom Williams first claimed such numbers were not kept and that it was too complicated to dissect the costs and expenses for individual power generation units. When asked why the publicly-traded company didn't track cost-benefit analysis for its various divisions, however, Williams said the profits for individual systems likely were kept but weren't public.

Statewide, Duke has been making approximately \$450 million in annual profits and has a total generation capacity of 12,000 megawatts. The Nantahala system has a production capacity of 100 megawatts. By applying a production capacity-to-profit ratio, the hydropower system up for relicensing accounts for roughly \$3.75 million of Duke's annual profits. Projected over the 40-year life of the license, that would total \$150 million in profits compared to Duke's \$6.5 million proposed compensation package to the region.

American Rivers, a national organization that monitors hydropower relicensing pegs Duke's profits off the Nantahala system much higher — in the neighborhood of \$8 million annually. Hydropower is cheaper to produce than other forms of power, especially since the dams are so old. Unlike coal and nuclear plants, no fuel is required as the river is free. Several of the dams and hydro stations have no employees.

Rate mandate

Duke Power recently settled with the North and South Carolina public utility commissions after an accounting probe in 2002 revealed the company concealed \$124 million in excess profits. Duke officials say the accounting discrepancies were a mistake. But an 11-month independent audit by accounting firm Grant Thornton indicates financial officers purposely and systematically doctored accounting records to conceal the profits.

A whistleblower alerted the state in 2001 to the alleged deceptive accounting methods, triggering the audit. Thornton's subsequent audit analyzed internal memos and emails. The accounting firm also interviewed several employees directly involved in the accounting scheme and determined the underreporting of profits was intentional.

A January 1999 email between Duke financial officers and internal auditors stated: "We are currently looking at reclassification of entries ... to help with our 'allowed return' problem." Auditors uncovered a spreadsheet that outlines various accounting methods that would lower the profit number reported to utility regulators while not impacting the profit reported to shareholders.

"This document (spreadsheet) is critical evidence of the existence of a coordinated plan to reclassify or adjust expenses to enhance Duke Power's regulatory position, without jeopardizing Duke Energy's consolidated earnings reported to investors," according to Thornton's report.

Following the accounting probe, Duke paid \$30 million to the state public utility commission to settle for the underreported profits.

While Duke settled with state energy regulators for the overcharges to Carolina customers, the question of possible wrongdoing remains unsettled. The state utility commission ensures regulated monopolies charge fair rates, but has no legal authority. Following the utility commission settlement, state prosecutors in Charlotte began investigating whether the company had committed criminal fraud. State prosecutors backed off, however, when the federal government launched a probe in late 2002. Federal prosecutors have subpoenaed thousands of documents and interviewed dozens of employees and are expected to announce within weeks whether Duke Power will be indicted.

California showdown

On another front, Duke Energy was subject to a federal probe over allegations of bid-rigging and withholding energy during California's energy crisis in 2000 and 2001. Duke was one of several large energy traders investigated by the Federal Energy Regulatory Commission following the California energy crisis.

While Duke admitted no wrongdoing, the company paid \$2.5 million to FERC to settle the issue. A FERC investigation found "no credible evidence" Duke had engaged in any of the alleged activities, according to a December 2003 FERC report coinciding with the \$2.5 million settlement. Duke was the second energy company to be cleared after a settlement. The money will create a fund for California power customers.

Duke's settlement with FERC also resolved issues of "wash" trading, where a power company buys and sells energy at the same price merely to inflate its volume of trading.

A small part of the whole

To Duke Power, the aging dams and hydro stations of the Nantahala system might of little significance in terms of their power-producing capacity. Together, the 11 dams in the hydropower network have a capacity of 100 megawatts. That represents one-half of 1 percent of Duke's total generation capacity. Nonetheless, Duke bought up the Nantahala system in 1988.

The company's primary interest in the region wasn't for the hydropower but for its proximity to neighboring utility giant Tennessee Valley Authority, according to Duke spokesman Williams. Direct access to TVA made it easier to wheel and deal power across the grid.

Duke can reel in power produced at coal plants in Ohio and resell it to its customers, or to another power company such as CP&L. Duke is one of the largest power brokers in the country. Without ownership of the lines that tie into TVA, Duke would have to pay to wheel power across another company's lines.

Should electric deregulation ever come to the region, Duke's connection to TVA will be even more important. Deregulation would end the rules that go along with regulated monopolies, namely the regulated profit ceilings.

Duke currently wholesales power across the grid and resells it at wholesale rates to other power companies. Under deregulation, Duke could resell the power at retail prices directly to customers.

What about Needmore?

The compensation package currently proposed by Duke Power is less than a third of what Duke Energy made off the region with the recent one-time sale of the surplus property along the Little Tennessee River. The 4,400-acre Needmore tract belonged to the Alcoa-owned Nantahala Power system, acquired in the 1930s for hydropower potential on the Little Tennessee. Dams were never built along the stretch, but the parcel was retained by Alcoa Power company over the years. When Duke bought the Nantahala system, Needmore was part of the package.

One month prior to the start of the hydropower relicensing negotiations, Duke Power transferred the parcel to Crescent Resources, a property development company wholly-owned by Duke. Duke Energy booked a \$19 million profit by selling the property to Crescent. Crescent in turn sold the property for \$19 million for permanent conservation.

That \$19 million in earnings was not reported to the state utility commission as profits. According to the commission, profits from the sale of Needmore fell outside the commission's regulatory authority, which is concerned solely with costs and returns relating directly to power generation and sales to Carolina customers.