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Previous Report Duke Energy
June 12, 2008 - \$18 - Hold

Rating: Raised to Buy from Hold

Duke Energy
(DUK-NYSE-\$14)
(Maybe the Sky Isn't Falling)

Duke	7/8			Performance	Price 7/8	Yr.-end % Chg.	12 Mos. %Chg.
Price	14			Duke	14	(5)	(17)
52-week range	19-12			Phila.22 El.	368	(8)	(31)
Earnings Per Share				Dow Industrials	8,164	(7)	(27)
2007 Adjusted **	1.23	11.4	P/E	Shares-millions	1,272		
2008 Adjusted **	1.21	11.8		Market Value-\$Bil	18		
2009 Consensus	1.21	11.8					
2010 Consensus	1.30	11.0					
2011 Estimate	1.40	10.2					
Dividend	0.96	6.7	Yield				
Book Value 12/31/08*	16.55	87	P/B	Analyst Coverage	20	30	% Buys

*Book value includes \$3.71 a share in Goodwill. **GAAP earnings were \$1.01 a share 2008 and \$1.20 a share 2007, Consensus Estimates from Bloomberg Financial Service

Recommended for Income with 12-month Price Target of \$17

Duke Energy's challenges are obvious; it's the execution that's difficult. Management's job is to obtain steady rate increases, reduce regulatory lag, cut expenses in a rising cost environment, and maintain high-quality service. Oh, as an add-on, the company, as a large emitter of Carbon Dioxide (CO₂), faces the task of blunting cost pressures of inevitable climate change legislation or EPA mandates.

Investors have long recognized Duke's situation. Its price decline of 17% for the trailing 12-months, although poor, compares to a 31% decline for the Philadelphia 22 Electric Stock Index and a 27% drop registered by the Dow Jones Industrials. Year to date, Duke Energy's share performance has been more in line with the averages, declining 5%, compared to 8% for the Philadelphia Index and 7% for the Dow Jones Industrials. At \$14, Duke trades at 11.8 times and 11.0 times 2009 and 2010 earnings, respectively. The average utility in the Dow Jones Utilities Average trades at slightly lower multiples, 11.3 times and 10.7 times, respectively. The major difference is Duke's payout of 80% (\$0.96 a share dividend) and 6.7% yield versus the Dow Utilities average payout of 52% and a 4.9% yield. Duke's 6.7% yield plus 4%-5% dividend growth works out to a 10.7%-11.7% total annual return.

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See page 7 of report for Analyst's Certification, pages 7-8 for Important Disclosures and page 8 for Other Disclosures and Disclaimers

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Actions that we believe will contribute to P/E multiple expansion are less onerous climate legislation than feared and reasonable rate relief by state commissions. Management has supported the Waxman Markey (HR 2454) bill passed by the House and will work on further changes in the Senate version, including longer phase-out of emission credits and softening of the 17% reduction in CO₂ emissions by 2020. Reasonable rate relief in North Carolina and South Carolina in early 2010 could further boost investor confidence.

Investment - Street Profile

According to Bloomberg Financial Service, Duke has 20 active recommendations - 6 buys and 14 holds. Most recent buy ratings were issued by Oppenheimer (7/1) and Edward D. Jones (6/23). Its largest shareholders as of March 31, 2009 include: State Street Corp. (52 million shares down from 98 million a year ago); Barclays (52 million shares up from 42 million); Franklin Resources (46 million shares up from 36 million), Vanguard Group (43 million shares up from 36 million), and Barrow Hanley (37 million shares down from 45 million).

Overview

Duke Energy's \$13.2 billion of revenues in 2008 were derived (before intercompany eliminations) \$9.9 billion (76%) from US electric and gas utilities, \$1.8 billion (14%) quasi-regulated and competitive generation, and \$1.1 billion (13%) International.

US Franchise E&G utilities operate in 5-states in the Southeast and Midwest whose combined service areas contain 11 million people, including 4 million customers. Commercial Power (CP) operates 7,600 megawatts of coal and natural gas generation in the Midwest, and is expanding what is currently a modest wind generation business. International Energy revenues are derived from generation in Latin America; another \$127 million represents earnings in minority equity investments in petrochemicals in Saudi Arabia (National Methanol); and gas distribution (Attiki) in Athens, Greece.

Adjusted earnings were \$1.21 a share in 2008; level with \$1.23 a share in 2007 and at the low end of management's incentive range of \$1.20-\$1.35 a share. The incentive target for 2009 is \$1.20 a share (Street consensus \$1.21 a share). Utilities earnings should be flat assuming lower first-half sales are offset by recovery in the second half and O&M is cut by \$100 million. Commercial Power earnings gains will stem from a return to SFAS #71 accounting and are expected to offset declines in International, primarily National Methanol.

Management's longer-term goal is to increase earnings 5%-7% compounded annually through 2013, to \$1.55-\$1.70 a share, and to increase the dividend annually. The Board's latest dividend increase was 4.5% to \$0.96 a share (\$0.01 a share increase per quarter) at the June declaration. The \$1.20 a share incentive works out to a 7.2% return on average book that would rise to 8.5% (\$1.55 a share)-9.4% (\$1.70 a share) in 2013. If book were reduced by Goodwill, comparable returns rise from 9.3% in 2008 to 10.7% (\$1.55 a share)-11.8% (\$1.70 a share) in 2013. Failure to increase return keeps 2013 earnings in the \$1.30 a share area. We estimate earnings growth of 4%-5% annually.

Growth in investment (rate base) is expected to exceed 6% annually compared to kilowatt hour sales of 2%-3% per annum longer term. Management claims flexibility in construction outlays but it seems limited. Of the \$24.8 billion budget, \$7.5 billion is already committed while \$12.8 billion represents ongoing capital needs that may be deferred but not eliminated, i.e., maintenance capital. Another \$4.6 billion, classified as discretionary, includes wind, smart grid, biomass and international.

Regulation to date has been encouraging. In June, Duke filed for a \$496 million (12.6%) rate increase in North Carolina and momentarily will file in South Carolina (we assume also in the 13% area). New rates will be effective in early 2010. The Ohio Commission signed off on a \$55 million electric rate settlement on July 8, 2009. Also in May 2008 the Ohio legislature passed a bill introducing an Electric Security Plan (ESP) enabling Commercial Power generation to return to SFAS 71 accounting, thus providing predictability in earnings. In Indiana, the commission supported construction of a first of its kind Integrated Gasification Combined Cycle (IGCC), approved construction caps, and allowed Construction Work In Progress (CWIP) in rate base.

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And of course, the elephant in the living room is Climate Change legislation (Global Warming) and cap & trade. Duke Energy is the third largest emitter of CO₂, behind Southern Co. (SO-\$32-Buy) and American Electric Power (AEP-\$28-Hold). The company announced its support of Waxman Markey HR 2454, a bill that squeaked by the House (219-212) last month. The bill allocates free emission credits initially and calls for CO₂ reduction 17% below 2005 levels by 2020 and 83% below by 2050. Renewables are to represent 20% of the 2020 load but one quarter can be met via energy efficiencies. Emission credits initially are the equivalent of 90% emissions level and decline steadily terminating in 2030. The Senate began hearings on its version in early July. Legislation could pass in 2009, but more likely 2010. In the Senate version, the utilities industry will push for a longer phase-out of emission allowances and a reduction in CO₂ requirement by 2020 less stringent than 17%. In short, further compromise is likely.

Earnings per Share Profile

Table 2 contains our estimates of earnings, rates of return, and book values for Duke Energy businesses before intercompany allocations for 2008. Utilities in North Carolina and South Carolina, Ohio, Indiana, and Kentucky accounted for \$0.88 a share, or 73% of consolidated 2008 results of \$1.20 a share. Commercial Power contributed \$0.18 a share and International \$0.24 a share. Other and intercompany eliminations were a negative \$0.10 a share.

Table 1
Estimated Earnings Per Share Profile
Before Intercompany Eliminations
2008

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
\$-millions	Consol.	Carol.	Ohio	Ky	Ohio-Ky	CP	Mwst	CP- Mwst	Ohio Reg	Ind.	Intl.	Other
Shs-mil	\$-Mil.	\$-Mil.	\$-Mil.	\$-Mil.	\$-Mil.	\$-Mil.	\$-Mil.	\$-Mil.	\$-Mil.	\$-Mil.	\$-Mil.	\$-Mil.
1,268					(3-4)			(6-7)				
Revenues	13,207	5,903	3,424	502	2,922	1,826			1,096	2,483	1,185	212
Oper Inc	2,840	1,292	616	70	546	338	(9)	347	208	458	287	187
Interest	741	331	94	18	76	59	0	59	17	123	34	159
Oper Pr Tx	2,099	961	522	53	469	279	0	279	190	335	253	28
Other Inc.	194	101	93	5	88	83	0	83	5	73	146	(219)
Tot Pre Tax	2,293	1,062	615	58	557	362	(9)	371	195	408	399	(191)
Tax Rate	33.7%	35.0%	37.1%	34.8%	37.3%	36.6%	36.2%	37.0%	37.0%	36.8%	22.8%	35.6%
Taxes	773	372	228	20	208	132	(3)	137	70	150	91	(68)
After Tax	1,520	690	387	37	350	230	(6)	235	125	258	308	(123)
Bal. to Com.	1,520	690	387	37	350	230	(6)	235	125	258	308	(123)
EPS	1.20	0.54	0.31	0.03	0.28	0.18	(0.00)	0.19	0.10	0.20	0.24	(0.10)
% Consol		45%	25%	2%	23%	15%	0%	15%	8%	17%	20%	-8%
Book Yr-end	16.55	5.77	5.26	0.31	4.95	2.85	1.10	1.75	2.10	2.05	1.69	1.78
% Consol		35%	32%	2%	30%	17%	7%	11%	13%	12%	10%	11%
Return Bk.	7.2%	9.4%	5.8%	9.5%	5.6%	6.4%	-0.4%	10.6%	4.7%	9.9%	14.3%	-5.4%

Source: Company statements & Shields' Estimates

Columns 1-2-3-4-10 are based on 10K and other filings; **Column 5** – Duke Ohio numbers (column 3) less Kentucky (Column 4); **Column 6** – Operating revenues for Commercial Power and expenses as per the Statistical Supplement with imputed tax rates and interest charges estimated by Shields; **Column 7** – Midwest results per management; **Column 8** – Imputes Commercial Power less Midwest; **Column 9** – proxy for Ohio regulated (column 5 less column 6); **Column 10** – Indiana from company statements; **Column 11** – International with interest expense and tax rate imputed by Shields. **Column 12** – What's left.

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US Franchise

Duke's overall regulatory climate is fair, not a bad description in a rising cost environment.

Carolinas: Duke Carolinas serves an area covering 22,000 square miles and a population of 6 million people in western North Carolina (about 70 % of system receipts) and western South Carolina (30%).

In June 2009, the company filed for a \$496 million (12.6%) rate increase in North Carolina based on a 2008 test year. The request is designed to provide an 11.5% return on a 53% common equity component and a rate base of \$14 billion. The last allowed return was 11%. The petition includes \$90 million for Construction Work in Progress (CWIP) on the 825 megawatt Cliffside unit. The commission has 300 days to decide the case, but rates can be collected subjected to refund after seven months (January 2010). A South Carolina filing is imminent, probably in the 12%-13% range. Duke Carolinas (**column 2**) earnings of \$0.54 a share in 2008 (45% of consolidated) represented a 9.4% return on book of \$5.77 a share. Earnings should be flat in 2009, but rate relief should increase profits to the \$0.62-\$0.65 a share area in 2010.

Ohio (Kentucky): Duke Ohio's 10K statements (**column 3**) consolidate Regulated Electric and Gas and Commercial Power. Regulated businesses include Union Light & Heat in Kentucky and Cincinnati Gas & Electric in Ohio. The combined service areas cover 3,000 square miles and a population of over 2 million people. Commercial Power is quasi-regulated, owns and operates generation totaling 7,600 megawatts and is aggressively expanding into wind generation. Ohio consolidated and Commercial Power results (**column 6**) exclude the effects of mark to market accounting and impairment of emission credits recorded in 2008.

Duke Ohio (**column 3**) earned \$0.31 a share (\$387 million) in 2008, 25% of consolidated Duke Energy. We estimate the profit breakdown at \$0.18 a share Commercial Power (**column 6**) and \$0.13 a share utilities (**columns 4 & 9**). The consolidated return on stated common at Duke Ohio was 5.8%, including 9.5% at Union Light & Heat in Kentucky, 6.4% at Commercial and 4.7% Ohio regulated. As of December 31, 2008, Duke Ohio goodwill stood at \$1.87 a share (\$2,360 million). Commercial Power goodwill was \$0.76 a share (\$960 million), leaving \$1.11 a share (\$1,400 million) for Ohio regulated. If book value at Ohio regulated were reduced by goodwill, the return rises to a more respectable 10.0%. The Ohio commission on July 8, 2009 signed off on a settlement of \$55 million in the electric distribution case.

Indiana: Duke Indiana (PSI Resources), a traditional integrated electric utility, serves a 22,000 square mile service area containing 2.4 million people in north central, central and southern Indiana. Indiana (**column 10**) earned \$0.20 a share (\$258 million) for a return on common of 9.9% in 2008. The Indiana Utility Regulatory Commission (IURC) in 2007 approved a first of its kind construction of the 630 megawatt Edwardsport Integrated Gasification Combined Cycle (IGCC) plant designed to capture and store CO₂ emissions. In January 2009, the IURC raised the approved cost to \$2.35 billion up from the previous \$1.985 billion. As of March 31, 2009, Edwardsport was 30% complete, had committed construction of \$1.2 billion and had an in service date in the summer of 2012.

Commercial Power

Generation: Commercial Power operates competitive and quasi-regulated generation totaling 7,600 megawatts. Generation totaling 4,000 megawatts was separated from T&D under Ohio deregulation legislation but, in May 2008, the legislature passed a bill giving generators the choice to join an Electric Security Plan (ESP) with regulatory oversight or a Market Rate Option (MRO) that would be fully competitive. The effective period for the ESP covers January 2009 through December 31, 2011.

Under the ESP, the Ohio commission has complete approval over rates for native load customers and authority to set earnings tests. Generation charges are market based, but native load customers have the ability to switch to alternate suppliers. The ESP provides rate riders for capacity, fuel and purchased power, reliability and transmission costs, all factors that qualify for SFAS #71 accounting for regulated entities. Utility accounting more accurately matches revenues with expenses and will produce more predictable earnings. The danger of course is that a major switch by native load customers to alternate suppliers could bring recovery of those riders into question. Customer switching to date has been modest.

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Midwest: The 3,600 megawatts of Midwest gas generation was transferred to Commercial Power, another Duke subsidiary, prior to the spin off of the natural gas business in 2007 (Spectra Energy-\$17-SE-Not Rated). The transfer, totaling \$1,400 million, was recorded as common equity. Midwest output is sold competitively, making it tough to compete with lower-cost coal and nuclear. Midwest posted an EBIT loss of \$9 million in 2008, including a one-time \$15 million writeoff of a Lehman Bros. transaction. Midwest was \$2 million EBIT-positive for three months ended March 31, 2009. Midwest's bid in the PJM capacity auction was successful with 1) \$41 per megawatt day for 2007/08; 2) \$112 per megawatt day – 08/09; 3) \$124 per megawatt day – 09/10; 4) \$174 – 11/12; and 5) \$16 per megawatt day – 12/13. Revenues from the bids could account for the equivalent of \$0.04 a share in 2009, \$0.08 a share in 2010; \$0.13 a share in 2011, and \$0.04 in 2012.

Wind: Wind generation received a huge boost under "Uncle Sam's" stimulus package – The American Recovery and Reinvestment Act of 2009. The act provides for 1) a three-year extension of the Production Tax Credits (PTC) thru December 31, 2012; 2) the ability to receive in lieu of the PTC, an Investment Tax Credit or Department of Treasury grant equal to 30% of qualified investment for units placed in service prior to December 31, 2012. The act also extended the 50% bonus depreciation for assets started in 2008/9 and placed in service by December 31, 2009.

Management estimates that the ITC/Grant option will add \$400 million to 2009 cash flow. The decision between the PTC or ITC may be made on a turbine per turbine basis. Our understanding is that Production Tax Credits produce steady earnings on an accounting basis for 10 years. Under the Investment Tax Credit (Grant), earnings per project are generated in year 1 and drop in year 2. We reviewed how we think the accounting works based on releases of FPL Group (FPL-\$55-Hold) in a May 12, 2009 report titled **WIND – Investment Tax Credits vs. Production Tax Credit Options**.

According to FPL Group, the typical (mid-point range) investment for a 100 megawatt wind unit is \$205 million. Assuming the entire investment qualifies (most of it should), the Investment Tax Credit would total \$61.5 million. According to the legislation, cash under the grant is due from the US Treasury the later of 60 days after the COD date or 60 days after the application is filed.

For accounting purposes, the investment tax credit and accelerated depreciation are amortized over the life of the project, typically 25 years. The earnings benefit stems from the difference between the book and tax basis. Under the stimulus, the cost basis per books is reduced by \$61.5 million to \$143.5 million (\$205.0 million cost less \$61.5 million). On the IRS books, the cost basis is reduced by half the ITC or \$30.8 million (\$61.5 million divided by 2) to \$174.3 million.

As a result, the IRS records \$30.8 million more in depreciation expense than book reporting. The increased depreciation at the IRS reduces income taxes payable per books by \$10.8 million (\$30.8 million times the applicable tax rate – 35%). Those tax savings are flowed thru in year 1. In year 2, earnings would decline without additional wind investment by the equivalent of \$10.8 million. By contrast, the Production Tax Credit scenario produces level earnings over the 10 year life of the PTC, then declines sharply.

Commercial Power has 522 megawatts in service and will add 211 megawatts by year end for a total 733 megawatts. The company has pipeline totaling 5,000 megawatts and plans to add at least 250 megawatts annually.

Commercial Power Returns: Capitalization of \$4,989 million at 2008 year end included book value of \$2.85 a share (\$3,616 million) and earnings (our estimates) of \$0.18 a share (\$230 million). Return on common was 6.4%. If Midwest generation investment (\$1,400 million) and losses (\$6 million) were accounted for separately, Commercial Power's return on book rises to 10.6%. In overseeing profits under the ESP, the Ohio Public Utilities Commission would likely treat the \$0.76 per share (\$960 million) goodwill as a non-earning asset. If goodwill were deducted from Commercial Power book, the return on common excluding Midwest rises to 18.7%.

Commercial Power earnings will benefit from SFAS accounting and the absence of unfavorable timing in collection of fuel and purchased power expenses and higher rates stemming from implementation of the ESP. Commercial Power earnings are estimated to increase \$0.03-\$0.05 a share in 2009 to a \$0.21-\$0.23 a share range.

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International Energy

International Energy businesses are located in Latin America, Saudi Arabia, and Athens, Greece. At 2008 year end, capacity totaled 4,018 megawatts; 2,112 megawatts of hydro (53%) in Brazil; 523 megawatts (hydro/natural gas) in Argentina; 645 megawatts in Peru (510 megawatts oil/diesel - 135 megawatts natural gas); 283 megawatts (oil/diesel) in El Salvador; and 150 megawatts (diesel) in Ecuador. Equity investments are in National Methanol Company (NMC) in Saudi Arabia and Attiki Gas Supply, a distributor in Athens, Greece.

International earnings of \$0.24 a share (\$308 million) in 2008 compare to \$0.23 a share (\$285 million) in 2007. Approximately \$0.13 a share (\$162 million) was derived from Latin America generation, mostly in Brazil. The remaining \$0.10 a share (\$127 million) stemmed from Saudi Arabia's NMC and Attiki gas distribution in Athens, and Other - \$0.01 a share (\$19 million). The earnings increase reflected improved margins at NMC and favorable exchange rates. Earnings in 2009 are expected to decline \$0.02 a share to \$0.22 a share, caused primarily by lower commodity prices at National Methanol.

EBIT

The following table presents management breakout of Earnings before Income Taxes (EBIT), including estimates for 2009.

Table 2
Management on-going EBIT
(2009-2006)

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	09/08	2009	est.	08/07	2008		07/06	2007	
	%	\$-mil	% total	%	\$-mil	% total	%	\$-mil	% total
U.S.EG	0.1	2,400	80	4.0	2,398	82	27.3	2,305	84
Commercial Pwr	11.6	470	16	51.4	421	14	491.5	278	10
Int'l. Energy	(10.0)	370	12	5.9	411	14	24.0	388	14
Crescent					(16)			61	2
EBIT Ongoing	0.8	3,240	108	6.0	3,214	110	23.4	3,032	111
Other	(15.0)	(250)	(8)	(1.3)	(294)	(10)	(44.5)	(298)	(11)
Total EBIT & Other	2.4	2,990	100	6.8	2,920	100	42.4	2,734	100

Source: Management Presentation

Analyst's Certification

I Raymond E. Moore certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report. Other Duke Energy reports issued by me are: 5/17/05 (\$28) – Hold; 6/12/08 (\$18) - Hold.

Important Disclosures

Guide to Investment Ratings:

Buy Total return is expected to exceed significantly the average total return of the analyst's industry coverage universe over the next 12 months.

Market Perform & Hold Total return is expected to equal the average total return of the analyst's industry coverage universe over the next 12 months.

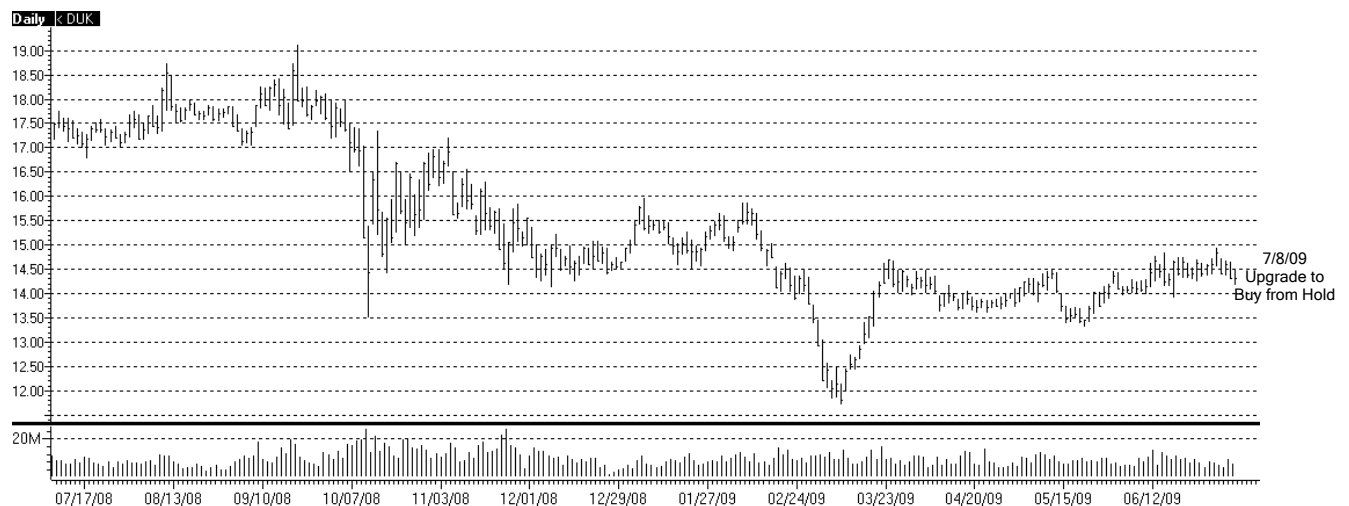
Sell Total return is expected to significantly under perform (15% plus) the total return of the industry coverage universe over the next 12 months.

Analyst's Ratings Distribution

		% Investment Banking
Buy	25%	0%
Hold	75%	0%
Sell	0%	0%

The principal risks to the achievement of our price targets include general market trends, disappointing earnings and lower energy prices and adverse regulatory developments.

Our target prices are based on projected earnings for the following calendar year, and an assumed price/earnings ratio in line with the company's historical valuation or those of other companies with similar businesses and prospects.



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