

LG&E and KU Energy LLC

Condensed Consolidated Financial Statements and Additional Information
(unaudited)

As of March 31, 2011 and December 31, 2010
And for the three months ended
March 31, 2011 and 2010

Index of Abbreviations

ARO	Asset Retirement Obligation
ASC	Accounting Standards Codification
BART	Best Available Retrofit Technology
CAIR	Clean Air Interstate Rule
CAMR	Clean Air Mercury Rule
CATR	Clean Air Transport Rule
CCN	Certificate of Public Convenience and Necessity
Clean Air Act Company	The Clean Air Act, as amended in 1990 LG&E and KU Energy LLC and Subsidiaries
DSM	Demand Side Management
ECR	Environmental Cost Recovery
E.ON	E.ON AG
EPA	U.S. Environmental Protection Agency
FAC	Fuel Adjustment Clause
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FGD	Flue Gas Desulfurization
GAAP	U.S. Generally Accepted Accounting Principles
GHG	Greenhouse Gas
GSC	Gas Supply Clause
IRP	Integrated Resource Plan
KDAQ	Kentucky Division for Air Quality
Kentucky Commission	Kentucky Public Service Commission
KU	Kentucky Utilities Company
LEM	LG&E Energy Marketing Inc.
LG&E	Louisville Gas and Electric Company
LKC	LG&E and KU Capital LLC
LKE	LG&E and KU Energy LLC and Subsidiaries
MISO	Midwest Independent Transmission System Operator
Moody's	Moody's Investor Services, Inc.
Mwh	Megawatt hours
NAAQS	National Ambient Air Quality Standards
NO ₂	Nitrogen Dioxide
NOV	Notice of Violation
NOx	Nitrogen Oxide
OVEC	Ohio Valley Electric Corporation
PCB	Polychlorinated Biphenyls
PPL	PPL Corporation
Predecessor	The Company during the time period prior to November 1, 2010
S&P	Standard & Poor's Rating Service
SCR	Selective Catalytic Reduction
SEC	U.S. Securities and Exchange Commission
Servco	LG&E and KU Services Company
SIP	State Implementation Plan
SO ₂	Sulfur Dioxide

Successor	The Company during the time period after October 31, 2010
TC2	Trimble County Unit 2
Utilities	LG&E and KU
VEBA	Voluntary Employee Beneficiary Association
Virginia Commission	Virginia State Corporation Commission
WKE	Western Kentucky Energy Corp. and its Affiliates

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LG&E and KU Energy LLC
Condensed Consolidated Statements of Income
(unaudited)
(\$ millions)

	Successor Three Months Ended March 31, 2011	Predecessor Three Months Ended March 31, 2010
Operating revenues	\$ 766	\$ 713
Operating expenses:		
Fuel for electric generation	215	209
Power purchased	18	40
Natural gas supply	89	81
Other operation and maintenance	190	167
Depreciation and amortization	<u>81</u>	<u>69</u>
Total operating expenses	<u>593</u>	<u>566</u>
Operating income	173	147
Equity in earnings of unconsolidated venture	1	3
Interest expense	36	6
Interest expense to affiliate	-	40
Other income (expense) - net	<u>(2)</u>	<u>(3)</u>
Income from continuing operations, before income taxes	136	101
Income taxes (Note 7)	<u>49</u>	<u>38</u>
Income from continuing operations	87	63
Discontinued operations:		
Loss from discontinued operations net of income tax	-	2
Loss on disposal of discontinued operations net of income tax ...	<u>-</u>	<u>1</u>
Loss from discontinued operations	<u>-</u>	<u>3</u>
Net income attributable to member	<u>\$ 87</u>	<u>\$ 60</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

LG&E and KU Energy LLC
Condensed Consolidated Statements of Comprehensive Income
(unaudited)
(\$ millions)

	Successor Three Months Ended March 31, 2011	Predecessor Three Months Ended March 31, 2010
Net income attributable to member	\$ 87	\$ 60
Other comprehensive income (loss):		
Defined-benefit pension and postretirement plans, net of tax benefit of \$0.....	(1)	-
Gain on derivative instruments, net of tax expense of \$0	-	1
Equity investee's other comprehensive loss, net of tax benefit of \$0.....	(1)	-
Comprehensive income attributable to member	\$ 85	\$ 61

The accompanying notes are an integral part of these condensed consolidated financial statements.

LG&E and KU Energy LLC
Condensed Consolidated Statements of Member's Equity
(unaudited)
(\$ millions)

	Membership Units <u>Outstanding</u>	Membership Units	Additional Paid-in Capital	Accumulated Other Comp. Inc.	Retained Earnings	Non- controlling Interest	Total Equity
Successor:							
Balance January 1, 2011	1,001	\$ -	\$ 3,958	\$ 6	\$ 47	\$ -	\$ 4,011
Net income attributable to member	-	-	-	-	87	-	87
Dividends declared	-	-	-	-	(54)	-	(54)
Other comprehensive loss ...	-	-	-	(2)	-	-	(2)
Balance March 31, 2011	<u>1,001</u>	<u>\$ -</u>	<u>\$ 3,958</u>	<u>\$ 4</u>	<u>\$ 80</u>	<u>\$ -</u>	<u>\$ 4,042</u>

	Membership Units <u>Outstanding</u>	Membership Units	Additional Paid-in Capital	Accumulated Other Comp. Loss	Retained Deficit	Non- controlling Interest	Total Equity
Predecessor:							
Balance January 1, 2010	1,001	\$ 774	\$ 4,224	\$ (43)	\$ (2,763)	\$ 32	\$ 2,224
Net income attributable to member	-	-	-	-	60	-	60
Dividends declared	-	-	-	-	(6)	-	(6)
Other comprehensive income	-	-	-	1	-	-	1
Disposal of discontinued operations	-	-	-	(11)	-	(32)	(43)
Balance March 31, 2010	<u>1,001</u>	<u>\$ 774</u>	<u>\$ 4,224</u>	<u>\$ (53)</u>	<u>\$ (2,709)</u>	<u>\$ -</u>	<u>\$ 2,236</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

LG&E and KU Energy LLC
Condensed Consolidated Balance Sheets
(unaudited)
(\$ millions)

Assets	March 31, 2011	December 31, 2010
Current assets:		
Cash and cash equivalents	\$ 94	\$ 11
Accounts receivable (less allowance for doubtful accounts 2011, \$20; 2010, \$17):		
Customer	151	160
Affiliate	-	2
Other	11	33
Unbilled revenues	131	170
Fuel, materials and supplies:		
Fuel (predominantly coal)	158	163
Natural gas stored underground	19	60
Other materials and supplies	78	75
Notes receivable from affiliate	45	61
Income taxes receivable	66	40
Deferred income taxes - net	95	66
Regulatory assets (Note 3)	17	22
Available for sale debt securities (Note 8)	-	163
Other intangible assets	44	58
Prepayments and other current assets	24	26
	933	1,110
Total current assets		
Investment in unconsolidated venture	31	31
	31	31
Property, plant and equipment:		
Regulated utility plant	7,193	6,230
Other	4	4
Less: accumulated depreciation	98	31
Construction work in progress	457	1,340
	457	1,340
Property, plant and equipment – net	7,556	7,543
	7,556	7,543
Deferred debits and other noncurrent assets:		
Regulatory assets (Note 3):		
Pension and postretirement benefits	330	330
Other regulatory assets	262	259
Goodwill	996	996
Other intangible assets	345	356
Other long-term assets	94	94
	94	94
Total deferred debits and other noncurrent assets	2,027	2,035
	2,027	2,035
Total assets	\$ 10,547	\$ 10,719

The accompanying notes are an integral part of these condensed consolidated financial statements.

LG&E and KU Energy LLC
Condensed Consolidated Balance Sheets (continued)
(unaudited)
(\$ millions)

	March 31, 2011	December 31, 2010
Liabilities and Equity:		
Current liabilities:		
Current portion of long-term debt (Note 8)	\$ 2	\$ 2
Note payable (Note 8)	-	163
Accounts payable.....	169	189
Accounts payable to affiliate (Note 10).....	2	3
Customer deposits	46	46
Accrued taxes	19	27
Regulatory liabilities (Note 3)	72	92
Other current liabilities.....	126	122
Total current liabilities	436	644
Long-term debt (Note 8).....	3,823	3,823
Deferred credits and other noncurrent liabilities:		
Deferred income taxes	391	240
Accumulated provision for pensions	312	449
Investment tax credits.....	148	150
Asset retirement obligations	103	103
Regulatory liabilities:		
Accumulated cost of removal of utility plant (Note 3).....	633	623
Other regulatory liabilities (Note 3)	382	394
Derivative liabilities (Note 4).....	29	32
Other long-term liabilities	248	250
Total deferred credits and other noncurrent liabilities.....	2,246	2,241
Equity:		
Membership units, without par value – authorized 10,000,000 units, outstanding 1,001 units	-	-
Additional paid-in capital	3,958	3,958
Accumulated other comprehensive income	4	6
Retained earnings	80	47
Total equity.....	4,042	4,011
Commitments and contingent liabilities (Note 9).....	-	-
Total liabilities and equity	\$ 10,547	\$ 10,719

The accompanying notes are an integral part of these condensed consolidated financial statements.

LG&E and KU Energy LLC
Condensed Consolidated Statements of Cash Flows
(unaudited)
(\$ millions)

	Successor Three Months Ended March 31, 2011	Predecessor Three Months Ended March 31, 2010
Cash flows from operating activities:		
Net income	\$ 87	\$ 60
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization.....	81	69
Deferred income taxes - net.....	120	5
Provision for pension and postretirement benefits	12	19
Loss from discontinued operations - net of tax	-	3
Other – net	(2)	(6)
Change in current assets and liabilities:		
Accounts receivable.....	33	(27)
Unbilled revenues	39	33
Fuel, materials and supplies.....	43	20
Income taxes receivable	(26)	-
Regulatory assets	4	32
Prepayments and other current assets.....	4	(1)
Accounts payable.....	(20)	(8)
Accounts payable to affiliates.....	(1)	11
Accrued taxes	(8)	21
Regulatory liabilities	(6)	(22)
Other current liabilities.....	4	(32)
Pension and postretirement benefits funding.....	(153)	(45)
Discontinued operations	-	24
Other – net	(1)	(14)
Net cash provided by operating activities.....	<u>210</u>	<u>142</u>
Cash flows from investing activities:		
Construction expenditures	(86)	(90)
Proceeds from sales of discontinued operations.....	-	21
Sales of marketable debt securities.....	163	-
Change in restricted cash.....	(2)	-
Loans to affiliates – net	16	-
Net cash provided by (used in) investing activities.....	<u>\$ 91</u>	<u>\$ (69)</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

LG&E and KU Energy LLC
Condensed Consolidated Statements of Cash Flows (continued)
(unaudited)
(\$ millions)

	Successor	Predecessor
	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Cash flows from financing activities:		
Repayments of short-term note payable	\$ (163)	\$ -
Debt issuance costs.....	(1)	-
Changes in notes payable to affiliate – net.....	-	(111)
Issuance of long-term debt to affiliate.....	-	50
Payment of dividends (Note 10)	(54)	(6)
Net cash used in financing activities	(218)	(67)
Change in cash and cash equivalents.....	83	6
Cash and cash equivalents at beginning of period.....	11	7
Cash and cash equivalents at end of period.....	\$ 94	\$ 13

The accompanying notes are an integral part of these condensed consolidated financial statements.

LG&E and KU Energy LLC
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 1 – Interim Financial Statements

The accompanying condensed consolidated financial statements and notes should be read in conjunction with LKE's Consolidated Financial Statements and Additional Information Report for 2010.

Terms and abbreviations are explained in the index of abbreviations. Dollars are in millions unless otherwise noted.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with GAAP for interim financial information and do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation in accordance with GAAP are reflected in the condensed consolidated financial statements. All adjustments are of a normal recurring nature, except as otherwise disclosed. The Condensed Consolidated Balance Sheet at December 31, 2010, is derived from the 2010 audited Consolidated Balance Sheet.

The results of operations for the three months ended March 31, 2011, are not necessarily indicative of the results to be expected for the full year ending December 31, 2011, or other future periods, because results for interim periods can be disproportionately influenced by various factors, developments and seasonal variations.

Consolidation and Basis of Accounting

The condensed consolidated financial statements include LKE, LG&E, KU, LEM, Servco, LKC and their wholly owned subsidiaries. All intercompany balances and transactions have been eliminated. Investments in business entities in which the Company does not control, but has the ability to exercise significant influence over operating and financial policies, are accounted for by the equity method.

Predecessor and Successor Financial Presentation

LKE became a wholly owned subsidiary of PPL when PPL acquired all of the Company's limited liability company interests from E.ON US Investments Corp. on November 1, 2010. LKE is a holding company under the Public Utility Holding Act of 2005.

LKE's condensed consolidated financial statements and accompanying footnotes have been segregated to present pre-acquisition activity as the Predecessor and post-acquisition activity as the Successor. Predecessor activity covers the time period prior to November 1, 2010. Successor activity covers the time period after October 31, 2010. Certain accounting and presentation methods were changed to acceptable alternatives to conform to PPL accounting policies, which are discussed in the Company's Financial Statements and Additional Information Report for 2010. The cost basis of certain assets and liabilities were changed as of November 1, 2010, as a result of the application of push-down accounting. Consequently, the financial position, results of operations and cash flows for the Successor period are not comparable to the Predecessor period.

Despite the separate presentation, the core operations of the Company have not changed. See Note 2, Acquisition by PPL, and Note 7, Goodwill and Intangible Assets, in the Company's Financial Statements and Additional Information Report for 2010 for information regarding the acquisition and the purchase accounting adjustments.

Note 2 – Summary of Significant Accounting Policies

The following accounting policy disclosures represent updates to Note 1, Summary of Significant Accounting Policies, in LKE's Consolidated Financial Statements and Additional Information Report for 2010 and should be read in conjunction with that discussion.

Equity Method Investment

LKE's equity method investment, included in Investment in unconsolidated venture on the Condensed Consolidated Balance Sheets, consists of its investment in Electric Energy, Inc ("EEI"). LKE owns 20% of the common stock of EEI, which owns and operates a coal-fired plant and natural gas facility in southern Illinois. Through a power marketer affiliated with its majority owner, EEI sells its output to third parties. Although LKE holds an investment interest in EEI, it is not the primary beneficiary and is therefore not consolidated into the Company's consolidated financial statements. LKE's investment in EEI, accounted for under the equity method of accounting, as of March 31, 2011 and December 31, 2010, totaled \$30 million. LKE's direct exposure to loss as a result of its involvement with EEI is generally limited to the value of its investment.

Cost Method Investment

LKE's cost method investment, included in Investment in unconsolidated venture on the Condensed Consolidated Balance Sheets, consists of the Utilities' combined 8.13% investment in OVEC. The Utilities and ten other electric utilities are owners of OVEC, which is located in Piketon, Ohio. At March 31, 2011 and December 31, 2010, the Utilities' investment in OVEC was not significant. LKE is not the primary beneficiary of OVEC; therefore, it is not consolidated into the Company's consolidated financial statements and is accounted for under the cost method of accounting.

Note 3 - Rates and Regulatory Matters

For a description of each line item of regulatory assets and liabilities and for descriptions of certain matters which may not have undergone material changes relating to the period covered by this quarterly report, reference is made to Note 3, Rates and Regulatory Matters, in LKE's Consolidated Financial Statements and Additional Information Report for 2010.

LG&E and KU are subject to the jurisdiction of the FERC and the Kentucky Commission, and KU is further subject to the jurisdiction of the Virginia Commission and the Tennessee Regulatory Authority in virtually all matters related to electric and natural gas utility regulation. As such, their accounting is subject to the regulated operations guidance of the FASB ASC. Given their position in the marketplace and the status of regulation in Kentucky and Virginia, there are no plans or intentions to discontinue the application of the regulated operations guidance of the FASB ASC.

LG&E's and KU's Kentucky base rates are calculated based on a return on capitalization (common equity, long-term debt and notes payable) including certain regulatory adjustments to exclude non-

regulated investments and environmental compliance plans recovered separately through the ECR mechanism. At the time base rates were determined, no recorded regulatory assets or regulatory liabilities were excluded from the return on capitalization utilized in the calculation of Kentucky base rates. Therefore, a return is earned on all Kentucky regulatory assets existing at the time base rates were determined, except where such regulatory assets were offset by associated liabilities and thus, have no net impact on capitalization.

As a result of purchase accounting, certain fair value amounts, reflecting contracts that have favorable or unfavorable terms relative to market (e.g., coal, purchased power, emission allowances), were recorded on the Condensed Consolidated Balance Sheets with offsetting regulatory assets or liabilities. Prior to and after the acquisition by PPL, LKE recovers the cost of these contracts. LKE's customer rates will continue to reflect these items at their original contracted prices.

KU's Virginia base rates are calculated based on a return on rate base. All regulatory assets and liabilities are excluded from the return on rate base utilized in the calculation of Virginia base rates.

KU's wholesale requirements rates for municipal customers are calculated based on annual updates to a rate formula that utilizes a return on rate base. All regulatory assets and liabilities are excluded from the return on rate base utilized in the development of municipal rates.

Kentucky Rate Cases

In January 2010, LG&E and KU filed applications with the Kentucky Commission requesting annual increases in electric base rates of approximately 12%, or \$95 million and \$135 million, respectively. In addition, LG&E requested an annual increase in natural gas base rates of approximately 8%, or \$23 million. In June 2010, LG&E, KU, and all of the intervenors, except the Attorney General of Kentucky ("AG"), agreed to stipulations providing for annual increases in LG&E's electric base rates of \$74 million, LG&E's natural gas base rates of \$17 million and KU's electric base rates of \$98 million, respectively. All parties, except the AG, jointly filed a request with the Kentucky Commission to approve such settlement. An Order in the proceeding was issued in July 2010, approving all the provisions in the stipulations and a return on equity range of 9.75% - 10.75%. The new rates became effective on August 1, 2010.

Virginia Rate Cases

On April 1, 2011, KU filed an application with the Virginia Commission requesting an annual increase in electric base rates for its Virginia jurisdictional customers in an amount of \$9 million or approximately 14%. The proposed increase reflects a rate of return on rate base of 8% based on a return on equity of 11%, inclusion of expenditures to complete TC2 and all new FGD controls in base rates, recovery of a 2009 regulatory asset and various other adjustments to revenue and expenses for the test year ended December 31, 2010. The Company expects new rates to go into effect in January 2012. KU cannot currently predict the outcome of this proceeding.

In June 2009, KU filed an application with the Virginia Commission requesting an annual increase in electric base rates for its Virginia jurisdictional customers in an amount of \$12 million or approximately 21%. The proposed increase reflected a proposed rate of return on rate base of 8.586% based on a return on equity of 12%. During December 2009, KU and the Virginia Commission Staff agreed to a Stipulation and Recommendation authorizing annual base rate revenue increases of \$11 million and a

return on rate base of 7.846% based on a 10.5% return on common equity. In March 2010, the Virginia Commission issued an Order approving the stipulation, with the increased rates to be put into effect as of April 1, 2010. As part of the stipulation, KU refunded \$1 million in interim rate increases in excess of the ultimately approved rates.

FERC Wholesale Rate Case

In May 2010, KU submitted to the FERC the annual adjustments to the formula rates, which incorporated certain proposed increases. Updated rates, including certain further adjustments from a review process involving wholesale requirements customers, became effective as of July 1, 2010, subject to certain review procedures by the wholesale requirements customers and the FERC. The review period ended in September 2010 and the rates that went into effect July 1, 2010, were determined to be final.

Regulatory Assets and Liabilities

The following regulatory assets and liabilities are included in the Condensed Consolidated Balance Sheets:

	March 31, 2011	December 31, 2010
Current regulatory assets:		
ECR (a)	\$ 5	\$ 5
GSC (b)	5	4
Coal contracts (c)	4	5
FAC (a)	3	3
Virginia levelized fuel factor (d)	-	5
	<u>17</u>	<u>22</u>
Total current regulatory assets	<u>\$ 17</u>	<u>\$ 22</u>
Non-current regulatory assets:		
Pension and postretirement benefits (e)	\$ 330	\$ 330
Other non-current regulatory assets:		
Storm restoration (f)	124	122
Unamortized loss on bonds (f)	34	34
Mark-to-market impact of interest rate swaps (g)	32	34
Coal contracts (c)	19	22
Other (h)	53	47
	<u>262</u>	<u>259</u>
Subtotal other non-current regulatory assets	<u>262</u>	<u>259</u>
Total non-current regulatory assets	<u>\$ 592</u>	<u>\$ 589</u>

	March 31, 2011	December 31, 2010
Current regulatory liabilities:		
Coal contracts	\$ 35	\$ 47
DSM	13	10
ECR	10	12
Emission allowances	9	12
GSC	4	9
Other (i)	<u>1</u>	<u>2</u>
Total current regulatory liabilities	<u>\$ 72</u>	<u>\$ 92</u>
Non-current regulatory liabilities:		
Accumulated cost of removal of utility plant	\$ 633	\$ 623
Other non-current regulatory liabilities:		
Coal contracts	205	213
OVEC power purchase contract	122	124
Deferred income taxes – net	38	40
Other (i)	<u>17</u>	<u>17</u>
Subtotal other non-current regulatory liabilities	<u>382</u>	<u>394</u>
Total non-current regulatory liabilities	<u>\$ 1,015</u>	<u>\$ 1,017</u>

- (a) The ECR and FAC regulatory assets have separate recovery mechanisms with recovery within twelve months.
- (b) The GSC regulatory asset, including Performance Based Rates, has a separate recovery mechanism with recovery within eighteen months.
- (c) Offsetting regulatory asset for fair value purchase accounting adjustment. See the Company's Consolidated Financial Statements and Additional Information Report for 2010 for information on the purchase accounting adjustments.
- (d) The Virginia levelized fuel factor regulatory asset has a separate recovery mechanism generally recoverable within twelve months. In its April 2011 rate case filing, KU requested recovery of this amount over a three-year period.
- (e) LG&E and KU recover this asset through pension and postretirement expenses included in the calculation of base rates.
- (f) These regulatory assets are recovered through base rates.
- (g) Beginning in the third quarter of 2010, based on an Order from the Kentucky Commission in the 2010 rate case, whereby the cost of a terminated interest rate swap was allowed to be recovered in base rates, the mark-to-market impact of the effective and ineffective interest rate swaps is considered probable of recovery through rates and therefore included in regulatory assets. See Note 4, Derivative Financial Instruments, for further discussion.

- (h) Other regulatory assets include:
- The Carbon Management Research Group and Kentucky Consortium for Carbon Storage contributions, an East Kentucky Power Cooperative (“EKPC”) FERC transmission settlement agreement, rate case expenses, swap termination, unamortized debt expense and the MISO exit costs, which are all recovered through base rates.
 - The FERC jurisdictional portion of the EKPC FERC transmission settlement agreement is recovered through the annual FERC formula rate updates.
 - FERC jurisdictional pension expense, which will be requested in the next FERC rate case.
 - Offsetting regulatory asset for fair value purchase accounting adjustment for leases. See the Company’s Consolidated Financial Statements and Additional Information Report for 2010 for information on the purchase accounting adjustments.
 - ARO regulatory assets. When an asset with an ARO is retired, the related ARO regulatory asset will be offset against the associated ARO asset and ARO liability.
 - Virginia levelized fuel factor regulatory asset to be recovered over a three year period beginning April 1, 2011.
- (i) Other regulatory liabilities include the emission allowance purchase accounting offset, MISO exit, postretirement benefits, FAC and a change in accounting method for FERC jurisdictional spare parts. See the Company’s Consolidated Financial Statements and Additional Information Report for 2010 for information on the purchase accounting adjustments.

FAC

In February 2011, KU filed an application with the Virginia Commission seeking approval of an increase in its fuel cost factor beginning with service rendered in April 2011. In March 2011, a hearing was held on KU’s requested fuel factor and an Order was issued approving a revised fuel factor to be in effect beginning with service rendered on and after April 1, 2011, with recovery of the regulatory asset over a three year period.

Storm Restoration

In December 2009, a major snow storm hit KU’s Virginia service area causing approximately 30,000 customer outages. During the normal 2009 Virginia Annual Information Filing (“AIF”), KU requested that the Virginia Commission establish a regulatory asset and defer for future recovery approximately \$6 million in incremental operation and maintenance expenses related to the storm restoration. In March 2011, the Virginia Commission issued a Staff Report on KU’s 2009 AIF stating that the Staff considers storm damage to be extraordinary, non-recurring and material to KU. The Staff Report also recommended establishing a regulatory asset for these costs, with recovery over a five year period upon approval in the next base rate case. In March 2011, a regulatory asset of \$6 million was established for actual costs incurred. In April 2011, KU filed an application with the Virginia Commission requesting an annual increase in electric base rates for its Virginia jurisdictional customers including recovery of the storm costs over five years.

Note 4 – Derivative Financial Instruments

The Company is subject to interest rate and commodity price risk related to on-going business operations. It currently manages these risks using derivative instruments, including swaps and forward contracts. The Company's policies allow for the interest rate risk to be managed through the use of fixed rate debt, floating rate debt and interest rate swaps. At March 31, 2011, LKE's potential annual exposure to increased interest expense, based on a 10% increase in interest rates, was not significant. The Company does not net collateral against derivative instruments.

Interest Rate Swaps

LKE uses over-the-counter interest rate swaps to limit exposure to market fluctuations in interest expense. Pursuant to Company policy, use of these derivative financial instruments is intended to mitigate risk, earnings and cash flow volatility and is not speculative in nature.

LG&E's interest rate swap agreements range in maturity through 2033, with aggregate notional amounts of \$179 million as of March 31, 2011 and December 31, 2010. Under these swap agreements, LG&E paid fixed rates averaging 4.52% and received variable rates based on London Interbank Offer Rate or the Securities Industry and Financial Markets Association's municipal swap index. Beginning in the third quarter of 2010, the unrealized gains and losses on the interest rate swaps are included in a regulatory asset based on an Order from the Kentucky Commission in the rate case, whereby the cost of a terminated swap was allowed to be recovered in base rates.

The table below shows the fair value and balance sheet location of interest rate swap derivatives:

<u>Balance Sheet Location</u>	Fair Value	
	March 31, 2011	December 31, 2010
Current derivative liability	\$ 3	\$ 2
Long-term derivative liability	29	32
	<u>\$ 32</u>	<u>\$ 34</u>

The interest rate swaps are accounted for on a fair value basis in accordance with the derivatives and hedging guidance of the FASB ASC. For the three months ended March 31, 2011 and 2010, the impact of the derivative positions on interest rate swaps recorded on the Condensed Consolidated Statements of Income was not significant.

No gain or loss on hedging interest rate swaps was recognized in other comprehensive income for the period ended March 31, 2011, and the loss recognized was not significant for the period ended March 31, 2010.

Prior to including the unrealized gains and losses on the interest rate swaps in regulatory assets, amounts previously recorded in accumulated other comprehensive income were reclassified into earnings in the same period during which the derivative forecasted transaction affected earnings. The amount included in regulatory assets for the three months ended March 31, 2011, and the amount amortized from accumulated other comprehensive income to earnings for the three months ended March 31, 2010, were not significant.

A decline of 100 basis points in the current market interest rates would increase the fair value of LKE's interest rate swap liabilities by \$27 million.

Energy Trading and Risk Management Activities

The Company conducts energy trading and risk management activities to maximize the value of power sales from physical assets it owns. Energy trading activities are principally forward financial transactions to manage price risk and are accounted for as non-hedging derivatives on a mark-to-market basis in accordance with the derivatives and hedging guidance of the FASB ASC.

Assets and liabilities from short-term and long-term energy trading and risk management derivative contracts were not significant at March 31, 2011 and December 31, 2010.

The Company maintains credit policies intended to minimize credit risk in wholesale marketing and trading activities by assessing the creditworthiness of potential counterparties prior to entering into transactions with them and continuing to evaluate their creditworthiness once transactions have been initiated. To further mitigate credit risk, the Company seeks to enter into netting agreements or require collateral such as cash deposits, letters of credit or parent company guarantees as security from counterparties. The Company uses credit ratings of S&P, Moody's and definitive qualitative and quantitative data to assess the financial strength of counterparties on an on-going basis. If no external rating exists, the Company assigns an internally generated rating for which it sets appropriate risk parameters. As risk management contracts are valued based on changes in market prices of the related commodities, credit exposures are revalued and monitored on a daily basis. At March 31, 2011, 100% of the trading and risk management commitments were with counterparties rated BBB-/Baa3 equivalent or better. The Company has reserved against credit risk based on LKE's own creditworthiness (for net liabilities) and its counterparties' creditworthiness (for net assets). The Company applies historical default rates within varying credit ratings over time provided by S&P or Moody's. At March 31, 2011 and December 31, 2010, credit reserves related to energy trading and risk management contracts were not significant.

The net volume of electricity based financial derivatives outstanding at March 31, 2011 and December 31, 2010, was 1,253,900 Mwh and 998,300 Mwh, respectively. Cash collateral posted by the Company related to the energy trading and risk management contracts was not significant at March 31, 2011 and December 31, 2010. Cash collateral related to the energy trading and risk management contracts is recorded in Prepayments and other current assets on the Condensed Consolidated Balance Sheets.

The Company manages the price risk of its estimated future excess economic generation capacity using market-traded forward contracts. Hedge accounting treatment has not been elected for these transactions; therefore, realized and unrealized gains and losses are included on the Condensed Consolidated Statements of Income. For the three months ended March 31, 2011 and 2010, the impact of the derivative positions on energy trading and risk management activities recorded on the Condensed Consolidated Statements of Income was not significant.

Credit Risk Related Contingent Features

Certain of the Utilities' derivative contracts contain credit contingent provisions which would permit the counterparties with which the Utilities are in a net liability position to require the transfer of additional collateral upon a decrease in the Utilities' credit ratings. Some of these provisions require the Utilities to transfer additional collateral or permit the counterparty to terminate the contract if the Utilities' credit ratings were to fall below investment grade. Some of these provisions also allow the counterparty to require additional collateral upon each decrease in the credit ratings at levels that remain above investment grade. In either case, if the Utilities' credit ratings were to fall below investment grade (i.e., below BBB- for S&P or Baa3 for Moody's) and assuming no assignment to an investment grade affiliate were allowed, most of these credit contingent provisions require either immediate payment of the net liability as a termination payment or immediate and ongoing full collateralization by the Utilities on derivative instruments in net liability positions.

Additionally, certain of the Utilities' derivative contracts contain credit contingent provisions that require the Utilities to provide "adequate assurance" of performance if the other party has reasonable grounds for insecurity regarding the Utilities' performance of its obligation under the contract. A counterparty demanding adequate assurance could require a transfer of additional collateral or other security, including letters of credit, cash and guarantees from a creditworthy entity. A demand for additional assurance would typically involve negotiations among the parties. However, amounts disclosed below represent assumed immediate payment or immediate and ongoing full collateralization for derivative instruments in net liability positions with "adequate assurance" provisions.

To determine net liability positions, the Utilities use the fair value of each agreement. The aggregate fair value of all derivative instruments with the credit contingent provisions described above that were in a net liability position at March 31, 2011 was \$24 million, of which LG&E had posted collateral of \$20 million in the normal course of business. The collateral posted by KU was not significant. At March 31, 2011, if the credit contingent provisions underlying these derivative instruments were triggered due to a credit downgrade of the Utilities' credit ratings below investment grade, LG&E would have been required to post an additional \$4 million of collateral to its counterparties and there would have been no material effect for KU.

Note 5 - Fair Value Measurements

The FASB ASC guidance clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, the FASB ASC guidance establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value.

The fair values of the interest rate swaps reflect price quotes from investment banks, consistent with the fair value measurements and disclosures guidance of the FASB ASC. This value is verified monthly by the Company using a model that calculates the present value of future payments under the swap utilizing current swap market rates obtained from another dealer active in the swap market and validated by market transactions. Market liquidity is considered; however, the valuation does not require an adjustment for market liquidity as the market is very active for the type of swaps used by the Company. LKE considered the impact of its own credit risk and that of counterparties by evaluating credit ratings

and financial information and adjusting market valuations to reflect such credit risks. LKE and all counterparties had strong investment grade ratings at March 31, 2011. In addition, LKE and certain counterparties have agreed to post margin if the credit exposure exceeds certain thresholds. Cash collateral posted by LG&E related to interest rate swaps at March 31, 2011 and December 31, 2010, was \$20 million and \$19 million, respectively. Cash collateral for interest rate swaps is classified as an Other long-term asset on the Condensed Consolidated Balance Sheets.

Energy trading and risk management contracts are valued using prices based on active trades from Intercontinental Exchange Inc. In the absence of a traded price, midpoints of the best bids and offers are the primary determinants of valuation. When sufficient trading activity is unavailable, other inputs include prices quoted by brokers or observable inputs other than quoted prices, such as one-sided bids or offers as of the balance sheet date. Quotes are verified quarterly using an independent pricing source of actual transactions. Quotes for combined off-peak and weekend timeframes are allocated between the two timeframes based on their historical proportional ratios to the integrated cost. No other adjustments are made to the forward prices. No changes to valuation techniques for energy trading and risk management activities occurred during the three months ended March 31, 2011 or 2010. Changes in market pricing, interest rate and volatility assumptions were made during the three months ended March 31, 2011 and 2010.

The fair values of cash and cash equivalents, accounts receivable, notes receivable, cash surrender value of key man life insurance, accounts payable and notes payable are substantially the same as their carrying values.

The Company has classified the applicable financial assets and liabilities that are accounted for at fair value into the three levels of the fair value hierarchy, as discussed in Note 1, Summary of Significant Accounting Policies, in the Consolidated Financial Statements and Additional Information Report for 2010. The Company classifies its derivative cash collateral balances within Level 1 based on the funds being held in a demand deposit account. The Company classifies its derivative energy trading and risk management contracts and interest rate swaps within Level 2 because it values them using prices actively quoted for proposed or executed transactions, quoted by brokers or observable inputs other than quoted prices. See Note 4, Derivative Financial Instruments, for further information.

The following tables set forth, by level within the fair value hierarchy, the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis.

<u>March 31, 2011</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Totals</u>
<u>Financial assets:</u>			
Cash and cash equivalents	\$ 94	\$ -	\$ 94
Notes receivable – affiliated company	45	-	45
Energy trading and risk management contract cash collateral	4	-	4
Interest rate swaps cash collateral	20	-	20
Other	1	1	2
Total financial assets	<u>\$ 164</u>	<u>\$ 1</u>	<u>\$ 165</u>

<u>March 31, 2011</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Totals</u>
<u>Financial liabilities:</u>			
Energy trading and risk management contracts	\$ -	\$ 2	\$ 2
Interest rate swaps	-	32	32
Total financial liabilities	<u>\$ -</u>	<u>\$ 34</u>	<u>\$ 34</u>

<u>December 31, 2010</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Totals</u>
<u>Financial assets:</u>			
Cash and cash equivalents:	\$ 11	\$ -	\$ 11
Short-term investments - municipal debt securities	163	-	163
Energy trading and risk management contract cash collateral	3	-	3
Interest rate swaps cash collateral	19	-	19
Total financial assets	<u>\$ 196</u>	<u>\$ -</u>	<u>\$ 196</u>

<u>Financial liabilities:</u>			
Energy trading and risk management contracts	\$ -	\$ 2	\$ 2
Interest rate swaps	-	34	34
Total financial liabilities	<u>\$ -</u>	<u>\$ 36</u>	<u>\$ 36</u>

Financial assets related to energy trading and risk management contracts were not significant at December 31, 2010.

There were no Level 3 measurements for the periods ending March 31, 2011 and December 31, 2010.

The following table presents the changes in net liabilities measured at fair value using significant unobservable inputs (Level 3) as defined in FASB ASC for the following period:

	<u>Predecessor</u>
	<u>Three Months</u>
	<u>Ended</u>
	<u>March 31, 2010</u>
Balance at beginning of period	\$ 75
Realized losses included in earnings	2
Unrealized losses included in earnings	2
Settlements	(16)
Balance at end of period	<u>\$ 63</u>

Financial Instruments Not Recorded at Fair Value

The carrying values and estimated fair values of the Company's non-trading financial instruments follow:

	March 31, 2011		December 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Long-term bonds	\$ 3,825	\$ 3,668	\$ 3,825	\$ 3,607

The fair value of these instruments was estimated using an income approach by discounting future cash flows at estimated current cost of funding rates.

Note 6 - Pension and Other Postretirement Benefit Plans

Components of Net Periodic Benefit Cost

The following tables provide the components of net periodic benefit cost for pension and other postretirement benefit plans:

<u>Pension Benefits:</u>	Successor		Predecessor	
	Three Months Ended March 31, 2011		Three Months Ended March 31, 2010	
Service cost	\$	6	\$	5
Interest cost		17		16
Expected return on plan assets		(16)		(13)
Amortization of prior service cost		1		2
Amortization of actuarial loss		5		5
Net periodic benefit cost	\$	13	\$	15

<u>Other Postretirement Benefits:</u>	Successor		Predecessor	
	Three Months Ended March 31, 2011		Three Months Ended March 31, 2010	
Service cost	\$	1	\$	1
Interest cost		3		3
Expected return on plan assets		(1)		(1)
Amortization of prior service cost		1		1
Net periodic benefit cost	\$	4	\$	4

Contributions

LKE made discretionary contributions to its pension plans of \$150 million and \$41 million in January 2011 and 2010, respectively. The amount of future contributions to the pension plans will depend upon

the actual return on plan assets and other factors, but the Company's intent is to fund its pension plans in a manner consistent with the requirements of the Pension Protection Act of 2006.

For the three months ended March 31, 2011, the Company made contributions to its other postretirement benefit plan totaling \$3 million. The Company anticipates making further voluntary contributions to fund Voluntary Employee Beneficiary Association trusts to match the annual postretirement expense and funding the 401(h) plan up to the maximum tax deductible amount.

Health Care Reform

In March 2010, Health Care Reform (the Patient Protection and Affordable Care Act of 2010) was signed into law. Many provisions of Health Care Reform do not take effect for an extended period of time and many aspects of the law which are currently unclear or undefined will likely be clarified in future regulations.

Effective January 1, 2011, provisions within Health Care Reform required dependent coverage up to age 26, removed the \$2 million lifetime maximum and eliminated the cost sharing for certain preventative care procedures. The impact to LKE is not expected to be material.

Beginning in 2013, provisions within Health Care Reform eliminated the tax deductibility of retiree health care costs to the extent of federal subsidies received by plan sponsors that provide retiree prescription drug benefits equivalent to Medicare Part D Coverage. As a result, in the first quarter of 2010, LKE recorded income tax expense to recognize the impact of the elimination that was not significant.

A provision within Health Care Reform beginning in 2018 is a potential excise tax on high-cost plans providing health coverage that exceeds certain thresholds. The Company has evaluated this provision of Health Care Reform on its benefit programs in consultation with its actuarial consultants and has determined that the excise tax will not have an impact on its postretirement medical plan.

The Company will continue to monitor the potential impact of any changes to the existing provisions and implementation guidance related to Health Care Reform.

Note 7 - Income Taxes

LKE's federal income tax return is included in a U.S. consolidated income tax return filed by LKE's direct parent. Prior to November 1, 2010, the return was included in the consolidated return of E.ON US Investments Corp. Due to the acquisition by PPL, the return will be included in the consolidated PPL return beginning November 1, 2010, for each tax period. Each subsidiary of the consolidated tax group calculates its separate income tax for each period. The resulting separate-return tax cost or benefit is paid to or received from the parent company or its designee. The Company also files income tax returns in various state jurisdictions. While 2007 and later years are open under the federal statute of limitations, Revenue Agent Reports for 2007-2008 have been received from the Internal Revenue Service ("IRS"), effectively closing these years to additional audit adjustments. Tax years beginning with 2007 were examined under an IRS program, Compliance Assurance Process ("CAP"). This program accelerates the IRS's review to begin during the year applicable to the return and ends 90 days after the return is filed. For 2008, the IRS allowed additional deductions in connection with the Company's application for a

change in repair deductions and disallowed certain bonus depreciation claimed on the original return. The net temporary tax impact for the Company was a \$25 million reduction in tax and was recorded in the second quarter of 2010. The 2009 federal return was filed in the third quarter of 2010 and the IRS issued a Partial Acceptance Letter in connection with CAP. The IRS is continuing to review storms and other repairs, contributions in aid of construction and purchased natural gas adjustments. No net material adverse impact is expected from these remaining areas. The short tax year beginning January 1, 2010 through October 31, 2010, is also being examined under CAP. No material items have been raised by the IRS at this time. The two month period beginning November 1, 2010 and ending December 31, 2010, is not currently under examination.

A reconciliation of LKE's effective income tax rate follows:

	Successor Three Months Ended March 31, 2011	Predecessor Three Months Ended March 31, 2010
<u>Reconciliation of Income Taxes</u>		
Federal income tax on income from continuing operations before income taxes at statutory tax rate – 35%	\$ 47	\$ 35
Increase (decrease) due to:		
State income taxes – net of federal income tax benefit	5	4
Investment and other tax credits	(1)	(1)
Reversal of excess deferred taxes	(1)	(1)
Other – net	(1)	1
Net increase	2	3
Income tax expense	\$ 49	\$ 38
Effective income tax rate	36.0%	37.6%

Unrecognized Tax Benefits

LKE had no material changes in unrecognized tax benefits since December 31, 2010, and does not expect any material changes to occur in unrecognized tax benefits during the next 12 months.

Note 8 – Debt

As summarized below, long-term debt consisted of first mortgage bonds, secured pollution control bonds, senior notes and a medium-term note.

	March 31, 2011	December 31, 2010
Current portion of long-term debt - medium term note	\$ 2	\$ 2
Unsecured senior notes payable	875	875
Secured first mortgage bonds	2,035	2,035
Pollution control revenue bonds, collateralized by first mortgage bonds	925	925
Fair value adjustment from purchase accounting	8	8
Unamortized discount	(20)	(20)
Total long-term debt	<u>3,825</u>	<u>3,825</u>
Less current portion	<u>2</u>	<u>2</u>
Long-term debt, excluding current portion	<u>\$ 3,823</u>	<u>\$ 3,823</u>

In November 2010, LG&E and KU issued first mortgage bonds totaling \$2,035 million and used the proceeds to repay loans from a PPL subsidiary and for general corporate purposes. Also in November 2010, LKE issued senior notes totaling \$875 million and used the proceeds to repay loans from a PPL subsidiary, and to return \$100 million of capital to PPL. The first mortgage bonds and senior notes were issued to the initial purchasers at a discount.

The first mortgage bonds and senior notes were issued by the respective issuer via transactions not requiring registration under the Securities Act of 1933. Each issuer entered into a registration rights agreement in which it agreed to file a registration statement with the SEC relating to an offer to exchange the first mortgage bonds, or senior notes, as the case may be, for registered, publicly tradable securities having substantially identical terms or, in certain circumstances, a registration statement with respect to the bonds or notes issued. If ultimate registration and/or certain milestones are not completed by certain dates in mid- and late 2011, the respective issuer has agreed to pay liquidated damages to the bondholders. The liquidated damages would total 0.25% per annum of the principal amount of the bonds or notes for the first 90 days and 0.50% per annum of the principal amount thereafter until the conditions described above have been cured. In April 2011, each issuer filed a registration statement on Form S-4 with the SEC, pursuant to the registration rights agreements described above.

At March 31, 2011, LKE had an aggregate \$925 million of outstanding pollution control indebtedness, of which \$231 million is in the form of insured auction rate securities wherein interest rates are reset either weekly or every 35 days via an auction process. The credit ratings of the monoline bond insurers have been reduced to levels below that of LG&E's or KU's rating due to exposures relating to insurance of sub-prime mortgages. As a result, the debt ratings of LG&E's or KU's insured pollution control bonds are based on LG&E's or KU's senior secured debt rating and are not influenced by the monoline bond insurer ratings. When a failed auction occurs, the interest rate is set pursuant to a formula stipulated in the indenture.

The average annualized interest rates on the auction rate bonds follow:

	Successor	Predecessor
	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
LG&E	0.40%	0.27%
KU	0.37%	0.27%

The instruments governing these auction rate bonds permit LKE to convert the bonds to other interest rate modes, such as various short-term variable rates, long-term fixed rates or intermediate-term fixed rates that are reset infrequently.

LKE's available for sale debt securities, totaling \$163 million at December 31, 2010, included certain pollution control bonds, which were repurchased from the remarketing agent in 2008. In January 2011, LG&E remarketed the Louisville/Jefferson County Metro Government 2003 Series A and 2007 Series B bonds, bearing interest at 1.90% into 2012, that were previously held by the Company. The proceeds from the remarketing were used to repay the borrowing under LG&E's credit facility. As of March 31, 2011, LKE had no remaining repurchased bonds.

See Note 4, Derivative Financial Instruments, for a discussion of the Company's interest rate swap agreements.

The Company maintained revolving credit facilities with an affiliate totaling \$300 million at March 31, 2011 and December 31, 2010, to ensure funding availability for the money pool. The Company pays the affiliate an annual commitment fee on the unused portion of the commitment based on the Utilities' current bond rating. The balances were as follows:

	Total Available	Amount Outstanding	Balance Available	Average Interest Rate
March 31, 2011	\$ 300	\$ -	\$ 300	N/A
December 31, 2010	300	-	300	N/A

As of March 31, 2011, LG&E and KU each maintained a \$400 million revolving line of credit with a group of banks maturing in December 2014. The revolving lines of credit allow LG&E and KU to issue letters of credit or borrow funds up to \$400 million each. Outstanding letters of credit reduce the facility's available borrowing capacity. LG&E and KU pay the banks an annual commitment fee on the unused portion of the commitment based on the respective company's current senior unsecured bond rating. At March 31, 2011, there were no borrowings outstanding under either facility. However, letters of credit totaling \$198 million have been issued under KU's facility to support outstanding tax exempt bonds. These credit agreements each contain financial covenants requiring the respective borrower's debt to total capitalization ratio to not exceed 70%, as calculated pursuant to the credit agreements and other customary covenants.

On April 29, 2011, KU entered into a new \$198 million letter of credit agreement that will be used to issue letters of credit to support outstanding tax exempt bonds. The facility matures in April 2014. On May 2, 2011, letters of credit totaling \$198 million were issued under the new agreement replacing the letters of credit previously issued under KU's credit facility.

LKE and its subsidiaries, where applicable, were in compliance with all debt covenants at March 31, 2011 and December 31, 2010.

Note 9 – Commitments and Contingencies

Except as may be discussed in this quarterly report (including Note 3, Rates and Regulatory Matters), material changes have not occurred in the current status of various commitments or contingent liabilities from that discussed in LKE's Consolidated Financial Statements and Additional Information Report for 2010 (including, but not limited to, Note 10, Related Party Transactions; Note 3, Rates and Regulatory Matters; and Note 11, Subsequent Events, to the financial statements of the Company contained therein).

Energy Purchases and Other Commitments

OVEC Power

Pursuant to a power purchase agreement with OVEC, extended in February 2011, 2040, pending regulatory approvals, the Utilities may be conditionally responsible for 8.13% pro-rata shares of certain obligations of OVEC under defined circumstances. These contingent liabilities may include unpaid OVEC indebtedness as well as shortfall amounts in certain excess decommissioning costs and postretirement benefits other than pension. The Utilities' contingent proportionate share of OVEC's outstanding debt was \$111 million at March 31, 2011. See Note 2, Summary of Significant Accounting Policies, for further information.

Legal Matters

LKE and its subsidiaries are involved in legal proceedings, claims and litigation in the ordinary course of business and cannot predict the outcome of such matters, or whether such matters may result in material liabilities, unless otherwise noted.

Construction Program

LKE had approximately \$224 million of commitments in connection with its construction programs at March 31, 2011.

In June 2006, LG&E and KU entered into a construction contract regarding the TC2 project. The contract is generally in the form of a turnkey agreement for the design, engineering, procurement, construction, commissioning, testing and delivery of the project, according to designated specifications, terms and conditions. The contract price and its components are subject to a number of potential adjustments which may serve to increase or decrease the ultimate construction price. During 2009 and 2010, LG&E and KU received several contractual notices from the TC2 construction contractor asserting historical force majeure and excusable event claims for a number of adjustments to the contract price, construction schedule, commercial operations date, liquidated damages or other relevant provisions. In September 2010, LG&E, KU and the construction contractor agreed to a settlement to resolve the force majeure and excusable event claims occurring through July 2010, under the TC2 construction contract, which settlement provided for a limited, negotiated extension of the contractual commercial operations date and/or relief from liquidated damage calculations. With limited exceptions the Company took care, custody and control of TC2 on January 22, 2011, and has dispatched the unit to meet customer demand since that date. LG&E, KU and the contractor agreed to a further amendment of

the construction agreement whereby the contractor will complete certain actions relating to identifying and completing any necessary modifications to allow operation of TC2 on all fuels in accordance with initial specifications prior to certain dates, and amending the provisions relating to liquidated damages. LKE cannot currently estimate the ultimate outcome of these matters.

TC2 CCN Application and Transmission Matters

LG&E's and KU's CCN for a transmission line associated with the TC2 construction has been challenged by certain property owners in Hardin County, Kentucky. Certain proceedings relating to CCN challenging and federal historic preservation permit requirements have concluded with outcomes in the Utilities' favor. With respect to the remaining on-going dispute, KU obtained various successful rulings during 2008 at the Hardin County Circuit Court confirming its condemnation rights. In August 2008, several landowners appealed such rulings to the Kentucky Court of Appeals and received a temporary stay preventing KU from accessing their properties. In May 2010, the Kentucky Court of Appeals issued an Order affirming the Hardin Circuit Court's finding that KU had the right to condemn easements on the properties. In May 2010, the landowners filed a petition for reconsideration with the Court of Appeals. In July 2010, the Court of Appeals denied that petition. In August 2010, the landowners filed for discretionary review of that denial by the Kentucky Supreme Court. In March 2011, the Kentucky Supreme Court denied the landowners' request for discretionary review.

Regulatory Issues

Market-Based Rate Authority

In July 2009, the FERC issued an order approving LG&E's and KU's September 2008 tri-annual application for updated market-based rate authority. During July 2009, affiliates of LG&E and KU completed a transaction terminating certain prior generation and power marketing activities in the Big Rivers Electric Corporation control area, which termination should ultimately allow a filing to request a determination that LG&E and KU are no longer deemed to have market power in such control area and that historical restrictions on LG&E and KU sales into that area are no longer applicable.

Integrated Resource Planning

IRP regulations require major utilities to make triennial IRP filings with the Kentucky Commission. In April 2011, LG&E and KU filed their 2011 joint IRP with the Kentucky Commission. The IRP provides historical and projected demand, resource and financial data, and other operating performance and system information. Pursuant to a December 2008 Order, KU will file with the Virginia Commission the 2011 joint IRP by September 1, 2011, along with certain supplemental information as required by this Order. Impending environmental regulation could result in the retirements of older, smaller coal-fired units and therefore, the IRP assumes potential retirements of approximately 800 megawatts of coal-fired capacity with replacement by combined cycle gas units in 2016. In addition the IRP assumes approximately 500 megawatts of peak demand reductions by 2017, via existing or expanded demand side management or energy efficiency programs. Implementation of the major findings of the IRP is subject to further Company analysis and decision-making and further regulatory approvals.

Mandatory Reliability Standards

As a result of the EPAct 2005, certain formerly voluntary reliability standards became mandatory in June 2007 and authority was delegated to various Regional Reliability Organizations (“RROs”) by the North American Electric Reliability Corporation (“NERC”), which was authorized by the FERC to enforce compliance with such standards, including promulgating new standards. Failure to comply with mandatory reliability standards can subject a registered entity to sanctions, including potential fines of up to \$1 million per day, as well as non-monetary penalties, depending upon the circumstances of the violation. The Utilities are members of the SERC Reliability Corporation (“SERC”), which acts as their RRO. The Utilities have continued to self-report potential violations of certain applicable reliability requirements and submit accompanying mitigation plans. The resolution of a number of these potential violation reports is pending. Any regional reliability entity determination concerning resolution of violations of the Reliability Standards remains subject to the approval of the NERC and the FERC. Therefore, the Utilities are unable to estimate the outcome of these matters. Additionally, the Utilities have one open self-report which has been the subject of a settlement with the SERC. This settlement was for no penalty but still requires FERC approval before becoming final. Mandatory reliability standard settlements commonly also include non-penalty elements, including compliance steps and mitigation plans. While the Utilities believe they are in compliance with the mandatory reliability standards, events of potential non-compliance may be identified from time-to-time. LKE cannot predict such potential violations or the outcome of self-reports described above.

Other

In February 2006, the Kentucky Commission initiated an administrative proceeding to consider the requirements of the federal EPAct 2005, Subtitle E Section 1252, Smart Metering, which concerns time-based metering and demand response, and Section 1254, Interconnections. The EPAct 2005 requires each state regulatory authority to conduct a formal investigation and issue a decision on whether or not it is appropriate to implement certain Section 1252 standards within eighteen months after the enactment of the EPAct 2005 and to commence consideration of Section 1254 standards within a year after the enactment of the EPAct 2005. Following a public hearing with all Kentucky jurisdictional electric utilities, in December 2006, the Kentucky Commission issued an Order in this proceeding indicating that the EPAct 2005 Section 1252 and Section 1254 standards should not be adopted. However, all the Kentucky Commission jurisdictional utilities are required to file real-time pricing pilot programs for their large commercial and industrial customers. LG&E and KU developed real-time pricing pilots for large industrial and commercial customers and filed the details of the plan with the Kentucky Commission in April 2007. In February 2008, the Kentucky Commission issued an Order approving the real-time pricing pilot programs proposed by LG&E and KU for implementation for their large commercial and industrial customers. The tariff was filed in October 2008, with an effective date of December 1, 2008. LG&E and KU file annual reports on the program within 90 days of each plan year-end for the three-year pilot period.

Pursuant to a 2004 rate case settlement agreement, and as referred to in the EPAct 2005 Administrative Order, LG&E made its responsive pricing and smart metering pilot program filing, which addresses real-time pricing for residential and general service customers, in March 2007. In July 2007, the Kentucky Commission approved the application, as filed, for a small number of residential customers and a sampling of other customers, and authorized LG&E to establish the responsive pricing and smart metering pilot program, recovery of non-specific customer costs through the DSM billing mechanism

and the filing of annual reports by April 1, 2009, 2010 and 2011. LG&E must also file an evaluation of the program by July 1, 2011.

Environmental Matters

The Company's operations are subject to a number of environmental laws and regulations in each of the jurisdictions in which it operates, governing, among other things, air emissions, wastewater discharges, the use, handling and disposal of hazardous substances and wastes, soil and groundwater contamination and employee health and safety. As indicated below and summarized at the conclusion of this section, evolving environmental regulations will likely increase the level of capital and operating and maintenance expenditures incurred by the Company during the next several years. Based upon prior regulatory precedent, the Company believes that many costs of complying with such pending or future requirements would likely be recoverable under the ECR or other potential cost-recovery mechanisms, but the Company can provide no assurance as to the ultimate outcome of such proceedings before the regulatory authorities.

General Environmental Proceedings

From time to time, LKE appears before the EPA, various state or local regulatory agencies and state and federal courts regarding matters involving compliance with applicable environmental laws and regulations. Such matters include a prior Section 114 information request from the EPA relating to new source review issues at LG&E's Mill Creek Unit 4 and Trimble County Unit 1 generation units and KU's Ghent Unit 2, a completed settlement with state regulators regarding compliance with particulate limits in the air permit for KU's Tyrone generating station, remediation obligations or activities for former manufactured gas plant sites, or other risks relating to elevated PCB levels at existing properties; liability under the Comprehensive Environmental Response, Compensation and Liability Act for cleanup at various off-site waste sites; and on-going claims regarding alleged particulate emissions from LG&E's Cane Run generating station and claims regarding GHG emissions from LKE's generating stations. Based on analysis to date, the resolution of these matters is not expected to have a material impact on the Company's operations.

Air

Ambient Air Quality:

The Clean Air Act requires the EPA to periodically review the available scientific data for six criteria pollutants and establish concentration levels in the ambient air sufficient to protect the public health and welfare with an extra margin for safety. These concentration levels are known as NAAQS. Each state must identify "nonattainment areas" within its boundaries that fail to comply with the NAAQS and develop a SIP to bring such nonattainment areas into compliance. If a state fails to develop an adequate plan, the EPA must develop and implement a plan. As the EPA increases the stringency of the NAAQS through its periodic reviews, the attainment status of various areas may change, thereby triggering additional emission reduction obligations under revised SIPs aimed to achieve attainment.

In 1997, the EPA established new NAAQS for ozone and fine particulates that required additional reductions in SO₂ and NO_x emissions from power plants. In 1998, the EPA issued its final "NO_x SIP Call" rule requiring reductions in NO_x emissions of approximately 85% from 1990 levels in order to mitigate ozone transport from the midwestern U.S. to the northeastern U.S. To implement the new

federal requirements, Kentucky amended its SIP in 2002 to require electric generating units to reduce their NOx emissions to 0.15 pounds weight per million British thermal units on a company-wide basis. In 2005, the EPA issued the CAIR which required additional SO₂ emission reductions of 70% and NOx emission reductions of 65% from 2003 levels. The CAIR provided for a two-phase cap and trade program, with initial reductions of NOx and SO₂ emissions due by 2009 and 2010, respectively, and final reductions due by 2015. In 2006, Kentucky proposed to amend its SIP to adopt state requirements similar to those under the federal CAIR.

In July 2008, a federal appeals court issued a ruling finding deficiencies in the CAIR and vacating it. In December 2008, the Court amended its previous Order, directing the EPA to promulgate a new regulation, but leaving the CAIR in place in the interim. The remand of the CAIR results in some uncertainty with respect to certain other EPA or state programs and proceedings and the Utilities' compliance plans relating thereto, due to the interconnection of the CAIR with such associated programs. In January 2010, the EPA proposed a revised NAAQS for ozone which would increase the stringency of the standard. In addition, the EPA published final revised NAAQS standards for NO₂ and SO₂ in February 2010 and June 2010, respectively, which are more stringent than previous standards. Depending on the level of action determined necessary to bring local nonattainment areas into compliance with the revised NAAQS standards, LKE's power plants are potentially subject to requirements for additional reductions in SO₂ and NOx emissions.

In August 2010, the EPA issued the proposed CATR, which serves to replace the CAIR. The CATR provides for a two-phase SO₂ reduction program with Phase I reductions due by 2012 and Phase II reductions due by 2014. The CATR provides for NOx reductions in 2012, but the EPA advised that it is studying whether additional NOx reductions should be required for 2014. The CATR is more stringent than the CAIR as it accelerates certain compliance dates and provides for only intrastate and limited interstate trading of emission allowances. In addition to its preferred approach, the EPA is seeking comment on an alternative approach which would provide for individual emission limits at each power plant. The EPA has announced that it will propose additional "transport" rules to address compliance with revised NAAQS standards for ozone and particulate matter which will be issued by the EPA in the future, as discussed below.

Hazardous Air Pollutants:

As provided in the Clean Air Act, the EPA investigated hazardous air pollutant emissions from electric utilities and submitted a report to Congress identifying mercury emissions from coal-fired power plants as warranting further study. In 2005, the EPA issued the CAMR establishing mercury standards for new power plants and requiring all states to issue new SIPs including mercury requirements for existing power plants. The EPA issued a model rule which provides for a two-phase cap and trade program with initial reductions due by 2010 and final reductions due by 2018. The CAMR provided for reductions of 70% from 2003 levels. The EPA closely integrated the CAMR and CAIR programs to ensure that the 2010 mercury reduction targets would be achieved as a "co-benefit" of the controls installed for purposes of compliance with the CAIR. In addition, in 2006, the Metro Louisville Air Pollution Control District adopted rules aimed at regulating additional hazardous air pollutants from sources including power plants.

In February 2008, a federal appellate court issued a decision vacating the CAMR. In March 2011, the EPA released the proposed utility Maximum Achievable Control Technology rule to replace the CAMR. The proposed rule would establish standards for hazardous air pollutants emitted by power plants

including mercury, other heavy metals, and acid gases. The emissions limitations specified in the proposed rule are stringent, requiring a 91% reduction in the case of mercury emissions. Upon promulgation of a final rule, facilities would have a short three-year period to comply with the new requirements, with the possibility of a one-year extension from the state. The Company will be unable to determine the exact impact on Company operations until such time as a final rule is promulgated by the EPA.

Acid Rain Program:

The Clean Air Act imposed a two-phased cap and trade program to reduce SO₂ emissions from power plants that were thought to contribute to “acid rain” conditions in the northeastern U.S. The Clean Air Act also contains requirements for power plants to reduce NO_x emissions through the use of available combustion controls.

Regional Haze:

The Clean Air Act also includes visibility goals for certain federally designated areas, including national parks, and requires states to submit SIPs that will demonstrate reasonable progress toward preventing future impairment and remedying any existing impairment of visibility in those areas. In 2005, the EPA issued its Clean Air Visibility Rule detailing how the Clean Air Act’s BART requirements will be applied to facilities, including power plants built between 1962 and 1974 that emit certain levels of visibility impairing pollutants. Under the final rule, as the CAIR provided for more visibility improvement than BART, states are allowed to substitute CAIR requirements in their regional haze SIPs in lieu of controls that would otherwise be required by BART. The final rule has been challenged in the courts. Additionally, because the regional haze SIPs incorporate certain CAIR requirements, the remand of the CAIR could potentially impact regional haze SIPs. See Ambient Air Quality above for a discussion of CAIR-related uncertainties.

LG&E and KU submitted analyses of the visibility impacts of its Kentucky BART-eligible sources to the KDAQ. Only LG&E’s Mill Creek plant was determined to have a significant regional haze impact. The KDAQ has submitted a regional haze SIP to the EPA which requires the Mill Creek plant to reduce its sulfuric acid mist emissions from Units 3 and 4. After approval of the Kentucky SIP by the EPA and revision of the Mill Creek plant’s Title V air permit, sorbent injection controls will be installed at the plant to reduce sulfuric acid mist emissions.

Ghent Opacity NOV:

In September 2007, the EPA issued a NOV alleging that KU had violated certain provisions of the Clean Air Act’s operating rules relating to opacity during June and July of 2007 at Units 1 and 3 of KU’s Ghent generating station. The parties have met on this matter and KU has received no further communications from the EPA. The Company is not able to estimate the outcome or potential effects of these matters, including whether substantial fines, penalties or remedial measures may result.

Ghent New Source Review NOV:

In March 2009, the EPA issued a NOV alleging that KU violated certain provisions of the Clean Air Act’s rules governing new source review and prevention of significant deterioration by installing FGD and SCR controls at its Ghent generating station without assessing potential increased sulfuric acid mist

emissions. KU contends that the work in question, as pollution control projects, was exempt from the requirements cited by the EPA. In December 2009, the EPA issued a Section 114 information request seeking additional information on this matter. In March 2010, KU received an EPA settlement proposal providing for imposition of additional permit limits and emission controls and anticipates continued settlement negotiations with the EPA. Negotiations between the EPA and KU are ongoing. Depending on the provisions of a final settlement or the results of litigation, if any, resolution of this matter could involve significant increased operating and capital expenditures. The Company is currently unable to determine the final outcome of this matter or the impact of an unfavorable determination on the Company's financial position or results of operations.

Installation of Pollution Controls:

Many of the programs under the Clean Air Act utilize cap and trade mechanisms that require a company to hold sufficient emissions allowances to cover its authorized emissions on a company-wide basis and do not require installation of pollution controls on every generating unit. Under cap and trade programs, companies are free to focus their pollution control efforts on plants where such controls are particularly efficient and utilize the resulting emission allowances for smaller plants where such controls are not cost effective. LG&E had previously installed FGD equipment on all of its generating units prior to the effective date of the acid rain program. KU met its Phase I SO₂ requirements primarily through installation of FGD equipment on Ghent Unit 1. LG&E's strategy for its Phase II SO₂ requirements, which commenced in 2000, is to use accumulated emission allowances to defer certain additional capital expenditures and continue to evaluate improvements to further reduce SO₂ emissions. KU's strategy for its Phase II SO₂ requirements, which commenced in 2000, includes the installation of additional FGD equipment, as well as using accumulated emission allowances and fuel switching to defer certain additional capital expenditures. LG&E and KU believe their costs in reducing SO₂, NO_x and mercury emissions to be comparable to those of similarly situated utilities with like generation assets. LG&E's and KU's compliance plans are subject to many factors including developments in the emission allowance and fuels markets, future legislative and regulatory enactments, legal proceedings and advances in clean air technology. LG&E and KU will continue to monitor these developments to ensure that its environmental obligations are met in the most efficient and cost-effective manner. LKE expects to incur additional capital expenditures currently approved in its ECR plans totaling approximately \$600 million during the 2011 through 2013 time period to achieve emissions reductions and manage coal combustion residuals. Monthly recovery is subject to periodic review by the Kentucky Commission.

TC2 Air Permit:

The Sierra Club and other environmental groups filed a petition challenging the air permit issued for the TC2 baseload generating unit which was issued by the KDAQ in November 2005. In September 2007, the Secretary of the Kentucky Environmental and Public Protection Cabinet issued a final Order upholding the permit. The environmental groups petitioned the EPA to object to the state permit and subsequent permit revisions. In determinations made in September 2008 and June 2009, the EPA rejected most of the environmental groups' claims but identified three permit deficiencies which the KDAQ addressed by revising the permit. In August 2009, the EPA issued an Order denying the remaining claims with the exception of two additional deficiencies which the KDAQ was directed to address. The EPA determined that the proposed permit subsequently issued by the KDAQ satisfied the conditions of the EPA Order although the agency recommended certain enhancements to the administrative record. In January 2010, the KDAQ issued a final permit revision incorporating the proposed changes to address the two EPA objections. In March 2010, the Sierra Club submitted a

petition to the EPA to object to the permit revision, which is now pending before the EPA. The Company believes that the final permit as revised should not have a material adverse effect on its financial condition or results of operations. However, until the EPA issues a final ruling on the pending petition and all applicable appeals have been exhausted, the Company cannot predict the final outcome of this matter.

GHG Developments:

In 2005, the Kyoto Protocol for reducing GHG emissions took effect, obligating 37 industrialized countries to undertake substantial reductions in GHG emissions. The U.S. has not ratified the Kyoto Protocol and there are currently no mandatory GHG emission reduction requirements at the federal level. As discussed below, legislation mandating GHG reductions has been introduced in the Congress, but no federal legislation has been enacted to date. In the absence of a program at the federal level, various states have adopted their own GHG emission reduction programs, including 11 northeastern U.S. states and the District of Columbia under the Regional GHG Initiative program and California. Substantial efforts to pass federal GHG legislation are on-going. The current administration has announced its support for the adoption of mandatory GHG reduction requirements at the federal level. The United States and other countries met in Copenhagen, Denmark in December 2009, in an effort to negotiate a GHG reduction treaty to succeed the Kyoto Protocol, which is set to expire in 2013. In Copenhagen, the U.S. made a nonbinding commitment to, among other things, seek to reduce GHG emissions to 17% below 2005 levels by 2020 and provide financial support to developing countries. The United States and other nations met in Cancun, Mexico in December 2010, to continue negotiations toward a binding agreement.

GHG Legislation:

LKE is monitoring on-going efforts to enact GHG reduction requirements and requirements governing carbon sequestration at the state and federal level and is assessing potential impacts of such programs and strategies to mitigate those impacts. In June 2009, the U.S. House of Representatives passed the American Clean Energy and Security Act of 2009, which was a comprehensive energy bill containing the first-ever nation-wide GHG cap and trade program. The bill provided for reductions in GHG emissions of 3% below 2005 levels by 2012, 17% by 2020 and 83% by 2050. In order to cushion potential rate impacts for utility customers, approximately 43% of emissions allowances would have initially been allocated at no cost to the electric utility sector, with this allocation gradually declining to 7% in 2029 and zero thereafter. The bill would have also established a renewable electricity standard requiring utilities to meet 20% of their electricity demand through renewable energy and energy efficiency by 2020. The bill contained additional provisions regarding carbon capture and sequestration, clean transportation, smart grid advancement, nuclear and advanced technologies and energy efficiency.

In September 2009, the Clean Energy Jobs and American Power Act, which was largely patterned on the House legislation, was introduced in the U.S. Senate. The Senate bill raised the emissions reduction target for 2020 to 20% below 2005 levels and did not include a renewable electricity standard. While the initial bill lacked detailed provisions for the allocation of emissions allowances, a subsequent revision incorporated allowance allocation provisions similar to the House bill. Although Senators Kerry and Lieberman and others worked to reach a consensus on GHG legislation, no bill passed the Senate in 2010. The Company is closely monitoring the progress of pending energy legislation, but the prospect for passage of comprehensive GHG legislation in 2011 is uncertain.

GHG Regulations:

In April 2007, the U.S. Supreme Court ruled that the EPA has the authority to regulate GHG under the Clean Air Act. In April 2009, the EPA issued a proposed endangerment finding concluding that GHGs endanger public health and welfare, which is an initial rulemaking step under the Clean Air Act. A final endangerment finding was issued in December 2009. In September 2009, the EPA issued a final GHG reporting rule requiring reporting by facilities with annual GHG emissions equivalent to at least 25,000 tons of carbon dioxide. A number of the Company's facilities are required to submit annual reports commencing with calendar year 2010. In May 2010, the EPA issued a final GHG "tailoring" rule, effective January 2011, requiring new or modified sources with GHG emissions equivalent to at least 75,000 tons of carbon dioxide to obtain permits under the Prevention of Significant Deterioration Program. Such new or modified facilities would be required to install Best Available Control Technology. While the Company is unaware of any currently available GHG control technology that might be required for installation on new or modified power plants, it is currently assessing the potential impact of the rule. The final rule will apply to new and modified power plants beginning in January 2011. The Company is unable to predict whether mandatory GHG reduction requirements will ultimately be enacted through legislation or regulations. In December 2010, the EPA announced that it plans to promulgate GHG New Source Performance Standards for power plants, including both new and existing facilities. A proposed rule is expected by July 2011, while a final rule is expected by May 2012. In the absence of either a proposed or final regulation, the Company is unable to assess the potential impact of any future regulation.

GHG Litigation:

A number of lawsuits have been filed asserting common law claims including nuisance, trespass and negligence against various companies with GHG emitting facilities. In October 2009, a three-judge panel of the United States Court of Appeals for the 5th Circuit in the case of *Comer v. Murphy Oil* reversed a lower court, holding that private plaintiffs have standing to assert certain common law claims against more than 30 utility, oil, coal and chemical companies. In March 2010, the court vacated the opinion of the three-judge panel and granted a motion for rehearing, but subsequently denied the appeal due to the lack of a quorum. The appellate ruling leaves in effect the lower court ruling dismissing the plaintiffs' claims. In January 2011, the Supreme Court denied petitioner's petition for review, which effectively brings the case to an end. The *Comer* complaint alleged that GHG emissions from the defendants' facilities contributed to global warming which increased the intensity of Hurricane Katrina. E.ON, the Company's former parent, was named as a defendant in the complaint, but was not a party to the proceedings due to the failure of the plaintiffs to pursue service under the applicable international procedures. LKE continues to monitor relevant GHG litigation to identify judicial developments that may be potentially relevant to operations.

Water/Waste

Ash Ponds and Coal-Combustion Byproducts:

The EPA has undertaken various initiatives in response to the December 2008 impoundment failure at the Tennessee Valley Authority's Kingston power plant, which resulted in a major release of coal combustion byproducts into the environment. The EPA issued information requests to utilities throughout the country, including LG&E and KU, to obtain information on their ash ponds and other impoundments. In addition, the EPA inspected a large number of impoundments located at power plants

to determine their structural integrity. The inspections included several of LG&E's and KU's impoundments, which the EPA found to be in satisfactory condition except for certain impoundments at LG&E's Mill Creek and Cane Run stations, which were determined to be in fair condition. In June 2010, the EPA published proposed regulations for coal combustion byproducts handled in landfills and ash ponds. The EPA has proposed two alternatives: (1) regulation of coal combustion byproducts in landfills and ash ponds as a hazardous waste; or (2) regulation of coal combustion byproducts as a solid waste with minimum national standards. Under both alternatives, the EPA has proposed safety requirements to address the structural integrity of ash ponds. In addition, the EPA will consider potential refinements of the provisions for beneficial reuse of coal combustion byproducts.

Water Discharges and PCB Regulations:

In March 2011, the EPA released a proposed cooling water intake structure rule pursuant to Section 316(b) of the Clean Water Act. The proposed rule would require a case-by-case review to identify appropriate measures to mitigate the impact of cooling water intake structures on aquatic life. Mitigation measures required as a result of the review could range from use of smaller mesh screens on intake structures to more costly measures such as construction of cooling towers. The exact impact of the rule will depend on the provisions contained in the final rule promulgated by the EPA and the subsequent implementation of the rule by the states. The EPA has also announced plans to develop revised effluent limitation guidelines governing discharges from power plants. The EPA has further announced plans to develop revised standards governing the use of PCB in electrical equipment. The Company is monitoring these ongoing regulatory developments, but will be unable to determine the impact until such time as new rules are finalized.

TC2 Water Permit:

In May 2010, the Kentucky Waterways Alliance and other environmental groups filed a petition with the Kentucky Energy and Environment Cabinet challenging the Kentucky Pollutant Discharge Elimination System permit issued in April 2010, which covers water discharges from the Trimble County generating station. In October 2010, the hearing officer issued a report and recommended Order providing for dismissal of the claims raised by the petitioners. In December 2010, the Secretary issued a final Order dismissing all claims and upholding the permit which petitioners subsequently appealed to Trimble County Circuit Court.

Basin Seepage or Groundwater Infiltration:

Seepages or groundwater infiltration has been detected at wastewater basins or landfills at various LG&E and KU plants. LG&E and KU have completed or are completing assessments of seepages at various facilities and are working with agencies to implement abatement measures for those seepages, where required. The potential cost to address identified seepages or other seepages at LG&E and KU plants is not now determinable, but could be significant.

Superfund

LG&E or KU are potentially responsible parties at several sites listed by the EPA under the federal Superfund program. Clean-up actions have been or are being undertaken at all of these sites, the costs of which have not been significant to the Company. However, should the EPA require different or

additional measures in the future, or should LG&E's or KU's share of costs at multi-party sites increase significantly more than currently expected, the costs to LG&E or KU could be significant.

LG&E or KU is remediating or has completed the remediation of several sites that were not addressed under a regulatory program such as Superfund, but for which LG&E or KU may be liable for remediation. These include a number of former coal gas manufacturing facilities in Kentucky previously or currently owned or operated by LG&E or KU or their predecessors or affiliates. There are additional sites, formerly owned or operated by LG&E or KU predecessors or affiliates, for which the Company lacks information on current site conditions and is therefore unable to predict what, if any, potential liability it may have.

Depending on the outcome of investigations at sites where investigations have not begun or been completed or developments at sites for which the Company currently lacks information, the costs of remediation and other liabilities could be substantial. It also could incur other non-remediation costs at sites included in current consent orders or other contaminated sites, the costs of which are not now determinable but could be significant.

Impact of Pending and Future Environmental Developments

As a company with significant coal-fired generating assets, LKE will likely be substantially impacted by pending or future environmental rules or legislation requiring mandatory reductions in GHG emissions or other air emissions, imposing more stringent standards on discharges to waterways, or establishing additional requirements for handling or disposal of coal combustion byproducts. These evolving environmental regulations will likely require an increased level of capital expenditures and increased incremental operating and maintenance costs by the Company over the next several years. Due to the uncertain nature of the final regulations that will ultimately be adopted by the EPA, including the reduction targets and the deadlines that will be applicable, the Company cannot finalize estimates of the potential compliance costs, but should the final rules incorporate additional emission reduction requirements, require more stringent emissions controls, or implement more stringent byproducts storage and disposal practices, such costs will likely be significant. With respect to NAAQS, CATR, utility Maximum Achievable Control Technology rule and coal combustion byproducts developments, based upon a preliminary analysis of proposed regulations, the Company may be required to consider actions such as upgrading existing emissions controls, installing additional emissions controls, upgrading byproducts disposal and storage and possible early replacement of coal-fired units. Capital expenditures for LKE associated with such actions are preliminarily estimated to be in the \$3.25 to \$3.75 billion range over the next ten years, although final costs may substantially vary. With respect to potential developments in water discharge, including the recently proposed Section 316(b) cooling water intake rule and the expected revisions to the effluent guidelines, revised PCB standards, or GHG initiatives, costs in such areas cannot be estimated due to the preliminary status or uncertain outcome of such developments, but would be in addition to the above amount and could be substantial. Ultimately, the precise impact on the Company's operations of these various environmental developments cannot be determined prior to the finalization of such requirements. Based upon prior regulatory precedent, the Company believes that many costs of complying with such pending or future requirements would likely be recoverable under the ECR or other potential cost-recovery mechanisms, but the Company can provide no assurance as to the ultimate outcome of such proceedings before the regulatory authorities.

Other

Argentina Matters

In connection with an administrative proceeding alleging a violation by a former Argentine subsidiary under that country's 2002-2003 emergency currency exchange laws, claims were brought against the subsidiary's then directors, including two individuals who are executive officers of the Company, in a specialized Argentine financial criminal court. Under applicable Argentine laws, directors of a local company may be liable for monetary penalties for a subject company's violations of the currency laws. In February 2011, the Argentine court issued an order acquitting the former subsidiary and its directors of all claims, which order has become final.

Guarantees

In connection with various divestitures, the Company has indemnified/guaranteed respective parties against certain liabilities that may arise in connection with these transactions and business activities. The terms of these indemnifications/guarantees vary, as do the expiration terms. The Company has issued direct financial guarantees to parties involved in the WKE lease termination, which occurred in July 2009. These guarantees cover the due and punctual payment, performance and discharge by each party of its respective present and future obligations. The most comprehensive of these guarantees is a guarantee covering operational, regulatory and environmental commitments and indemnifications made by WKE under the WKE Transaction Termination Agreement. This guarantee has a term of 12 years beginning on July 16, 2009 and a cumulative maximum exposure of \$200 million. Certain items, such as non-excluded government fines and penalties, fall outside the cumulative cap. Another guarantee with a maximum exposure of \$100 million covering other indemnifications expires in 2023. Certain matters are currently under discussion among the parties, including one matter currently in arbitration, the outcomes of which cannot be predicted at this time. See Note 19, Discontinued Operations, in the Company's Consolidated Financial Statements and Additional Information Report for 2010 for further information. Additionally, the Company has indemnified various third parties related to historical obligations for divested subsidiaries and affiliates. The indemnifications vary by entity and the maximum amounts range from being capped at the sale price to no specified maximum; however, the Company is not aware of claims made by any party at this time. The Company could be required to perform on these indemnifications in the event of covered losses or liabilities being claimed by an indemnified party. No additional material loss is anticipated by reason of such indemnifications. LKE has recorded liabilities for all guarantees totaling \$12 million.

Other Contractual Obligations

As described in Note 19, Discontinued Operations, in the Company's Consolidated Financial Statements and Additional Information Report for 2010, WKE issued a swap agreement to a third party customer, which expired on December 31, 2010. The swap was accounted for as a derivative until its expiration date and had a liability at December 31, 2010, of \$9 million, which was paid in January 2011.

Note 10 – Related Party Transactions

The Company's balances with affiliates as of March 31, 2011 and December 31, 2010, were with PPL and its affiliates. See Note 7, Income Taxes, and Note 8, Debt, for further information.

LKE relies on dividends from its subsidiaries to fund its dividends to its sole member and to meet its other cash requirements. The net assets of LG&E and KU are subject to Section 305(a) of the Federal Power Act, which makes it unlawful for a public utility to make or pay a dividend from any funds "properly included in capital account." The meaning of this limitation has never been clarified under the Federal Power Act. LG&E and KU believe, however, that this statutory restriction, as applied to their circumstances, would not be construed or applied by the FERC to prohibit the payment from retained earnings of dividends that are not excessive and are for lawful and legitimate business purposes. Also, under Virginia law, KU is prohibited from making loans to affiliates without prior approval of the Virginia Commission. There are no comparable statutes under Kentucky law applicable to LG&E and KU. However, Orders from the Kentucky Commission require LG&E and KU to obtain prior regulatory consent or approval before loaning funds to any affiliates.

Interest Charges

Interest expense related to loans from PPL affiliates was not significant for the three months ended March 31, 2011. There were no loans from PPL and its affiliates during three months ended March 31, 2010. There were no loans from E.ON during the three months ended March 31, 2011. Interest expense related to loans from E.ON was \$40 million for the three months ended March 31, 2010.

Intercompany Balances

The Company had the following balances with PPL and its affiliates as of March 31, 2011 and December 31, 2010:

	March 31, 2011	December 31, 2010
Accounts receivable	\$ -	\$ 2
Notes receivable	45	61
Accounts payable	2	3

The Company paid dividends of \$54 million to its sole member, PPL, in the three months ended March 31, 2011. The Company paid dividends of \$6 million in the three months ended March 31, 2010 to E.ON US Investments Corp.

Note 11 – Subsequent Events

Subsequent events have been evaluated through May 9, 2011, the date of issuance of these statements and these statements contain all necessary adjustments and disclosures resulting from that evaluation.

On May 2, 2011, LG&E and KU filed notices of intent to file ECR plans with the Kentucky Commission. The plans will be filed on or after June 1, 2011.

On April 29, 2011, KU entered into a new \$198 million letter of credit agreement that will be used to issue letters of credit to support outstanding tax exempt bonds. The facility matures in April 2014. On May 2, 2011, letters of credit totaling \$198 million were issued under the new agreement replacing the letters of credit previously issued under KU's credit facility. In May 2011, one national rating agency downgraded the long-term rating of four of KU's pollution control bonds by one notch in connection with the substitution of the letters of credit enhancing these four bonds.

On April 21 and 22, 2011, LKE, LG&E and KU each filed a Form S-4, Registration Statement, with the SEC, as agreed in their senior notes and first mortgage bonds registration rights agreements. The Forms S-4 relate to an offer to exchange the senior notes or first mortgage bonds with registered, publicly tradable securities.

On April 21, 2011, LG&E and KU filed their 2011 joint IRP with the Kentucky Commission.

On April 1, 2011, KU filed a rate adjustment request with the Virginia Commission. If approved, the \$9 million base rate increase, an increase of approximately 14%, would be effective January 2012. Inclusive in that request is the recovery over five years of \$6 million in expenses from the December 2009 winter storm that affected KU's Virginia jurisdiction.

Forward-Looking Information

Statements contained in this report concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements which are other than statements of historical fact are “forward-looking statements” within the meaning of the federal securities laws. Although LKE believes that the expectations and assumptions reflected in these statements are reasonable, there can be no assurance that these expectations will prove to be correct. Forward-looking statements are subject to many risks and uncertainties, and actual results may differ materially from the results discussed in forward-looking statements. In addition to the specific factors discussed in Risk Factors in LKE’s Consolidated Financial Statements and Additional Information Report for 2010 and in Management’s Discussion and Analysis in this report, the following are among the important factors that could cause actual results to differ materially from the forward-looking statements.

- continuing ability to recover fuel and natural gas supply costs in a timely manner;
- weather conditions affecting generation, customer energy use and operating costs;
- operation, availability and operating costs of existing generation facilities;
- transmission and distribution system conditions and operating costs;
- potential laws or regulations to reduce emissions of GHGs;
- collective labor bargaining negotiations;
- the outcome of litigation against the LKE and its subsidiaries;
- potential effects of threatened or actual terrorism, war or other hostilities or natural disasters;
- the commitments and liabilities against LKE and its subsidiaries;
- market demand and prices for energy, capacity, transmission services, emission allowances and delivered fuel;
- competition in retail and wholesale power and natural gas markets;
- liquidity of wholesale power markets;
- defaults by counterparties under energy, fuel or other power product contracts;
- market prices of commodity inputs for ongoing capital expenditures;
- capital market conditions, including the availability of capital or credit, changes in interest rates, and decisions regarding capital structure;
- the fair value of debt and equity securities and the impact on defined benefit costs and resultant cash funding requirements for defined benefit plans;
- interest rates and their effect on pension and retiree medical liabilities;
- volatility in or the impact of other changes in financial or commodity markets and economic conditions;
- the profitability and liquidity, including access to capital markets and credit facilities of LKE and its subsidiaries;
- new accounting requirements or new interpretations or applications of existing requirements;
- changes in securities and credit ratings;
- current and future environmental conditions, regulations and requirements and the related costs of compliance, including environmental capital expenditures, emission allowance costs and other expenses;
- political, regulatory or economic conditions in states, regions or countries where LKE or its subsidiaries conducts business;
- receipt of necessary governmental permits, approvals and rate relief;
- new state or federal legislation, including new tax, environmental, health care or pension-related legislation;

- state or federal regulatory developments;
- the outcome of any rate cases by LG&E or KU at the Kentucky Commission, the FERC, the Virginia Commission or the Tennessee Regulatory Authority;
- the impact of any state or federal investigations applicable to the LKE and its subsidiaries and the energy industry;
- the effect of any business or industry restructuring;
- development of new projects, markets and technologies;
- performance of new ventures; and
- business or asset acquisitions and dispositions.

Any such forward-looking statements should be considered in light of such important factors.

New factors that could cause actual results to differ materially from those described in forward-looking statements emerge from time to time, and it is not possible for LKE to predict all such factors, or the extent to which any such factor or combination of factors may cause actual results to differ from those contained in any forward-looking statement. Any forward-looking statement speaks only as of the date on which such statement is made, and LKE undertakes no obligation to update the information contained in such statement to reflect subsequent developments or information.

Management's Discussion and Analysis

Overview

Management's Discussion and Analysis should be read in conjunction with LKE's condensed consolidated financial statements and the accompanying notes. Terms and abbreviations are explained in the Index of Abbreviations. Dollars are in millions unless otherwise noted.

LKE, headquartered in Louisville, Kentucky, is a holding company with energy and utility operations through its subsidiaries, LG&E and KU. LG&E and KU, which constitute substantially all of LKE's assets, are regulated utilities engaged in the generation, transmission, distribution and sale of electric energy. LG&E also engages in the distribution and sale of natural gas in Kentucky. Refer to the Business section in LKE's Consolidated Financial Statements and Additional Information Report for 2010 for further information regarding the business. See Overview in Management's Discussion and Analysis in the Company's Consolidated Financial Statements and Additional Information Report for 2010 for a discussion of LKE's strategy and the risks and challenges that it faces in its business. See Forward-Looking Information, Note 9, Commitments and Contingencies, and the remainder of items in Management's Discussion and Analysis in this report and Risk Factors and Management's Discussion and Analysis in the Company's Consolidated Financial Statements and Additional Information Report for 2010 for more information concerning the material risks and uncertainties that LKE faces in its business and with respect to its future earnings and cash flows.

Predecessor and Successor Financial Presentation

LKE's Condensed Consolidated Financial Statements and related financial and operating data include the periods before and after PPL's acquisition of LKE on November 1, 2010, and are labeled as Predecessor or Successor, as applicable. LKE applied push-down accounting to account for the acquisition. For accounting purposes only, push-down accounting is considered to create a new entity due to new cost basis assigned to assets, liabilities and equity as of the acquisition date. Consequently, certain results of LKE's operations and cash flows for the Predecessor period in 2010 and the Successor periods in 2010 and 2011 are not consistent; however, management does not believe that the core operations of the Company have changed as a result of the acquisition.

Environmental Matters

General

Protection of the environment is a major priority for the Company and a significant element of its business activities. Extensive federal, state and local environmental laws and regulations are applicable to LKE's air emissions, water discharges and the management of hazardous and solid waste, among other areas; and the costs of compliance or alleged non-compliance cannot be predicted with certainty but could be material. In addition, costs may increase significantly if the requirements or scope of environmental laws or regulations, or similar rules, are expanded or changed from prior versions by the relevant agencies. Costs may take the form of increased capital or operating and maintenance expenses; monetary fines, penalties or forfeitures or other restrictions. Many of these environmental law considerations are also applicable to the operations of key suppliers, or customers, such as coal producers, industrial power users, etc., and may impact the costs of their products or their demand for LKE's services.

Climate Change

Recent developments continue to indicate an increased possibility of significant climate change or GHG legislation or regulation, at the international, federal, regional and state levels. During December 2009, as part of the United Nation's Copenhagen Accord, the U.S. agreed to a non-binding goal to reduce GHG emissions to 17% below 2005 levels by 2020. Additionally, during 2009, the U.S. House of Representatives passed comprehensive GHG legislation, which included a number of measures to limit GHG emissions and achieve GHG emission reduction targets below 2005 levels of 3% by 2012, 17% by 2020 and 83% by 2050. Similar legislation has been considered in the U.S. Senate, but the prospects for passage remain uncertain. In late 2009, the EPA issued a final endangerment finding relating to mobile sources of GHGs and a GHG reporting requirement beginning in 2010. In 2010, the EPA issued a final rule requiring implementation of best available control technology for GHG emissions from new or modified power plants, effective January 2011. In December 2010, the EPA announced that it intends to propose New Source Performance Standards addressing GHG emissions from new and existing power plants, with a proposed rule expected in July 2011. In 2011, legislation was introduced in both the House and Senate which seeks to bar the EPA from regulating GHG emissions under the existing authority of the Clean Air Act, but, to date, no such legislation has been enacted. Finally, a number of U.S. states, although not currently including Kentucky, have adopted GHG-reduction legislation or regulation of various sorts. The developing GHG initiatives include a number of differing structures and formats, including direct limitations on GHG sources, issuance of allowances for GHG emissions, cap-and-trade programs for such allowances, renewable or alternative generation portfolio standards and mechanisms relating to demand reduction, energy efficiency, smart-grid, transmission expansion, carbon-sequestration or other GHG-reducing efforts. While the final terms and impacts of such initiatives cannot be estimated, LKE, a holding company for primarily coal-fired utility companies, could be highly affected by such proceedings.

Other Environmental Regulatory Initiatives

The EPA has proposed or announced that it intends to propose, and in some cases has finalized, a number of additional environmental regulations that could substantially impact utilities with coal-fired generating assets. These regulatory initiatives include revisions to the ambient air quality standards for SO₂, NO₂, ozone and particulate matter 2.5 microns in size or less, rules aimed at mitigating the interstate transport of SO₂ and NO_x, a program governing emissions of hazardous air pollutants from utility generating units, a program for the management of coal combustion residuals, revised effluent guidelines for utility generating facilities and standards for cooling water intake structures. Such requirements could potentially mandate upgrade of existing emission controls, installation of additional emission controls such as FGDs, SCRs, fabric filter bag houses, activated carbon injection, wet electrostatic precipitators, closure of ash ponds and retrofit of landfills, installation of cooling towers, deployment of new water treatment technologies and retirement of facilities that cannot be retrofitted on a cost effective basis.

The cost to LKE and the effect on LKE's business of complying with potential GHG restrictions and other environmental regulatory initiatives will depend upon provisions of any final rules and how the rules are implemented by the EPA. Some of the design elements which may have the greatest effect on LKE include (a) the required levels and timing of emissions caps, discharge limits or similar standards, (b) the sources covered by such requirements, (c) transition and mitigation provisions, such as phase-in periods, free allowances or price caps, (d) the availability and pricing of relevant mitigation or control

technologies, goods or services and (e) economic, market and customer reaction to electricity price and demand changes due to environmental concerns.

Ultimately, environmental matters or potential environmental matters can represent an important element of current or future potential capital requirements, future unit retirement or replacement decisions, supply and demand for electricity, operating and maintenance expenses or compliance risks for the Company. Based on prior regulatory precedent, LKE currently anticipates that many of such direct costs may be recoverable by LKE through rates or other regulatory mechanisms, particularly with respect to coal-related generation, but the availability, timing or completeness of such rate recovery cannot be assured. Ultimately, climate change and other environmental matters will likely increase the level of capital expenditures and operating and maintenance costs incurred by the Company during the next several years. With respect to NAAQS, CATR, the utility Maximum Achievable Control Technology rule and coal combustion byproducts developments, based on a preliminary analysis of proposed regulations, the Company may be required to consider actions such as upgrading existing emissions controls, installing additional emissions controls, upgrading byproducts disposal and storage and possible early replacement of coal-fired units. In order to comply with the coal combustion residual rules and the above referenced air rules, capital expenditures for LKE are preliminarily estimated to be in the \$3.25 to \$3.75 billion range over the next ten years, although final costs may substantially vary. This estimate does not include compliance with GHG rules or contemplated water-related environmental changes, including the recently proposed Section 316(b) cooling water intake rule and the expected revisions to the effluent guidelines. See Risk Factors and Note 9, Commitments and Contingencies, for further information.

Results of Operations

The following discussion begins with a description of key factors that management expects may impact future earnings and continues with a summary of LKE's earnings. This section ends with Statement of Income Analysis, which includes explanations of significant changes in principal items in LKE's Condensed Consolidated Statements of Income, comparing the three months ended March 31, 2011, with the same period in 2010.

As a result of the November 1, 2010 acquisition of LKE by PPL, LKE's results for the three months ended March 31, 2011 are on a different basis of accounting than its results for the three months ended March 31, 2010. When discussing LKE's results of operations for 2011, compared with 2010, material differences resulting from the different bases of accounting will be isolated for purposes of comparability. See Predecessor and Successor Financial Presentation for further information.

The results for interim periods can be disproportionately influenced by various factors and developments and by seasonal variations, and as such, the results of operations for interim periods do not necessarily indicate results or trends for the year or for future operating results. Due to weather, revenue and earnings are generally highest during the first and third quarters and lowest in the second quarter.

Outlook

LKE projects higher earnings in 2011, compared with 2010, as a result of higher retail revenues and lower financing cost due to lower debt balances resulting from an equity contribution provided by PPL, upon the November 1, 2010 acquisition and the issuance in late 2010 of first mortgage bonds which the Company used to refund higher cost debt, partially offset by higher depreciation. Retail revenues are

expected to increase as a result of the Kentucky rate cases and recoveries associated with environmental investments. Depreciation is expected to increase due to commencing dispatch of TC2 in January 2011, to serve customer demands. See Risk Factors for a discussion of the risk factors that may impact the 2011 outlook.

Net Income

The following table summarizes the significant components of net income for the three months ended March 31, 2011 and 2010, and the changes therein:

	Successor Three Months Ended March 31, 2011	Predecessor Three Months Ended March 31, 2010	Increase (Decrease)
Total operating revenues	\$ 766	\$ 713	\$ 53
Total operating expenses	<u>593</u>	<u>566</u>	<u>27</u>
Operating income	173	147	26
Equity in earnings of unconsolidated venture	1	3	(2)
Interest expense	36	6	30
Interest expense to affiliated companies	-	40	(40)
Other income (expense) - net	<u>(2)</u>	<u>(3)</u>	<u>1</u>
Income from continuing operations, before income taxes	136	101	35
Income tax expense	<u>49</u>	<u>38</u>	<u>11</u>
Income from continuing operations	87	63	24
Loss from discontinued operations net of income tax	-	2	(2)
Loss on disposal of discontinued operations net of income tax	<u>-</u>	<u>1</u>	<u>(1)</u>
Net income attributable to member	<u>\$ 87</u>	<u>\$ 60</u>	<u>\$ 27</u>

Statement of Income Analysis - Margin

Non-GAAP Financial Measures

The following discussion includes financial information prepared in accordance with GAAP, as well as a non-GAAP financial measure, Margin. In calculating this measure, utility revenues and expenses associated with approved cost recovery tracking mechanisms are offset. These mechanisms allow for timely recovery of certain expenses, returns on capital investments associated with environmental regulations and performance incentives. As a result, this measure represents the net revenues from LKE's operations. This performance measure is used, in conjunction with other information, internally by senior management and the Board of Directors to manage LKE's operations. LKE believes that Margin provides another criterion to make investment decisions.

Margin is not intended to replace Operating income, which is determined in accordance with GAAP, as an indicator of overall operating performance. Other companies may use different measures to present the results of their operations.

The following table reconciles Operating income to Margin as defined by LKE:

	<u>Successor</u> Three Months Ended March 31, 2011	<u>Predecessor</u> Three Months Ended March 31, 2010
Operating income (a)	\$ 173	\$ 147
Adjustments:		
Other operation and maintenance expenses (a)	190	167
Depreciation and amortization (a)	81	69
Net adjustments (b)	<u>(33)</u>	<u>(28)</u>
Margin (c)	<u>\$ 411</u>	<u>\$ 355</u>

(a) As reported on the Condensed Consolidated Statements of Income.

(b) The components of these adjustments are detailed in the table below.

(c) Margin is higher primarily due to the increase in Kentucky base rates, effective August 1, 2010, partially offset by lower volumes largely due to milder weather in 2011.

The following table provides details of margin revenue and expense adjustments:

	<u>Successor</u> Three Months Ended March 31, 2011	<u>Predecessor</u> Three Months Ended March 31, 2010
Revenue adjustments (a)		
Commodity swaps marked-to-market (b)	\$ -	\$ (2)
Total revenue adjustments	<u>\$ -</u>	<u>\$ (2)</u>

	Successor Three Months Ended March 31, 2011	Predecessor Three Months Ended March 31, 2010
Expense adjustments (a)		
ECR mechanism (c)	\$ 18	\$ 12
DSM mechanism (c)	5	6
GSC mechanism (c)	1	1
Consumables (d)	7	9
Transmission (d)	2	2
Fuel operating and maintenance expenses (e)	-	(4)
Total expense adjustments	<u>\$ 33</u>	<u>\$ 26</u>

- (a) To include/exclude the impact of any revenues and expenses consistent with the way management reviews Margin internally.
- (b) See Note 5, Derivative Financial Instruments, for additional information. The net unrealized gains/losses from commodity swaps are located in Operating revenues on the Condensed Consolidated Statements of Income; however, the accounts are located in Other income (expense) - net for management review purposes.
- (c) Relates to costs associated with the Kentucky Commission's approved cost recovery mechanisms. These costs are recovered in customer rates and are therefore included in Margin.
- (d) Included in Other operation and maintenance expenses on the Condensed Consolidated Statements of Income.
- (e) For management review purposes, Fuel operating and maintenance expenses are excluded from Margin. The expenses were previously included in Fuel for electric generation on the Condensed Consolidated Statement of Income under the Predecessor.

Operating Revenues

Operating revenues and the changes therein follow:

	Successor Three Months Ended March 31, 2011	Predecessor Three Months Ended March 31, 2010	Increase (Decrease)
Electric	\$ 624	\$ 579	\$ 45
Natural gas	142	134	8
	<u>\$ 766</u>	<u>\$ 713</u>	<u>\$ 53</u>

Electric Revenues

The \$45 million increase in electric revenues for the three months ended March 31, 2011, compared with the three months ended March 31, 2010, was primarily due to:

	Increase <u>(Decrease)</u>
Base rate price variance (a)	\$ 37
Demand revenue (b)	18
Resale sales (c)	8
Wholesale sales to municipals and transmission revenues	2
Retail sales volumes (d)	(14)
FAC price variance	(3)
Financial swaps	(3)
	<u>\$ 45</u>

- (a) The increase in revenues due to the base rate price variance during the three months ended March 31, 2011, compared with the three months ended March 31, 2010, resulted from higher base rates effective August 1, 2010. See Note 3, Rates and Regulatory Matters, for further discussion of the Kentucky rate cases.
- (b) Demand revenue increased during the three months ended March 31, 2011, compared with the three months ended March 31, 2010, as a result of higher demand rates effective August 1, 2010. See Note 3, Rates and Regulatory Matters, for further discussion of the Kentucky rate cases.
- (c) Resale sales increased during the three months ended March 31, 2011, compared with the three months ended March 31, 2010, primarily as a result of increased volumes due to increased generation from improved performance of coal-fired generating units and the addition of TC2, a new jointly owned generating facility.
- (d) Retail sales volumes decreased during the three months ended March 31, 2011, compared with the three months ended March 31, 2010, primarily as a result of reduced consumption by residential and commercial customers due to milder 2011 winter.

Natural Gas Revenues

The \$8 million increase in natural gas revenues for the three months ended March 31, 2011, compared with the three months ended March 31, 2010, was primarily due to:

	Increase (Decrease)
Change in classification (a)	\$ 25
Retail base rates price variance (b)	5
Wholesale sales	2
GSC revenue (c)	(16)
Retail sales volumes (d)	(8)
	<u>\$ 8</u>

- (a) Revenues associated with the GSC rate mechanism were included as an offset to Natural gas supply expenses on the Condensed Consolidated Statement of Income for the three months ended March 31, 2010, and were included in Operating revenues on the Condensed Consolidated Statement of Income for the three months ended March 31, 2011.
- (b) The increase in revenues due to the base rate price variance during the three months ended March 31, 2011, compared with the three months ended March 31, 2010, resulted from higher base rates effective August 1, 2010. See Note 3, Rates and Regulatory Matters, for further discussion of the Kentucky rate cases.
- (c) GSC revenues decreased primarily due to pricing.
- (d) Retail sales volumes decreased during the three months ended March 31, 2011, compared with the three months ended March 31, 2010, primarily as a result of reduced consumption due to a decline in total heating degree days. The decrease in revenues due to volume was partially offset by increased Weather Normalization Adjustment revenues resulting from lower natural gas volumes.

Operating Expenses

The changes in operating expenses for the three months ended March 31, 2011, compared with the three months ended March 31, 2010, are as follows:

	Increase (Decrease)
Fuel for electric generation	\$ 6
Power purchased	(22)
Natural gas supply	8
Other operation and maintenance	23
Depreciation and amortization	12
	<u>\$ 27</u>

Fuel for Electric Generation

The \$6 million increase for the three months ended March 31, 2011, compared with the three months ended March 31, 2010, was primarily due to:

	Increase (Decrease)
Fuel usage volumes (a)	\$ 9
Commodity costs for coal and natural gas	1
Other operation and maintenance (b)	(3)
Other	(1)
	<u>\$ 6</u>

- (a) Fuel usage volumes due to TC2 going on-line in January 2011, which was offset in part by the decrease in volumes at other KU generating units.
- (b) Fuel handling costs are included in Fuel for electric generation on the Condensed Consolidated Statement of Income for the three months ended March 31, 2010, and are included in Other operation and maintenance expenses on the Condensed Consolidated Statement of Income for the three months ended March 31, 2011.

Power Purchased

The \$22 million decrease for the three months ended March 31, 2011, compared with the three months ended March 31, 2010, was primarily due to the expiration a long-term power purchased contract in May 2010.

Natural Gas Supply Expenses

The \$8 million increase for the three months ended March 31, 2011, compared with the three months ended March 31, 2010, was primarily due to:

	Increase (Decrease)
Change in classification (a)	\$ 25
Wholesale sales of natural gas volumes	2
Lower purchase volumes of natural gas delivered to the distribution system	(10)
Lower prices of natural gas delivered to the distribution system	(10)
Other	1
	<u>\$ 8</u>

- (a) Revenues associated with the GSC rate mechanism were included as an offset to Natural gas supply expenses on the Condensed Consolidated Statement of Income for the three months ended March 31, 2010, and were included in Operating revenues on the Condensed Consolidated Statement of Income for the three months ended March 31, 2011.

Other Operation and Maintenance Expenses

The \$23 million increase for the three months ended March 31, 2011, compared with the three months ended March 31, 2010, was primarily due to:

	Increase <u>(Decrease)</u>
Steam maintenance (a)	\$ 5
PPL support charges	5
Steam operations (b)	5
Other	8
	<u>\$ 23</u>

- (a) The steam maintenance expense increased due to a scheduled Ghent unit 3 outage in 2011 in addition to increased boiler and burner maintenance cost.
- (b) The steam operating expense increased primarily due to increases in scrubber reactant expenses and other consumables.

Depreciation and amortization

The \$12 million increase for the three months ended March 31, 2011, compared with the three months ended March 31, 2010, was primarily due to commencing dispatch of TC2 to serve customer demands in January 2011.

Interest Expense

The \$10 million decrease was primarily due to lower interest rates and lower debt balances for the three months ended March 31, 2011, compared with the three months ended March 31, 2010. See variance details below:

	Increase <u>(Decrease)</u>
Interest rates (a)	\$ (4)
Debt balances (b)	(7)
Other	1
	<u>\$ (10)</u>

- (a) Interest rates on the first mortgage bonds and senior notes were lower than the rates on the Fidelity Corporation, an E.ON AG affiliate loans which were replaced.
- (b) LKE's debt balances were \$1.3 billion lower for the three months ended March 31, 2011, compared with the three months ended March 31, 2010, primarily as a result of an equity contribution from PPL, at the time of acquisition. This was partially offset by higher debt balances at the Utilities. See Note 8, Debt, for further information.

Income Tax Expense

See Note 7, Income Taxes, for a reconciliation of differences between the U.S. federal income tax expense at statutory rates and LKE's income tax expense.

Financial Condition

Liquidity and Capital Resources

LKE expects to continue to have access to adequate sources of liquidity through operating cash flows, cash and cash equivalents, credit facilities and/or infusion of capital from its parent.

LKE had the following:

	March 31, 2011	December 31, 2010
Cash and cash equivalents	\$ 94	\$ 11
Available for sale debt securities (a)	-	163
	<u>\$ 94</u>	<u>\$ 174</u>
	March 31, 2011	December 31, 2010
Current portion of long-term debt	\$ 2	\$ 2
Note payable (b)	-	163
	<u>\$ 2</u>	<u>\$ 165</u>

- (a) 2010 amount represents tax-exempt bonds issued by Louisville/Jefferson County, Kentucky, on behalf of LG&E that were subsequently purchased by LG&E. Such bonds were remarketed to unaffiliated investors in January 2011. See Note 8, Debt, for further information.
- (b) 2010 amount represents borrowings on LG&E's \$400 million revolving line of credit with a group of banks. See Note 8, Debt, for further information.

The \$83 million increase in LKE's cash and cash equivalents position was primarily the net result of the following:

- \$191 million of cash provided by operating activities,
- proceeds of \$163 million from sales of marketable debt securities,
- a net decrease in loans to affiliates of \$16 million,
- a net decrease in short-term debt of \$163 million,
- \$67 million of construction expenditures, and
- the payment of \$54 million of distributions to PPL.

Credit Facilities

See Note 8, Debt, for LKE's total committed borrowing capacity under its credit facilities and the use of this borrowing capacity.

Auction Rate Securities

Auctions for auction rate securities issued by LKE continued to fail throughout 2010 and thus far in 2011. LKE held \$163 million of its own securities at December 31, 2010, that at one time were auction rate securities. These securities consisted entirely of pollution control bonds and were remarketed in January 2011. See Note 8, Debt, for further discussion.

Credit Ratings

A downgrade in LKE's credit ratings could impact its ability to access capital and increase the cost of credit facilities and any new debt. LKE's credit ratings reflect the views of three national rating agencies. A security rating is not a recommendation to buy, sell or hold securities and is subject to revision or withdrawal at any time by the rating agency. In March 2011, one national agency revised downward the long-term bond ratings of LKE, LG&E and KU and the short-term ratings of LG&E and KU by one notch, and left the ratings on credit watch with negative implications as the result of PPL's proposed acquisition of the Central Networks business in the United Kingdom. In April 2011, the same agency removed the negative credit watch for all ratings and upgraded by one notch the short-term ratings of LG&E and KU. In May 2011, one national rating agency downgraded the long-term rating of four of KU's pollution control bonds by one notch in connection with the substitution of the letters of credit enhancing these four bonds.

In October 2010, one national rating agency revised downward the short-term credit rating of the pollution control bonds and the issuer ratings of LKE, LG&E and KU as a result of the then pending acquisition by PPL. Another raised the long-term rating of the pollution control bonds as a result of the addition of the first mortgage bonds as collateral. In October 2010, a third national rating agency provided an initial rating of the Company's pollution control bonds, senior notes and first mortgage bonds.

Ratings Triggers

LKE has various derivative and non-derivative contracts, including contracts for the sale and purchase of electricity and fuel, commodity transportation and interest rate instruments, which contain provisions requiring LKE to post additional collateral, or permit the counterparty to terminate the contract if LKE's credit rating was to fall below investment grade. See Note 4, Derivative Financial Instruments, for a discussion of Credit Risk Related Contingent Features, including a discussion of the potential additional collateral that would have been required for derivative contracts in a net liability position at March 31, 2011. At March 31, 2011, if LKE's credit ratings had been below investment grade, LKE would have been required to prepay or post an additional \$75 million of collateral to counterparties for both derivative and non-derivative commodity and commodity-related contracts used in its generation, marketing and trading operations and interest rate contracts.

Risk Management

Market Risk

LKE is exposed to market risk from equity instruments, interest rate instruments and commodity instruments, as discussed below. However, regulatory cost recovery mechanisms significantly mitigate those risks.

Commodity Price Risk:

The Utilities' rates are set by regulatory commissions and the fuel costs incurred are directly recoverable from customers. As a result, LG&E and KU are subject to commodity price risk for only a small portion of on-going business operations. LKE conducts energy trading and risk management activities to maximize the value of the physical assets at times when the assets are not required to serve the Utilities' customers, and the Company manages energy commodity risk using derivative instruments, including swaps and forward contracts. The following chart sets forth the changes in the net fair value of LKE's commodity derivative contracts for the three months ended March 31, 2011 and 2010. See Note 4, Derivative Financial Instruments, for further information.

	Successor	Predecessor
	Three Months	Three Months
	Ended	Ended
	March 31, 2011	March 31, 2010
Fair value of contracts outstanding at January 1	\$ (2)	\$ -
Contracts realized or otherwise settled	-	1
Fair value of new contracts	1	(4)
Other changes in fair value (a)	-	5
	<u> </u>	<u> </u>
Fair value of contracts outstanding at March 31	<u>\$ (1)</u>	<u>\$ 2</u>

(a) Represents the change in value of outstanding transactions and the value of transactions entered into and settled during the period.

Interest Rate Risk:

LKE and its subsidiaries have issued debt to finance their operations, which exposes them to interest rate risk. LKE's policies allow for the interest rate risk to be managed through the use of fixed rate debt, floating rate debt and interest rate swaps. Pursuant to LKE's company policy, use of these financial instruments is intended to mitigate risk, earnings and cash flow volatility and is not speculative in nature. At March 31, 2011, the Company's annual exposure to increased interest expense, based on a 10% increase in interest rates, was not significant.

Securities Price Risk:

LKE has securities price risk through its participation in defined benefit pension and postretirement benefit plans. Declines in the market price of debt and equity securities could impact contribution requirements. See Management's Discussion and Analysis in the Company's Financial Statements and Additional Information Report for 2010 for a discussion of the assumptions and sensitivities regarding the Company's defined benefit pension and postretirement benefit plans assumptions.

Credit Risk

LKE is exposed to potential losses as a result of nonperformance by counterparties of their contractual obligations. LKE maintains credit policies and procedures to limit counterparty credit risk including evaluating credit ratings and financial information along with having certain counterparties post margin if the credit exposure exceeds certain thresholds.

LKE is exposed to potential losses as a result of nonpayment by customers. The Company maintains an allowance for doubtful accounts composed of accounts aged more than four months. Accounts are written off as management determines them uncollectible. See Application of Critical Accounting Policies and Estimates and Note 2, Summary of Significant Accounting Policies, for further discussion.

Certain of LKE's derivative instruments contain provisions that require it to provide immediate and on-going collateralization on derivative instruments in net liability positions based upon LKE's credit ratings from each of the major credit rating agencies. See Note 4, Derivative Financial Instruments, for information regarding exposure and the risk management activities.

Related Party Transactions

LKE and its subsidiaries engage in related party transactions. LKE is not aware of any material ownership interest or operating responsibility by the executive officers of LKE in outside partnerships, including leasing transactions with variable interest entities or other entities doing business with LKE. See Note 10, Related Party Transactions, for additional information on related party transactions.

Acquisitions, Development and Divestitures

LKE has been constructing a new 760 megawatts capacity base-load, coal-fired unit, TC2, which is jointly owned by LKE (75%), together with the Illinois Municipal Electric Authority and the Indiana Municipal Power Agency (combined 25%). With limited exceptions the Company took care, custody and control of TC2 on January 22, 2011, and has dispatched the unit to meet customer demand since that date. LG&E and KU and the contractor agreed to a further amendment of the construction agreement whereby the contractor will complete certain actions relating to identifying and completing any necessary modifications to allow operation of TC2 on all fuels in accordance with initial specifications prior to certain dates, and amending the provisions relating to liquidated damages. See Note 9, Commitments and Contingencies, for further information. LKE continuously reexamines development projects based on market conditions and other factors to determine whether to proceed, to cancel or to expand the projects.

Application of Critical Accounting Policies and Estimates

LKE's financial condition and results of operations are impacted by the methods, assumptions and estimates used in the application of critical accounting policies. The following accounting policies are particularly important to the financial condition and results of operations of LKE and require estimates or other judgments of matters inherently uncertain: price risk management, regulatory mechanisms, defined benefits, asset impairment, loss accruals, AROs, income tax uncertainties, and purchase price allocation. See Management's Discussion and Analysis in the Company's Consolidated Financial Statements and Additional Information Report for 2010 for a discussion of each critical accounting policy.

Quantitative and Qualitative Disclosures About Market Risk

Reference is made to Risk Management in Management's Discussion and Analysis. See Note 4, Derivative Financial Instruments, for further information.

Controls and Procedures

(a) Evaluation of disclosure controls and procedures

LKE's management, including its principal executive officer and principal financial officer, has evaluated the Company's disclosure controls and procedures related to the recording, processing, summarizing and reporting of information in its periodic reports as of March 31, 2011. These disclosure controls and procedures have been designed by the Company to ensure that (i) material information required for disclosure by the Company in its reports, including its consolidated subsidiaries, is accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, by other employees of the Company and its subsidiaries as appropriate to allow timely decisions regarding required disclosure, and (ii) this information is recorded, processed, summarized, evaluated and reported, particularly during the period for which this quarterly report has been prepared.

(b) Change in internal controls over financial reporting

LKE's principal executive officer and principal financial officer have concluded that there were no changes in the Company's internal control over financial reporting that occurred during the Company's first fiscal quarter of 2011 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Legal Proceedings

For a discussion of the significant legal proceedings, including, but not limited to, certain rates and regulatory, environmental, climate change, litigation and other matters, involving the Company, refer to the Notes to Consolidated Financial Statements in LKE's Consolidated Financial Statements and Additional Information Report for 2010. Reference is also made to the matters described in Note 3, Rates and Regulatory Matters, Note 9, Commitments and Contingencies, and Note 11, Subsequent Events, of this quarterly report. Except as described in this quarterly report, to date the proceedings reported in the Company's Consolidated Financial Statements and Additional Information Report for 2010 have not materially changed.

Risk Factors

There have been no material changes in LKE's risk factors from those disclosed in LKE's Consolidated Financial Statements and Additional Information Report for 2010.