

LG&E and KU Energy LLC

Consolidated Financial Statements and Additional Information

As of December 31, 2010 and 2009 and

for the years ended December 31, 2010, 2009 and 2008

Index of Abbreviations

AG	Attorney General of Kentucky
ARO	Asset Retirement Obligation
ASC	Accounting Standards Codification
BART	Best Available Retrofit Technology
Big Rivers	Big Rivers Electric Corporation
CAIR	Clean Air Interstate Rule
CAMR	Clean Air Mercury Rule
CATR	Clean Air Transport Rule
CCN	Certificate of Public Convenience and Necessity
Centro	Distribuidora de Gas Del Centro S.A.
Clean Air Act	The Clean Air Act, as amended in 1990
CMRG	Carbon Management Research Group
Company	LG&E and KU Energy LLC and Subsidiaries (formerly E.ON U.S. LLC and Subsidiaries)
CT	Combustion Turbine
Cuyana	Distribuidora de Gas Cuyana S.A.
DSM	Demand Side Management
ECR	Environmental Cost Recovery
EEI	Electric Energy, Inc.
EKPC	East Kentucky Power Cooperative, Inc.
E.ON	E.ON AG
E.ON Spain	E.ON Espana S.L
E.ON U.S.	E.ON U.S. LLC and Subsidiaries
EPA	U.S. Environmental Protection Agency
EPAct 2005	Energy Policy Act of 2005
FAC	Fuel Adjustment Clause
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FGD	Flue Gas Desulfurization
Fidelia	Fidelia Corporation (an E.ON affiliate)
GAAP	U.S. Generally Accepted Accounting Principles
GAC	Group Annuity Contract
GHG	Greenhouse Gas
GSC	Gas Supply Clause
Gwh	Gigawatt hours or one thousand Mwh
IBEW	International Brotherhood of Electrical Workers
IMEA	Illinois Municipal Electric Agency
IMPA	Indiana Municipal Power Agency
IRS	Internal Revenue Service
KCCS	Kentucky Consortium for Carbon Storage
KDAQ	Kentucky Division for Air Quality
Kentucky Commission	Kentucky Public Service Commission
KIUC	Kentucky Industrial Utility Consumers, Inc.
KU	Kentucky Utilities Company
kWh	Kilowatt hours

Index of Abbreviations

LEM	LG&E Energy Marketing Inc.
LG&E	Louisville Gas and Electric Company
LIBOR	London Interbank Offered Rate
LKC	LG&E and KU Capital LLC (formerly LG&E Capital Corp. and E.ON U.S. Capital Corp.)
LKE	LG&E and KU Energy LLC and Subsidiaries (formerly E.ON U.S. LLC and Subsidiaries)
Mcf	Thousand Cubic Feet
MMcf	Million Cubic Feet
MISO	Midwest Independent Transmission System Operator
MMBtu	Million British thermal units
Moody's	Moody's Investor Services, Inc.
MVA	Megavolt-ampere
Mw	Megawatts
Mwh	Megawatt hours
NAAQS	National Ambient Air Quality Standards
NGHH	Natural Gas-Henry Hub
NO ₂	Nitrogen Dioxide
NOV	Notice of Violation
NOx	Nitrogen Oxide
OATT	Open Access Transmission Tariff
OMU	Owensboro Municipal Utilities
OVEC	Ohio Valley Electric Corporation
PBR	Performance Based Rates
PPL	PPL Corporation
Predecessor	The Company during the time period prior to November 1, 2010
PUHCA 2005	Public Utility Holding Company Act of 2005
RSG	Revenue Sufficiency Guarantee
S&P	Standard & Poor's Rating Service
SCR	Selective Catalytic Reduction
SERC	SERC Reliability Corporation
Servco	LG&E and KU Services Company (formerly E.ON U.S. Services Inc.)
SIP	State Implementation Plan
SO ₂	Sulfur Dioxide
SPP	Southwest Power Pool, Inc.
Successor	The Company during the time period after October 31, 2010
TC1	Trimble County Unit 1
TC2	Trimble County Unit 2
TVA	Tennessee Valley Authority
Utilities	LG&E and KU
VDT	Value Delivery Team Process
VEBA	Voluntary Employee Beneficiary Association
Virginia Commission	Virginia State Corporation Commission
WKE	Western Kentucky Energy Corp. and its Affiliates
WNA	Weather Normalization Adjustment

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Forward-Looking Information

LKE uses forward-looking statements in this annual report. Statements that are not historical facts are forward-looking statements, and are based on beliefs and assumptions of management, and on information currently available to management. Forward-looking statements include statements preceded by, followed by or using such words as “believe,” “expect,” “anticipate,” “plan,” “estimate” or similar expressions. Such statements speak only as of the date they are made, and the Company undertakes no obligation to update publicly any of them in light of new information or future events. Actual results may materially differ from those implied by forward-looking statements due to known and unknown risks and uncertainties. Factors that could cause actual results to differ materially from those indicated in any forward-looking statement include, but are not limited to:

- fuel supply availability;
- weather conditions affecting generation production, customer energy use and operating costs;
- operation, availability and operating costs of existing generation facilities;
- transmission and distribution system conditions and operating costs;
- collective labor bargaining negotiations;
- the outcome of litigation against the Company;
- potential effects of threatened or actual terrorism or war or other hostilities;
- commitments and liabilities;
- 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 the Company’s 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 the other changes in financial or commodity markets and economic conditions;
- profitability and liquidity, including access to capital markets and credit facilities;
- new accounting requirements or new interpretations or applications of existing requirements;
- securities and credit ratings;
- current and future environmental conditions 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 the Company 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 impact of any state or federal investigations applicable to the Company and the energy industry;
- the effect of any business or industry restructuring;
- development of new projects, markets and technologies;
- performance of new ventures; and

- asset acquisitions and dispositions.

In light of these risks and uncertainties, the events described in the forward-looking statements might not occur or might occur to a different extent or at a different time than the Company has described. For additional details regarding these and other risks and uncertainties, see Risk Factors.

Business

General

LKE is a holding company with regulated utility operations through its subsidiaries, LG&E and KU. 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 PUHCA 2005.

Headquartered in Allentown, Pennsylvania, PPL is an energy and utility holding company that was incorporated in 1994. Through its subsidiaries, PPL owns or controls about 19,000 megawatts of generating capacity in the U.S., sells energy in key U.S. markets and delivers electricity and natural gas to about 5.3 million customers in the U.S. and the U.K.

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. LG&E and KU maintain their separate identities and serve customers in Kentucky under their respective names. KU also serves customers in Virginia under the Old Dominion Power name and it serves customers in Tennessee under the KU name.

LG&E provides electric service to approximately 395,000 customers in Louisville and adjacent areas in Kentucky, covering approximately 700 square miles in nine counties. KU provides electric service to approximately 514,000 customers in 77 counties in central, southeastern and western Kentucky, to approximately 30,000 customers in five counties in southwestern Virginia and to less than ten customers in Tennessee. KU also sells wholesale electric energy to 12 municipalities in Kentucky. During 2010, approximately 95% of the electricity generated by LG&E and 98% of that generated by KU was produced by their coal-fired electric generating stations. The remainder is generated by natural gas and oil fueled CTs and hydroelectric power plants. LG&E purchases, transports, distributes or stores natural gas for 320,000 customers in Kentucky.

LKC has been the primary holding company for the Company's non-utility businesses. Its businesses included:

- *WKE*. WKE had a 25-year lease of and operated the generating facilities of Big Rivers, a power generation cooperative in western Kentucky and a coal-fired facility owned by Henderson Municipal Power and Light, which is owned by the City of Henderson, Kentucky. The Company classified WKE as discontinued operations effective December 31, 2005 and it terminated the WKE lease and disposed of the operations in July 2009.
- *Argentine Natural Gas Distribution*. Through its Argentine natural gas distribution operations, LKC owned interests in entities which distribute natural gas to approximately one million customers in Argentina through two distribution companies (Centro and Cuyana). The Company classified its Argentine natural gas distribution operations as discontinued operations effective December 31, 2009 and it sold the operations on January 1, 2010.

For further discussion of the WKE lease and the Argentine natural gas distribution matters, See Note 13, Commitments and Contingencies and Note 19, Discontinued Operations.

Servco provides services to affiliated entities, including LKE, LG&E, KU, LKC and LEM, at cost, as permitted under PUHCA 2005.

Predecessor and Successor

LKE's historical financial results are presented using "Predecessor" or "Successor" to designate the periods before or after PPL's acquisition of LKE. Predecessor covers the time period prior to November 1, 2010. Successor covers the time period after October 31, 2010. Certain accounting and presentation methods were changed to acceptable alternatives to conform to PPL accounting policies and 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 1, Summary of Significant Accounting Policies, for the major differences in Predecessor and Successor accounting policies. See Note 2, Acquisition by PPL, for information regarding the acquisition and the purchase accounting adjustments.

Operations

Dollars are in millions unless otherwise noted.

For the year ended December 31, 2010, 89% of total operating revenues were derived from electric operations and 11% from natural gas operations. The sources of electric operating revenues and volumes of sales for the following periods in 2010, 2009 and 2008 were as follows:

	Successor		Predecessor					
	November 1, 2010 through December 31, 2010		January 1, 2010 through October 31, 2010		Year Ended December 31, 2009		Year Ended December 31, 2008	
	Revenues	Volumes (Gwh)	Revenues	Volumes (Gwh)	Revenues	Volumes (Gwh)	Revenues	Volumes (Gwh)
Residential	\$ 163	2,076	\$ 749	9,698	\$ 790	10,690	\$ 763	11,009
Industrial and commercial	187	2,900	939	14,524	1,014	16,200	1,023	17,283
Municipals	15	326	88	1,676	91	1,848	92	1,971
Other retail	37	482	201	2,594	207	2,927	190	3,010
Wholesale	7	118	26	421	45	759	155	3,142
	<u>\$ 409</u>	<u>5,902</u>	<u>\$ 2,003</u>	<u>28,913</u>	<u>\$ 2,147</u>	<u>32,424</u>	<u>\$ 2,223</u>	<u>36,415</u>

LKE's all time peak electric load occurred in 2010 and was 7,175 Mw on August 4, 2010, when the temperature reached highs of 102 and 96 degrees Fahrenheit in Louisville and Lexington, respectively.

The sources of natural gas operating revenues and volumes of sales for the following periods in 2010, 2009 and 2008 were as follows:

	Successor		Predecessor					
	November 1, 2010 through December 31, 2010		January 1, 2010 through October 31, 2010		Year Ended December 31, 2009		Year Ended December 31, 2008	
	Revenues	Volumes (MMcf)	Revenues	Volumes (MMcf)	Revenues	Volumes (MMcf)	Revenues	Volumes (MMcf)
Residential	\$ 56	6,583	\$ 137	14,424	\$ 230	19,742	\$ 281	21,338
Industrial and commercial	22	2,903	58	7,319	98	9,600	136	10,914
Other retail	5	490	11	1,097	20	1,568	23	1,677
Wholesale	2	2,614	5	8,719	6	10,866	12	12,241
	<u>\$ 85</u>	<u>12,590</u>	<u>\$ 211</u>	<u>31,559</u>	<u>\$ 354</u>	<u>41,776</u>	<u>\$ 452</u>	<u>46,170</u>

Natural gas billings include a WNA mechanism which adjusts the distribution cost component of residential and commercial customers to normal temperatures during the heating season months of November through April, somewhat mitigating the effect of above- or below-normal weather on residential and commercial revenues. In July 2009, the Kentucky Commission approved LG&E's request to make the current WNA mechanism permanent.

During 2010, the maximum daily natural gas send out was approximately 416,000 Mcf, occurring on December 13, 2010, when the average temperature for the day in Louisville was 15 degrees Fahrenheit. Supply on that day consisted of approximately 305,000 Mcf from pipeline deliveries, approximately 111,000 Mcf from on-system natural gas storage.

The Company's power generating system includes coal-fired steam generating stations, with natural gas and oil fueled CTs which supplement the system during peak or emergency periods. As of December 31, 2010, LKE's system capacity was:

Fuel/Plant	Total Mw Summer Capacity (a)	% Ownership	Ownership or Lease Interest in Mw	Location
Coal (steam)				
Ghent	1,918	100.00	1,918	Carroll County, KY
Mill Creek	1,472	100.00	1,472	Jefferson County, KY
E.W. Brown	684	100.00	684	Mercer County, KY
Cane Run	563	100.00	563	Jefferson County, KY
Trimble County (b)	511	75.00	383	Trimble County, KY
Green River	163	100.00	163	Muhlenberg County, KY
Tyrone	71	100.00	71	Woodford County, KY
OVEC - Clifty Creek (c)	1,304	8.13	106	Jefferson County, IN
OVEC - Kyger Creek (c)	1,086	8.13	88	Gallia County, OH
Total steam	7,772		5,448	
Natural gas/oil (combustion turbines)				
Trimble County	960	100.00	960	Trimble County, KY
E.W. Brown	947	100.00	947	Mercer County, KY
Paddy's Run	193	100.00	193	Jefferson County, KY
Haefling	36	100.00	36	Fayette County, KY
Zorn	14	100.00	14	Jefferson County, KY
Cane Run	14	100.00	14	Jefferson County, KY
Total combustion turbines	2,164		2,164	
Hydro				
Ohio Falls Hydroelectric Station	52	100.00	52	Jefferson County, KY
Dix Dam Hydroelectric Station	24	100.00	24	Mercer County, KY
Total hydro	76		76	
Total system capacity	10,012		7,688	

- (a) The capacity of generation units is based on a number of factors, including the operating experience and physical conditions of the units and may be revised periodically to reflect changed circumstances.
- (b) TC1 is jointly owned with IMEA and IMPA. See Note 14, Jointly Owned Electric Utility Plant, for further information.
- (c) LKE is contractually entitled to 8.13% of OVEC's output based on a power purchase agreement which is comprised of annual minimum debt service payments, as well as contractually-required reimbursement of plant operating, maintenance and other expenses. OVEC's capacity is shown at unit nameplate ratings.

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. LKE owns a 75% interest in TC2. Unit 2 is coal-fired and has a capacity of 760 Mw, of which LKE's share is 570 Mw.

On December 31, 2010, LKE's electric transmission system included 177 substations (86 of which are shared with the distribution system) with transformer capacity of approximately 19,896 MVA and approximately 4,987 miles of lines. The electric distribution system included 575 substations (86 of which are shared with the transmission system) with transformer capacity of approximately 12,268 MVA and approximately 18,043 miles of overhead lines and 4,571 miles of underground conduit.

The Company's natural gas transmission system includes 391 miles of transmission mains, consisting of 255 miles of natural gas transmission lines, 119 miles of natural gas storage lines and 17 miles of natural gas combustion turbine lines. The Company's natural gas distribution system includes 4,235 miles of distribution mains.

Five underground natural gas storage fields, with a current working natural gas capacity of approximately 15 million Mcf, help provide economical and reliable natural gas service to ultimate consumers. By using natural gas storage facilities, LG&E avoids the costs typically associated with more expensive pipeline transportation capacity to serve peak winter heating loads. Natural gas is stored in the summer season for withdrawal in the subsequent winter heating season. Without its storage capacity, LG&E would be required to buy additional natural gas and pipeline transportation services during the winter months when customer demand increases and when the prices for natural gas supply and transportation services are typically at their highest. Several suppliers under contracts of varying duration provide competitively priced natural gas. The underground storage facilities, in combination with its purchasing practices, enable LG&E to offer natural gas sales service at competitive rates. At December 31, 2010, LG&E had a 12 million Mcf inventory balance of natural gas stored underground valued at \$60 million.

A number of large commercial and industrial customers purchase their natural gas requirements directly from alternate suppliers for delivery through LG&E's distribution system. These large commercial and industrial customers account for approximately one-fourth of LG&E's annual throughput.

The estimated maximum deliverability from storage during the early part of the heating season is expected to be in excess of 350,000 Mcf/day. Under mid-winter design conditions, LG&E expects to be able to withdraw about 307,000 Mcf/day from its storage facilities. The deliverability of natural gas from the storage facilities decreases as storage inventory levels are reduced by seasonal withdrawals. LKE had a power supply contract with OMU that was terminated by OMU in May 2010. LKE owns 8.13% of OVEC's common stock. LKE has power purchase rights for its portion of OVEC's output. Additional information regarding this relationship is provided in Note 1, Summary of Significant Accounting Policies and Note 13, Commitments and Contingencies, for further information.

LKE contracts with the TVA to act as LKE's transmission reliability coordinator and SPP to function as LKE's independent transmission operator, pursuant to FERC requirements. The TVA and SPP contracts provide services through August 31, 2011 and August 31, 2012, respectively. See Note 3, Rates and Regulatory Matters, for further information.

LG&E and KU jointly dispatch their generation units with the lowest cost generation used to serve their retail native load. When LG&E has excess generation capacity after serving its own retail native load and its generation cost is lower than that of KU, KU purchases electricity from LG&E. When KU has excess generation capacity after serving its own retail native load and its generation cost is lower than that of LG&E, LG&E purchases electricity from KU. These transactions are recorded as intercompany wholesale sales and purchases and are recorded by each company at a price equal to the seller's fuel cost. Savings realized from purchasing electricity intercompany instead of generating from their own higher costs units or purchasing from the market are shared equally between the Utilities. The volume of energy each company has to sell to the other is dependent on its native load needs and its available generation.

Substantially all of the Company's real and tangible property located in Kentucky is subject to a mortgage lien, securing LG&E's and KU's first mortgage bonds. See Note 11, Long-Term Debt, for further information.

Rates and Regulations

PPL is a holding company under PUHCA 2005. PPL, its utility subsidiaries, including LG&E and KU, and certain of its non-utility subsidiaries are subject to extensive regulation by the FERC with respect to numerous matters, including: electric utility facilities and operations, wholesale sales of power and related transactions, accounting practices, issuances and sales of securities, acquisitions and sales of utility properties, payments of dividends out of capital and surplus, financial matters and inter-system sales of non-power goods and services. LG&E and KU believe that they have adequate authority (including financing authority) under existing FERC Orders and regulations to conduct their business and will seek additional authorization when necessary.

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

On April 28, 2010, E.ON U.S. announced that a Purchase and Sale Agreement (the "Agreement") had been entered into among E.ON US Investments Corp., PPL and E.ON.

The transaction was subject to customary closing conditions, including the expiration or termination of the applicable waiting period under the Hart-Scott-Rodino Act, receipt of required regulatory approvals (including state regulators in Kentucky, Virginia and Tennessee and the FERC) and the absence of injunctions or restraints imposed by governmental entities.

Change of control and financing-related applications were filed on May 28, 2010, with the Kentucky Commission and on June 15, 2010, with the Virginia Commission and the Tennessee Regulatory Authority. An application with the FERC was filed on June 28, 2010. During the second quarter of 2010, a number of parties were granted intervenor status in the Kentucky Commission proceedings and data request filings and responses occurred. Early termination of the Hart-Scott-Rodino waiting period was received on August 2, 2010.

A hearing in the Kentucky Commission proceedings was held on September 8, 2010, at which time a unanimous settlement agreement was presented. In the settlement, LG&E and KU committed that no base rate increases would take effect before January 1, 2013. The LG&E and KU rate increases that took effect on August 1, 2010, were not impacted by the settlement. Under the terms of the settlement, the Utilities retain the right to seek approval for the deferral of “extraordinary and uncontrollable costs.” Interim rate adjustments will continue to be permissible during that period for existing fuel, environmental and demand-side management cost trackers. The agreement also substitutes an acquisition savings shared deferral mechanism for the requirement that the Utilities file a synergies plan with the Kentucky Commission. This mechanism, which will be in place until the earlier of five years or the first day of the year in which a base rate increase becomes effective, permits the Utilities to earn up to a 10.75% return on equity. Any earnings above a 10.75% return on equity will be shared with customers on a 50%/50% basis. On September 30, 2010, the Kentucky Commission issued an Order approving the transfer of ownership of LG&E and KU via the acquisition of E.ON U.S. by PPL, incorporating the terms of the submitted settlement. On October 19, 2010 and October 21, 2010, respectively, Orders approving the acquisition of E.ON U.S. by PPL were received from the Virginia Commission and the Tennessee Regulatory Authority. The Commissions’ Orders contained a number of other commitments with regard to operations, workforce, community involvement and other matters.

In mid-September 2010, LG&E and KU and other applicants in the FERC change of control proceeding reached an agreement with the protesters, whereby such protests have been withdrawn. The agreement, which was filed for consideration with the FERC, includes various conditional commitments, such as a continuation of certain existing undertakings with protesters in prior cases, an agreement not to terminate certain KU municipal customer contracts prior to January 2017, an exclusion of any transaction-related costs from wholesale energy and tariff customer rates to the extent that the Company agreed not to seek the same transaction-related cost from retail customers and agreements to coordinate with protesters in certain open or ongoing matters. A FERC Order approving the transaction was received on October 26, 2010, and the transaction was completed on November 1, 2010.

In January 2010, LG&E and KU filed applications with the Kentucky Commission requesting increases in electric base rates of approximately 12%, or \$95 million and \$135 million annually, respectively. In addition, LG&E requested an increase in its natural gas base rates of approximately 8%, or \$23 million annually. In June 2010, LG&E and KU and all of the intervenors, except the AG, agreed to stipulations providing for increases in LG&E’s electric base rates of \$74 million annually, LG&E’s natural gas base rates of \$17 million annually and KU’s electric base rates of \$98 million annually. 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, including a return on equity range of 9.75-10.75%. The new rates became effective on August 1, 2010.

In June 2009, KU filed an application with the Virginia Commission requesting an increase in electric base rates for its Virginia jurisdictional customers in an amount of \$12 million annually or approximately 21%. The proposed increase reflected a proposed rate of return on rate base of 8.586% based on a return of equity of 12%. As permitted pursuant to a Virginia Commission Order, KU elected to implement the proposed rates effective November 1, 2009, on an interim basis. During December 2009, KU and the Virginia Commission Staff agreed to a Stipulation and Recommendation authorizing a base rate revenue increase of \$11 million annually 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 approximately \$1 million in interim rate amounts in excess of the ultimate approved rates.

In January 2009, a significant ice storm passed through LG&E's and KU's service areas causing approximately 404,000 customer outages, followed closely by a severe wind storm in February 2009, causing approximately 81,000 customer outages. LG&E and KU filed applications with the Kentucky Commission in April 2009, requesting approval to establish regulatory assets and defer for future recovery approximately \$107 million in incremental operation and maintenance expenses related to the storm restoration for LG&E and KU. In September 2009, the Kentucky Commission issued Orders allowing the establishment of regulatory assets of up to \$107 million based on their actual costs for storm damages and service restoration due to the January and February 2009 storms. In September 2009, LG&E and KU established regulatory assets of \$101 million for actual costs incurred. The Utilities received approval in their 2010 base rate cases to recover these assets over a ten year period with recovery beginning August 1, 2010.

In September 2008, high winds from the remnants of Hurricane Ike passed through the service area causing significant outages and system damage. In October 2008, LG&E and KU filed applications with the Kentucky Commission requesting approval to establish regulatory assets and defer for future recovery approximately \$27 million of expenses related to the storm restoration. In December 2008, the Kentucky Commission issued Orders allowing the Utilities to establish regulatory assets for these amounts based on their actual costs for storm damages and service restoration due to Hurricane Ike. In December 2008, LG&E and KU established regulatory assets of \$26 million for actual costs incurred. The Utilities received approvals in their 2010 base rate cases to recover these assets over a ten year period beginning August 1, 2010.

In September 2008, KU filed an application with the FERC for increases in electric base rates applicable to wholesale power sales contracts or interchange agreements involving, collectively, twelve Kentucky municipalities. The application requested a shift from an all-in stated unit charge rates to an unbundled formula rate, including an annual adjustment mechanism. In May 2009, the FERC issued an Order approving a settlement among the parties in the case, incorporating increases of approximately 3% from prior rates and a return on equity of 11%. In May 2010, KU submitted to the FERC the proposed current 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.

By mutual agreement, the parties' settlement of the 2008 application left outstanding the issue of whether KU must allocate to the municipal customers a portion of renewable resources it may be required to procure on behalf of its retail ratepayers. An Order was issued by the FERC in July 2010, indicating that KU is not required to allocate a portion of any renewable resources to the twelve municipalities, thus resolving the remaining issue.

In July 2008, LG&E and KU filed applications with the Kentucky Commission requesting increases in electric and natural gas base rates. In January 2009, LG&E, KU, the AG, the KIUC and all other parties to the rate cases filed settlement agreements with the Kentucky Commission, under which LG&E's natural gas base rates increased by \$22 million annually and LG&E's and KU's electric base rates decreased by \$13 million and \$9 million annually, respectively. Orders approving the settlement agreement were received in February 2009. The new rates were implemented effective February 6, 2009.

For a further discussion of regulatory matters, see Note 3, Rates and Regulatory Matters.

Coal Supply

Coal-fired generating units provided approximately 96% of net kWh generation for 2010. The remaining net generation was provided by natural gas and oil fueled CTs and hydroelectric plants. Coal is expected to be the predominant fuel used by LKE in the foreseeable future, with natural gas and oil being used for peaking capacity and flame stabilization in coal-fired boilers or in emergencies. The Company has no nuclear generating units and has no plans to build any in the foreseeable future.

Fuel inventory is maintained at levels estimated to be necessary to avoid operational disruptions at the coal-fired generating units. Reliability of coal deliveries can be affected periodically by a number of factors, including fluctuations in demand, coal mine production issues and other supplier or transporter operating difficulties.

LKE has entered into coal supply agreements with various suppliers for coal deliveries for 2011 and beyond and normally augments its coal supply agreements with spot market purchases. The Company has a coal inventory policy which it believes provides adequate protection under most contingencies.

LKE expects to continue purchasing most of its coal, which has sulfur content in the 0.7% - 3.5% range, from eastern and western Kentucky, southern Indiana, southern Illinois, Ohio, Wyoming and West Virginia for the foreseeable future. This supply, in combination with the Company's SO₂ removal systems, is expected to enable LKE to continue to provide electric service in compliance with existing environmental laws and regulations. Coal is delivered to LKE's generating stations by a mix of transportation modes, including barge, truck and rail.

Natural Gas Supply

LG&E purchases natural gas supplies from multiple sources under contracts for varying periods of time, while transportation services are purchased from Texas Gas Transmission LLC ("Texas Gas") and Tennessee Gas Pipeline Company ("Tennessee Gas").

LG&E currently transports natural gas on the Texas Gas system under Rate Schedules No-Notice Service ("NNS"), Firm Transport ("FT") and Short-Term Firm ("STF"). LG&E's total winter season NNS capacity is 184,900 MMBtu/day and its total summer season NNS capacity is 60,000 MMBtu/day. The three separate NNS agreements, which provide for equal amounts of capacity, are subject to termination by LG&E during 2015, 2016 and 2018. LG&E's FT capacity is 10,000 MMBtu/day throughout the year (winter and summer seasons). The FT agreement is subject to termination by LG&E during 2016. LG&E's winter season STF capacity is 100 MMBtu/day and its summer season capacity is 18,000 MMBtu/day. The STF agreement is subject to termination by LG&E during 2013. LG&E also transports on the Tennessee Gas system under Rate Schedule Firm Transport-A ("FT-A"). LG&E's FT-A capacity is 51,000 MMBtu/day throughout the year (winter and summer seasons). The FT-A agreement with Tennessee Gas expires during 2012.

LG&E participates in rate and other proceedings affecting the regulated interstate natural gas pipelines that provide it service. Both Texas Gas and Tennessee Gas have active proceedings at the FERC in which LG&E is participating. Although neither pipeline is currently billing charges subject to refund, Tennessee Gas has filed at the FERC for an increase in base rates as well as other charges with an anticipated effective date of June 1, 2011. However, LG&E's current negotiated rate in its transportation

agreement with Tennessee Gas insulates it from the potential impact of increases in base rates as proposed by Tennessee Gas for the duration of that agreement.

LG&E also has a portfolio of supply arrangements of various terms with a number of suppliers designed to meet its firm sales obligations. These natural gas supply arrangements include pricing provisions that are market-responsive. In tandem with pipeline transportation services, these natural gas supplies provide the reliability and flexibility necessary to serve LG&E's natural gas customers.

Seasonality

Demand for and market prices for electricity and natural gas are affected by weather. As a result, LKE's overall operating results in the future may fluctuate substantially on a seasonal basis, especially when more severe weather conditions such as heat waves or winter storms make such fluctuations more pronounced. The pattern of this fluctuation may change depending on the type and location of the facilities LKE owns and the terms of its contracts to purchase or sell electricity and natural gas.

Environmental Matters

General

Protection of the environment is a major priority for LKE and a significant element of its business activities. LKE's properties and operations are subject to extensive environmental-related oversight by federal, state and local regulatory agencies, including via air quality, water quality, waste management and similar laws and regulations. Therefore, LKE must conduct its operations in accordance with numerous permit and other requirements issued under or contained in such laws or regulations.

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 United States 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. 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, LG&E and KU, as primarily coal-fired utilities, could be highly affected by such proceedings.

Among other emissions, GHGs include carbon-dioxide, which is produced via the combustion of fossil fuels such as coal and natural gas. LKE's generating fleet is approximately 71% coal-fired, 28% oil/natural gas-fired and 1% hydroelectric based on capacity. During 2010, LKE produced approximately 96% of its electricity from coal, 3% from natural gas combustion and 1% from hydroelectric generation, based on Mwh. During 2010, LKE's emissions of GHGs were approximately 32.6 million metric tons of carbon-dioxide equivalents from LKE's owned or controlled generation sources. While its generation activities account for the bulk of its GHG emissions, other GHG sources at LKE include operation of motor vehicles and powered equipment, leakage or evaporation associated with natural gas pipelines, refrigerating equipment and similar activities.

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 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, CAMR replacement 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 \$3.0 to \$3.5 billion range over the next 10 years although final costs may substantially vary. This estimate does not include compliance with GHG rules or contemplated water-related environmental changes See Risk Factors, Management's Discussion and Analysis and Note 13, Commitments and Contingencies, for further information.

State Executive or Legislative Matters

In November 2008, the Commonwealth of Kentucky issued an action plan to create efficient, sustainable energy solutions and strategies and move toward state energy independence. The plan outlines the following seven strategies to work toward these goals:

- Improve the energy efficiency of Kentucky's homes, buildings, industries and transportation fleet
- Increase Kentucky's use of renewable energy
- Sustainably grow Kentucky's production of biofuels
- Develop a coal-to-liquids industry in Kentucky to replace petroleum-based liquids
- Implement a major and comprehensive effort to increase natural gas supplies, including coal-to-natural gas in Kentucky
- Initiate aggressive carbon capture/sequestration projects for coal-generated electricity in Kentucky
- Examine the use of nuclear power for electricity generation in Kentucky

In December 2009, the Governor of Kentucky's Executive Task Force on Biomass and Biofuels issued a final report to establish potential strategic actions to develop biomass and biofuels industries in

Kentucky. The plan noted the potential importance of biomass as a renewable energy source available to Kentucky and discussed various goals or mechanisms, such as the use of approximately 25 million tons of biomass for generation fuel annually, allotment of electricity and natural gas taxes and state tax credits to support biomass development.

In January 2010, a state-established Kentucky Climate Action Plan Council (the “Council”) commenced formal activities. The Council, which includes governmental, industry, consumer and other representatives, seeks to identify possible Kentucky responses to potential climate change and federal legislation, including increasing statewide energy efficiency, energy independence and economic growth. The Council has established various technical work groups, including in the areas of energy supply and energy efficiency/conservation, to provide input, data and recommendations.

During the current session of the Kentucky General Assembly, as during prior legislative sessions, legislators have introduced or are expected to introduce various bills with respect to environmental or utility matters, including potential requirements relating to renewable energy portfolios, energy conservation measures, coal mining or coal byproduct operations and other matters. The current session is scheduled to end in March 2011 and until such time the prospects and final terms of any such legislation cannot be determined. Legislative and regulatory actions as a result of these proposals and their impact on LKE, which may be significant, cannot currently be predicted.

Franchises and Licenses

LG&E and KU provide electric delivery service, and LG&E provides natural gas distribution service, in their various service areas pursuant to certain franchises, licenses, statutory service areas, easements and other rights or permissions granted by state legislatures, cities or municipalities or other entities.

Competition

There are currently no other electric utilities operating within the electric service areas of LKE. Neither the Kentucky General Assembly nor the Kentucky Commission has adopted or approved a plan or timetable for retail electric industry competition in Kentucky. The nature or timing of any legislative or regulatory actions regarding industry restructuring and their impact on LKE, which may be significant, cannot currently be predicted. Virginia, formerly a competitive jurisdiction, has enacted legislation which implements a hybrid model of cost-based regulation. See Note 3, Rates and Regulatory Matters, for further information.

Alternative energy sources such as electricity, oil, propane and other fuels provide indirect competition for natural gas revenues. Marketers may also compete to sell natural gas to certain large end-users. Approximately 25% of LG&E’s annual throughput is purchased by large commercial and industrial customers directly from alternate suppliers for delivery through LG&E’s distribution system. LG&E does not profit from its sale of natural gas as a commodity; therefore, customer natural gas purchases from alternative suppliers do not impact profitability. In addition, some large industrial and commercial customers may be able to physically bypass LG&E’s facilities and seek delivery service directly from interstate pipelines or other natural gas distribution systems.

In April 2010, the Kentucky Commission commenced a proceeding to investigate natural gas retail competition programs, their regulatory, financial and operational aspects and potential benefits, if any, of such programs to Kentucky consumers. A number of entities, including LKE, were parties to the

proceeding. In December 2010, the Kentucky Commission issued an Order in the proceeding declining to endorse natural gas competition at the retail level, noting the existence of a number of transition or oversight costs and an uncertain level of economic benefits in such programs. With respect to existing natural gas transportation programs available to large commercial or industrial users, the Order indicates that the Kentucky Commission will review the utilities' current tariff structures, user thresholds and other terms and conditions of such programs, as part of such utilities' next regular natural gas rate cases.

Employees and Labor Relations

LKE had 3,160 employees at December 31, 2010, consisting of 3,122 full-time employees and 38 part-time employees. Of the total employees, 831, or 26%, were operating, maintenance and construction employees represented by the IBEW Local 2100 and the United Steelworkers of America ("USWA") Local 9447-01. In November 2008, LG&E and its employees represented by the IBEW Local 2100 entered into a three-year collective bargaining agreement that provides for negotiated increases or changes to wages, benefits or other provisions. In August 2009, KU and its employees represented by the IBEW Local 2100 entered into a three-year collective bargaining agreement that provides for negotiated increases or changes to wages, benefits or other provisions and annual wage re-openers. In August 2008, KU and its employees represented by the USWA Local 9447-01 entered into a three-year collective bargaining agreement that provides for negotiated increases or changes to wages, benefits or other provisions and annual wage re-openers.

Officers of the Company

Officers are elected annually by the Board of Directors. There are no family relationships among any of the executive officers, nor is there any arrangement or understanding between any executive officer and any other person pursuant to which the officer was selected.

Except as may be set forth in Legal Proceedings, there have been no events under any bankruptcy act, no criminal proceedings and no judgments or injunctions material to the evaluation of the ability and integrity of any executive officer during the past five years.

Listed below are the executive officers at December 31, 2010.

Name	Age	Positions Held During the Past Five Years	Dates
Victor A. Staffieri	55	Chairman of the Board, President and Chief Executive Officer	May 2001 – present
John R. McCall	67	Executive Vice President, General Counsel, Corporate Secretary and Chief Compliance Officer	July 1994 – present
Chris Hermann	63	Senior Vice President – Energy Delivery	February 2003 – present
Paula H. Pottinger	53	Senior Vice President – Human Resources	January 2006 – present
S. Bradford Rives	52	Chief Financial Officer	September 2003 – present
Paul W. Thompson	53	Senior Vice President – Energy Services	June 2000 – present
Martyn Gallus*	46	Senior Vice President – Energy Marketing	September 2010 – present
		Managing Director – E.ON Energy Trading	January 2008 – September 2010
		Senior Vice President – Energy Marketing	December 2000 – January 2008

Officers generally serve in the same capacities at the Company, LG&E and KU.

* Martyn Gallus resigned as Senior Vice President of Energy Marketing effective January 3, 2011. Mr. Gallus, due to an assignment with a former international affiliate, was an officer of LKE only.

Risk Factors

Any of the events or circumstances described as risks below could result in a significant or material adverse effect on the business, results of operations, cash flows or financial condition. The risks and uncertainties described below may not be the only risks and uncertainties that LKE faces. Additional risks and uncertainties not currently known or that LKE currently deems immaterial may also result in a significant or material adverse effect on the business, results of operations, cash flow or financial condition.

LKE's business is subject to significant and complex governmental regulation.

Various federal and state entities, including but not limited to the FERC, Kentucky Commission, Virginia Commission and the Tennessee Regulatory Authority regulate many aspects of utility operations of LKE, including the following:

- the rates that LKE may charge and the terms and conditions of the Company's service and operations;
- financial and capital structure matters;
- siting and construction of facilities;
- mandatory reliability and safety standards and other standards of conduct;
- accounting, depreciation and cost allocation methodologies;
- tax matters;
- affiliate restrictions;
- acquisition and disposal of utility assets and securities; and
- various other matters.

Such regulations or changes thereto may subject LKE to higher operating costs or increased capital expenditures and failure to comply could result in sanctions or possible penalties. In any rate-setting proceedings, federal or state agencies, intervenors and other permitted parties may challenge rate requests and ultimately reduce, alter or limit the rates the Company seeks.

The profitability of LKE is highly dependent on its ability to recover the costs of providing energy and utility services to its customers and earn an adequate return on its capital investments. LKE currently provides services to retail customers at rates approved by one or more federal or state regulatory commissions, including those commissions referred to above. While these rates are generally regulated based on an analysis of their costs incurred in a base year, the rates LKE is allowed to charge may or may not match its costs at any given time. While rate regulation is premised on providing a reasonable opportunity to earn a reasonable rate of return on invested capital, there can be no assurance that the applicable regulatory commissions will consider all of the costs to have been prudently incurred or that the regulatory process in which rates are determined will always result in rates that will produce full recovery of LKE's costs or an adequate return on LKE's capital investments. If the Company's costs are not adequately recovered through rates, it could have an adverse affect on the business, results of operations, cash flows or financial condition.

As part of the PPL acquisition commitments, LKE has agreed, subject to certain limited exceptions such as fuel and environmental cost recoveries, that no base rate increase would take effect for Kentucky retail customers before January 1, 2013.

Transmission and interstate market activities of LKE, as well as other aspects of the business, are subject to significant FERC regulation.

LKE is subject to extensive regulation by the FERC covering matters including rates charged to transmission users, market-based or cost-based rates applicable to wholesale customers; interstate power market structure; construction and operation of transmission facilities; mandatory reliability standards; standards of conduct and affiliate restrictions and other matters. Existing FERC regulation, changes thereto or issuances of new rules or situations of non-compliance, including but not limited to the areas of market-based tariff authority, RSG resettlements in the MISO market, mandatory reliability standards and natural gas transportation regulation can affect the earnings, operations or other activities of LKE.

Changes in transmission and wholesale power market structures could increase costs or reduce revenues.

Wholesale sales fluctuate with regional demand, fuel prices and contracted capacity. Changes to transmission and wholesale power market structures and prices may occur in the future, are not estimable and may result in unforeseen effects on energy purchases and sales, transmission and related costs or revenues. These can include commercial or regulatory changes affecting power pools, exchanges or markets in which LKE participates.

LKE undertakes significant capital projects and these activities are subject to unforeseen costs, delays or failures, as well as risk of inadequate recovery of resulting costs.

LKE's business is capital intensive and requires significant investments in energy generation and distribution and other infrastructure projects, such as projects for environmental compliance. The completion of these projects without delays or cost overruns is subject to risks in many areas, including the following:

- approval, licensing and permitting;
- land acquisition and the availability of suitable land;
- skilled labor or equipment shortages;
- construction problems or delays, including disputes with third party intervenors;
- increases in commodity prices or labor rates;
- contractor performance;
- environmental considerations and regulations;
- weather and geological issues; and
- political, labor and regulatory developments.

Failure to complete capital projects on schedule or on budget, or at all, could adversely affect the Company's financial performance, operations and future growth.

The costs of compliance with, and liabilities under, environmental laws are significant and are subject to continual changes.

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, LKE's 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.

LKE is subject to operational and financial risks regarding certain on-going developments concerning environmental regulation.

A number of regulatory initiatives have been implemented or are under development which could have the effect of significantly increasing the environmental regulation or operational or compliance costs related to a number of emissions or operating activities which are associated with the combustion of coal as occurs at the Company's generating stations. Such developments could include potential new or revised federal or state legislation or regulation regarding emissions of NO_x, SO₂, mercury and other particulates generally and regarding storage of coal combustion byproducts. Additional regulatory initiatives may occur in other areas involving the Company's operations, including revision of limitations on water discharge or intake activities or increased standards relating to polychlorinated biphenyl usage. Compliance with any new laws or regulations in these matters could result in significant changes to LKE's operations, significant capital expenditures by the Company or significant increases in the cost of conducting business.

Operating results are affected by weather conditions, including storms and seasonal temperature variations, as well as by significant man-made or accidental disturbances, including terrorism or natural disasters.

These weather or other factors can significantly affect the finances or operations of LKE by changing demand levels; causing outages; damaging infrastructure or requiring significant repair costs; affecting capital markets and general economic conditions or impacting future growth.

LKE is subject to operational and financial risks regarding potential developments concerning global climate change.

Various regulatory and industry initiatives have been implemented or are under development to regulate or otherwise reduce emissions of GHGs, which are emitted from the combustion of fossil fuels such as coal and natural gas, as occurs at the Company's generating stations. Such developments could include potential federal or state legislation or industry initiatives allocating or limiting GHG emissions; establishing costs or charges on GHG emissions or on fuels relating to such emissions; requiring GHG capture and sequestration; establishing renewable portfolio standards or generation fleet-diversification requirements to address GHG emissions; promoting energy efficiency and conservation; changes in transmission grid construction, operation or pricing to accommodate GHG-related initiatives; or other measures. The generation fleet of LKE is predominantly coal-fired and may be highly impacted by developments in this area. Compliance with any new laws or regulations regarding the reduction of GHG emissions could result in significant changes to LKE's operations, significant capital expenditures by the Company and a significant increase in the cost of conducting business. LKE may face strong competition for, or difficulty in obtaining, required GHG-compliance related goods and services, including construction services, emissions allowances and financing, insurance and other inputs relating thereto. Increases in LKE's costs or prices of producing or selling electric power due to GHG-related

developments could materially reduce or otherwise affect the demand, revenue or margin levels applicable to its power, thus adversely affecting its financial condition or results of operations.

LKE is subject to physical, market and economic risks relating to potential effects of climate change.

Climate change may produce changes in weather or other environmental conditions, including temperature or precipitation changes, such as warming or drought. These changes may affect farm and agriculturally-dependent businesses and activities, which are an important part of Kentucky's economy and thus may impact consumer demand for electric power. Temperature increases could result in increased overall electricity volumes or peaks and precipitation changes could result in altered availability of water for plant cooling operations. These or other meteorological changes could lead to increased operating costs, capital expenses or power purchase costs by LKE. Conversely, climate change could have a number of potential impacts tending to reduce demand. Changes may entail more frequent or more intense storm activity, which, if severe, could temporarily disrupt regional economic conditions and adversely affect electricity demand levels. As discussed in other risk factors, storm outages and damage often directly decrease revenues or increase expenses, due to reduced usage and higher restoration charges, respectively. GHG regulation could increase the cost of electric power, particularly power generated by fossil fuels and such increases could have a depressive effect on the regional economy. Reduced economic and consumer activity in the service area of LKE both in general and specific to certain industries and consumers accustomed to previously low-cost power, could reduce demand for LKE's electricity. Also, demand for services could be similarly lowered should consumers' preferences or market factors move toward favoring energy efficiency, low-carbon power sources or reduced electric usage generally.

The business of LKE is subject to risks associated with local, national and worldwide economic conditions.

The consequences of prolonged recessionary conditions may include a lower level of economic activity and uncertainty or volatility regarding energy prices and the capital and commodity markets. A lower level of economic activity might result in a decline in energy consumption, unfavorable changes in energy and commodity prices and slower customer growth, which may adversely affect LKE's future revenues and growth. Instability in the financial markets, as a result of recession or otherwise, also may affect the cost of capital and the ability to raise capital. A deterioration of economic conditions may lead to decreased production by LKE's industrial customers and, therefore, lower consumption of electricity. Decreased economic activity may also lead to fewer commercial and industrial customers and increased unemployment, which may in turn impact residential customers' ability to pay. Further, worldwide economic activity has an impact on the demand for basic commodities needed for utility infrastructure. Changes in global demand may impact the ability to acquire sufficient supplies and the cost of those commodities may be higher than expected.

LKE's business is concentrated in the Midwest United States, specifically Kentucky.

Although LKE also operates in Virginia and Tennessee, the business of LKE is concentrated in Kentucky. Local and regional economic conditions, such as population growth, industrial growth, expansion and economic development or employment levels, as well as the operational or financial performance of major industries or customers, can affect the demand for energy and LKE's results of operations. Significant industries and activities in the service area of LKE include airport and logistics

activities; automotive; aluminum and steel smelting and fabrication; chemical and rubber processing; coal, mineral and ceramic related activities; educational institutions; health care facilities; paper and pulp processing; metal fabrication; and water and sewer utilities. Any significant downturn in these industries or activities or in local and regional economic conditions in LKE's service area may adversely affect the demand for electricity in the service area.

LKE is subject to operational risks relating to LKE's generating plants, transmission facilities, distribution equipment, information technology systems and other assets and activities.

Operation of power plants, transmission and distribution facilities, information technology systems and other assets and activities subjects LKE to many risks, including the breakdown or failure of equipment; accidents; security breaches, viruses or outages affecting information technology systems; labor disputes; obsolescence; delivery/transportation problems and disruptions of fuel supply and performance below expected levels. Occurrences of these events may impact the ability of LKE to conduct its business efficiently or lead to increased costs, expenses or losses.

Although LKE maintains customary insurance coverage for certain of these risks common to utilities, it does not have insurance covering the transmission and distribution systems, other than substations, because it has found the cost of such insurance to be prohibitive. If LKE is unable to recover the costs incurred in restoring transmission and distribution properties following damage resulting from ice storms, tornados or other natural disasters or to recover the costs of other liabilities arising from the risks of its business, through a change in rates or otherwise, or if such recovery is not received on a timely basis, it may not be able to restore losses or damages to its properties without an adverse effect on its financial condition, results of operations or its reputation.

LKE is subject to liability risks relating to its generation, transmission, distribution and retail businesses.

The conduct of the physical and commercial operations of LKE subjects it to many risks, including risks of potential physical injury, property damage or other financial affects, caused to or caused by employees, customers, contractors, vendors, contractual or financial counterparties and other third parties.

LKE could be negatively affected by rising interest rates, downgrades to bond credit ratings or other negative developments in its ability to access capital markets.

In the ordinary course of business, LKE is reliant upon adequate long-term and short-term financing means to fund significant capital expenditures, debt interest or maturities and operating needs. As a capital-intensive business, the Company is sensitive to developments in interest rate levels; credit rating considerations; insurance, security or collateral requirements; market liquidity and credit availability and refinancing steps necessary or advisable to respond to credit market changes. Changes in these conditions could result in increased costs and decreased liquidity available to the Company.

LKE is subject to commodity price risk, credit risk, counterparty risk and other risks associated with the energy business.

General market or pricing developments or failures by counterparties to perform their obligations relating to energy, fuels, other commodities, goods, services or payments could result in potential increased costs to the Company.

LKE is subject to risks associated with defined benefit retirement plans, health care plans, wages and other employee-related matters.

LKE sponsors pension and postretirement benefit plans for its employees. Risks with respect to these plans include adverse developments in legislation or regulation, future costs or funding levels, returns on investments, market fluctuations, interest rates and actuarial matters. Changes in health care rules, market practices or cost structures can affect current or future funding requirements or liabilities. Without sustained growth in respective investments over time to increase the value of plan assets, LKE could be required to fund plans with significant amounts of cash. LKE is also subject to risks related to changing wage levels, whether related to collective bargaining agreements or employment market conditions, ability to attract and retain key personnel and changing costs of providing health care benefits.

LKE is subject to risks associated with federal and state tax regulations.

Changes in taxation as well as the inherent difficulty in quantifying potential tax effects of business decisions could negatively impact results of operations. LKE is required to make judgments in order to estimate its obligations to taxing authorities. These tax obligations include income, property, sales and use and employment-related taxes. LKE also estimates its ability to utilize tax benefits and tax credits. Due to the revenue needs of the states and jurisdictions in which LKE operates, various tax and fee increases may be proposed or considered. LKE cannot predict whether legislation or regulation will be introduced or the effect on the Company of any such changes. If enacted, any changes could increase tax expense and could have a negative impact on its results of operations and cash flows.

LKE may incur liabilities in connection with discontinued operations.

In connection with various divestitures, LKE has indemnified or guaranteed parties against certain liabilities and with respect to certain transactions. These indemnities and guarantees relate to, among other things, liabilities which may arise with respect to the period during which LKE or its subsidiaries operated the divested businesses, and to certain ongoing contractual relationships and entitlements with respect to which LKE or its subsidiaries made commitments in connection with the divestiture. A number of commitments exist in particular with respect to the termination of a transaction in which WKE leased and operated a number of generating stations, and LKE's indemnification of LKE's officers applies to certain officers' activities as officers of a subsidiary in connection with an ongoing proceeding pertaining to a business in Argentina LKE divested. Although LKE made accruals reflecting estimates of the net costs and liabilities expected to arise from these discontinued operations, actual liabilities may exceed these amounts.

Legal Proceedings

Rates and Regulatory Matters

For a discussion of current rates and regulatory matters, including recent electric and natural gas base rate increase proceedings, rate commitments in change-of-control proceedings, TC2 proceedings, FERC, Kentucky Commission and Virginia Commission proceedings and other rates or regulatory matters affecting LKE, see Note 3, Rates and Regulatory Matters, and Note 13, Commitments and Contingencies.

Environmental

For a discussion of environmental matters, including potential coal combustion byproduct or ash pond regulation; additional reductions in SO₂, NO_x and other regulated emissions; NOVs; other emissions proceedings; manufactured gas plant sites; environmental permit challenges; and other environmental items affecting LKE, see Risk Factors, Note 3, Rates and Regulatory Matters, and Note 13, Commitments and Contingencies.

Climate Change

For a discussion of matters relating to potential climate change, GHG emission or global warming developments, including increased legislative and regulatory activity which could limit or increase costs applicable to fossil fuel generation sources, legal proceedings claiming damages relating to global warming, GHG reporting requirements and other matters, see Business, Risk Factors, Management's Discussion and Analysis and Note 13, Commitments and Contingencies.

Litigation

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 are pending 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. The subsidiary and the relevant executive officers believe their actions were in compliance with the relevant laws and have presented defenses in the administrative and criminal proceedings. LKE has standard indemnification arrangements with its executive officers. The former subsidiary is now owned by a third party, which has agreed to indemnify LKE and the relevant executive officers.

For a discussion of litigation matters, see Note 13, Commitments and Contingencies.

Other

In the normal course of business, other lawsuits, claims, environmental actions and other governmental proceedings arise against LKE. To the extent that damages are assessed in any of these lawsuits, the Company believes that its insurance coverage is adequate. Management, after consultation with legal counsel, does not anticipate that liabilities arising out of currently pending or threatened lawsuits and claims will have a material adverse effect on LKE's financial position or results of operations.

Selected Financial Data

Dollars are in millions unless otherwise noted.

	Successor	Predecessor				
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31,			
			2009	2008	2007	2006
Operating revenues	<u>\$ 494</u>	<u>\$ 2,214</u>	<u>\$ 2,501</u>	<u>\$ 2,675</u>	<u>\$ 2,416</u>	<u>\$ 2,373</u>
Operating income (loss)	<u>\$ 96</u>	<u>\$ 438</u>	<u>\$ (1,082)</u>	<u>\$ (1,361)</u>	<u>\$ 463</u>	<u>\$ 426</u>
Income from continuing operations after income taxes attributable to company	<u>\$ 45</u>	<u>\$ 191</u>	<u>\$ (1,317)</u>	<u>\$ (1,614)</u>	<u>\$ 228</u>	<u>\$ 207</u>
Total assets	<u>\$ 10,719</u>	<u>\$ 9,755</u>	<u>\$ 9,429</u>	<u>\$ 11,454</u>	<u>\$ 12,173</u>	<u>\$ 11,315</u>
Long-term debt obligations (including amounts due within one year)	<u>\$ 3,825</u>	<u>\$ 5,083</u>	<u>\$ 5,036</u>	<u>\$ 4,085</u>	<u>\$ 3,441</u>	<u>\$ 2,695</u>

Management's Discussion and Analysis and Notes to Financial Statements should be read in conjunction with the above information.

Management's Discussion and Analysis

Management's Discussion and Analysis should be read in conjunction with the Consolidated Financial Statements and Notes for the years ended December 31, 2010, 2009 and 2008. Dollars are in millions unless otherwise noted.

The purpose of "Management's Discussion and Analysis" is to provide information about LKE's performance in implementing its' strategies and managing risks and challenges. Specifically:

- "Overview" provides background regarding LKE's business and identifies significant matters with which management is primarily concerned in evaluation of LKE's financial condition and operating results.
- "Results of Operations" provides a description of LKE's operating results in 2010, 2009 and 2008, including a review of earnings and a brief outlook for 2011.
- "Financial Condition" provides an analysis of LKE's liquidity position and credit profile, including its sources of cash (including bank credit facilities and sources of operating cash flow) and uses of cash (including contractual obligations and capital expenditure requirements) and the key risks and uncertainties that impact LKE's past and future liquidity position and financial condition. This subsection also includes a discussion of LKE's current credit ratings.
- "Application of Critical Accounting Policies and Estimates" provides an overview of the accounting policies that are particularly important to the results of operations and financial condition of LKE and that require its management to make significant estimates, assumptions and other judgments.

Overview

LKE, headquartered in Louisville, Kentucky, is a wholly owned subsidiary of PPL. LKE is a holding company with energy and utility operations conducted through its subsidiaries, LG&E and KU, which constitute substantially all of LKE's assets. LG&E and KU 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. See the Business section for a description of the business. The rates LG&E and KU charge their customers requires approval of the appropriate regulatory government agency. See Note 3, Rates and Regulatory Matters, for information regarding rate cases, regulatory assets and liabilities and other regulatory matters.

PPL Corporation acquired LKE on November 1, 2010. Headquartered in Allentown, Pennsylvania, PPL is an energy and utility holding company that was incorporated in 1994. Through its subsidiaries, PPL owns or controls about 19,000 megawatts of generating capacity in the U.S., sells energy in key U.S. markets and delivers electricity and natural gas to about 5.3 million customers in the U.S. and the U.K. Following the acquisition, LKE's business did not change; both LG&E and KU continue operating as subsidiaries of LKE, which is now an intermediary holding company in the PPL group of companies. See Note 2, Acquisition by PPL, for further information regarding the acquisition.

In operating its business, the Company faces several risks including credit risks, liquidity risks, interest rate risks and commodity and price risks. For instance, the Company has credit risks from counterparties, customers and effects of its own credit ratings. LKE attempts to manage these risks through the adoption of financial and operational risk management programs that, among other things, are designed to monitor and

reduce its exposure to these risks. Identified within “Management’s Discussion and Analysis” of “Financial Condition” and “Results of Operations” are risks LKE’s management currently consider material; these risks are not the only risks faced by LKE. Additional risks not presently known or currently deemed immaterial may also impair LKE’s business operations. See Risk Factors and Financial Condition - Risk Management for further discussion.

Predecessor and Successor Financial Presentation

LKE’s financial statements and related financial and operating data include the periods before or after PPL’s acquisition of LKE on November 1, 2010, and are labeled as Predecessor or Successor. 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, LKE’s results of operations and cash flows for the Predecessor and Successor periods in 2010 are shown separately, rather than combined, in its audited financial statements.

In the “Management’s Discussion and Analysis” of “Results of Operations” and “Financial Condition”, the Company has included disclosure of the combined Predecessor and Successor results of operations and cash flows. Such presentation is considered to be a non-GAAP disclosure. LKE has included such disclosure because the Company believes it facilitates the comparison of 2010 operating and financial performance to 2009 and 2008, and because the core operations of the Company have not changed as a result of the acquisition.

Competition

See the Business section for information concerning competition.

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 United States 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. 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 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, CAMR replacement 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 \$3.0 to \$3.5 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. See Risk Factors and Note 13, Commitments and Contingencies, for further information.

Results of Operations

The utility business is affected by seasonal temperatures. As a result, operating revenues (and associated operating expenses) are not generated evenly throughout the year. Revenue and earnings are generally highest during the first and third quarters and lowest in the second quarter due to weather.

Net Income

The following table summarizes the significant components of net income for 2010, 2009 and 2008 and the changes therein:

	Combined	Successor	Predecessor		
	Year Ended December 31, 2010	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009	2008
Total operating revenues	\$ 2,708	\$ 494	\$ 2,214	\$ 2,501	\$ 2,675
Total operating expenses	2,174	398	1,776	2,090	2,230
Loss on impairment	-	-	-	(1,493)	(1,806)
Operating income (loss)	534	96	438	(1,082)	(1,361)
Equity in earnings of unconsolidated venture	3	-	3	-	29
Derivative gain (loss)	19	-	19	18	(37)
Interest expense	41	20	21	21	46
Interest expense to affiliated companies	135	4	131	155	138
Other income (expense) – net	(10)	(2)	(8)	5	17
Income (loss) from continuing operations, before income taxes	370	70	300	(1,235)	(1,536)
Income tax expense	134	25	109	82	78
Income (loss) from continuing operations	236	45	191	(1,317)	(1,614)
Loss from discontinued operations net of income tax	(4)	-	(4)	(151)	(173)
Gain (loss) on disposal of discontinued operations net of income tax	5	2	3	(69)	-
Net income (loss)	237	47	190	(1,537)	(1,787)
Noncontrolling interest-loss from discontinued operations	-	-	-	(5)	(8)
Net income (loss) attributable to member	<u>\$ 237</u>	<u>\$ 47</u>	<u>\$ 190</u>	<u>\$ (1,542)</u>	<u>\$ (1,795)</u>

The change in LKE's net income was as follows:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Total operating revenues	\$ 207	\$ (174)
Total operating expenses	84	(140)
Loss on impairment	(1,493)	(313)
Operating income	1,616	279
Equity in earnings of unconsolidated venture	3	(29)
Derivative gain (loss)	1	55
Interest expense	20	(25)
Interest expense to affiliated companies	(20)	17
Other income (expense) – net	(15)	(12)
Income (loss) from continuing operations before income taxes	1,605	301
Income tax expense	52	4
Income (loss) from continuing operations	1,553	297
Loss from discontinued operations net of income tax	(147)	(22)
Gain (loss) on disposal of discontinued operations net of income tax	74	(69)
Net income (loss)	1,774	250
Noncontrolling interest-loss from discontinued operations	5	3
Net income (loss) attributable to member	<u>\$ 1,779</u>	<u>\$ 253</u>

Operating Revenues

Operating revenues follow:

	Combined	Successor	Predecessor	
	Year Ended December 31, 2010	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008
Electric	\$ 2,412	\$ 409	\$ 2,003	\$ 2,147 \$ 2,223
Natural gas	296	85	211	354 452
	<u>\$ 2,708</u>	<u>\$ 494</u>	<u>\$ 2,214</u>	<u>\$ 2,501 \$ 2,675</u>

The changes in operating revenues were as follows:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Electric	\$ 265	\$ (76)
Natural gas	(58)	(98)
	<u>\$ 207</u>	<u>\$ (174)</u>

Electric Revenues

The \$265 million increase from 2009 to 2010 and the \$76 million decrease from 2008 to 2009 in electric revenues were primarily due to:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Retail sales volumes (a)	\$ 119	\$ (76)
Base rate price variance (b)	72	(17)
Demand revenues (c)	30	1
Increased fuel costs billed through the FAC	26	11
Sales to municipal customers (d)	12	(1)
Other operating revenues primarily due to late payment charges	6	14
Transmission revenue	6	-
Increased recoverable program spending billed through the DSM	4	16
Merger surcredit termination in February 2009	2	27
Increased recoverable capital spending billed through ECR	1	57
Wholesale sales (e)	(13)	(113)
VDT surcredit termination in August 2008	-	5
	<u>\$ 265</u>	<u>\$ (76)</u>

- (a) Retail sales volumes increased during 2010 compared to 2009 as a result of increased consumption primarily due to increased heating degree days during the first and fourth quarters of 2010 and increased cooling degree days during the second and third quarters of 2010. Additionally, improved economic conditions in 2010 and significant storm outages in 2009 contributed to the increased volumes.

The decrease in retail sales volumes during 2009 compared to 2008 was attributable to reduced consumption by retail customers, as a result of milder weather and weakened economic conditions, in addition to significant storm outages during 2009.

- (b) The increase in revenues due to the base rate price variance during 2010 compared to 2009 resulted from higher base rates effective August 1, 2010. As part of the 2010 Kentucky rate case, the 2001 and 2003 ECR plans were added to rate base, which caused a portion of this increase. See Note 3, Rates and Regulatory Matters, for further discussion of the 2010 Kentucky rate cases.

The decrease in revenues due to the base rate price variance during 2009 compared to 2008 resulted from a reduction in base energy rates effective February 6, 2009. See Note 3, Rates and Regulatory Matters, for further discussion of the 2008 Kentucky rate case.

- (c) Demand revenues increased during 2010 compared to 2009 as a result of higher demand rates effective August 1, 2010 and higher customer peak demand. See Note 3, Rates and Regulatory Matters, for further discussion of the 2010 Kentucky rate cases.

- (d) The increase in sales to municipal customers during 2010 compared to 2009 was primarily due to increased volumes as a result of increased cooling and heating degree days, improved economic conditions and a decline in storm outages.
- (e) The decrease in wholesale sales during 2010 compared to 2009 resulted from decreased volumes to third parties and decreased revenues from financial swaps. The decrease in wholesale volumes was primarily due to increased consumption by residential customers as a result of increased cooling and heating degree days, increased coal-fired generation outages and increased consumption by industrial customers as a result of improved economic conditions. Financial energy swap revenues decreased as a result of less activity from the buyback of positions in 2010.

The decrease in wholesale sales during 2009 compared to 2008 was primarily due to decreased volumes to third parties, due to lower economic capacity caused by lower spot market pricing and higher scheduled coal-fired generation outages.

Natural Gas Revenues

The \$58 million decrease in natural gas revenues from 2009 to 2010 and \$98 million decrease from 2008 to 2009 were primarily due to:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Reduction in natural gas prices billed through GSC	\$ (82)	\$ (76)
Retail sales volumes (a)	13	(35)
Retail base rates price variance (b)	10	16
Off-system wholesale sales decrease due to lower demand	-	(6)
Other	1	3
	<u>\$ (58)</u>	<u>\$ (98)</u>

- (a) Retail sales volumes increased during 2010 compared to 2009, as a result of increased consumption primarily due to colder temperatures during the first and fourth quarters of 2010 and improved economic conditions. The increase in revenues resulting from higher volumes was partially offset by decreased revenues from the WNA.

Retail sales volumes decreased during 2009 compared to 2008 as a result of milder weather and weakened economic conditions. The decrease in the volume variance in 2009 was partially offset by increased WNA revenues resulting from lower natural gas sales volumes.

- (b) The increase in revenues due to the base rate price variance during 2010 compared to 2009 resulted from higher base rates effective August 1, 2010. See Note 3, Rates and Regulatory Matters, for further discussion of the 2010 Kentucky rate case.

The increase in revenues due to the base rate price variance during 2009 compared to 2008 was due to the change in base rates resulting from the application of the base rate case settlement in February 2009. See Note 3, Rates and Regulatory Matters, for further discussion of the 2008 Kentucky rate case.

Operating Expenses

Fuel for electric generation and natural gas supply expenses comprise a large component of total operating expenses. Increases or decreases in the cost of fuel and natural gas supply are reflected in electric and natural gas retail rates through the GSC and FAC, subject to the approval of the FERC, the Kentucky Commission, the Virginia Commission, and the Tennessee Regulatory Authority. Operating expenses and the changes therein for 2010, 2009 and 2008 follow:

	Combined	Successor	Predecessor	
	Year Ended December 31, 2010	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008
Fuel for electric generation	\$ 861	\$ 138	\$ 723	\$ 762 \$ 859
Power purchased	117	15	102	136 153
Natural gas supply expense	162	53	109	243 349
Other operation and maintenance expenses	750	143	607	678 604
Depreciation and amortization	284	49	235	271 265
	<u>\$ 2,174</u>	<u>\$ 398</u>	<u>\$ 1,776</u>	<u>\$ 2,090</u> <u>\$ 2,230</u>

The changes in operating expenses were as follows:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Fuel for electric generation	\$ 99	\$ (97)
Power purchased	(19)	(17)
Natural gas supply expense	(81)	(106)
Other operation and maintenance expenses	72	74
Depreciation and amortization	13	6
	<u>\$ 84</u>	<u>\$ (140)</u>

Fuel for Electric Generation

The \$99 million increase from 2009 to 2010 and \$97 million decrease from 2008 to 2009 were primarily due to:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Fuel usage volumes (a)	\$ 94	\$ (117)
Commodity costs for coal and natural gas	8	20
Other	(3)	-
	<u>\$ 99</u>	<u>\$ (97)</u>

- (a) Fuel usage volumes increased in 2010 compared to 2009 due to increased native load sales. Fuel usage volumes decreased in 2009 compared to 2008 due to decreased native load and wholesale sales.

Power Purchased Expense

The \$19 million decrease from 2009 to 2010 and \$17 million decrease from 2008 to 2009 were primarily due to:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Power purchased from OMU	\$ (40)	\$ 12
Demand payments for third party purchases	(1)	3
Prices for purchases used to serve retail customers	10	(16)
Third party purchased volumes for native load (a)	7	(7)
OMU settlement received in 2009 (b)	6	(6)
Other	(1)	(3)
	<u>\$ (19)</u>	<u>\$ (17)</u>

- (a) Third party purchase volumes with counterparties other than OMU increased in 2010 compared to 2009 primarily due to the termination of the OMU agreement. Third party purchase volumes with counterparties other than OMU decreased in 2009 compared to 2008 primarily due to availability of power for native load customers from the OMU agreement.
- (b) See Note 13, Commitments and Contingencies, for further discussion of the OMU settlement.

Natural Gas Supply Expense

The \$81 million decrease from 2009 to 2010 and \$106 million decrease from 2008 to 2009 were primarily due to:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Cost of natural gas supply billed to customers due to lower cost per Mcf	\$ (95)	\$ (73)
Natural gas volumes delivered	13	(26)
Wholesale sales of purchased natural gas volumes	-	(5)
Other	1	(2)
	<u>\$ (81)</u>	<u>\$ (106)</u>

Other Operation and Maintenance Expenses

The \$72 million increase from 2009 to 2010 and \$74 million increase from 2008 to 2009 were primarily due to:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Administrative and general expense (a)	\$ 38	\$ 6
Steam expense (b)	15	17
Generation expense (c)	8	(2)
Bad debt expense (d)	6	(1)
Transmission expense (e)	7	(1)
DSM program spending	2	19
Legal expenses (f)	-	(6)
Distribution expense	-	2
Power supply expense	-	(4)
Pension expense (g)	(6)	44
Other	2	-
	<u>\$ 72</u>	<u>\$ 74</u>

- (a) Administrative and general expense increased in 2010 compared to 2009 primarily due to increased expense related to the purchase of LKE by PPL, higher labor expense and insurance expense, partially offset by lower IT expense related to the implementation of the Customer Care Solution system in 2009. Administrative and general expense increased in 2009 compared to 2008 primarily due to increased consulting fees for software training and increased labor and benefit cost.
- (b) Steam expense increased in 2010 compared to 2009 primarily due to increased generation, boiler and electric maintenance expense related to outage work. Steam expense increased in 2009 compared to 2008 due to the utilization of SCRs year-round and increased scope of work related to scheduled outages.
- (c) Generation expense increased in 2010 compared to 2009 primarily due to overhaul of Paddy's Run Unit 13.
- (d) Bad debt expense increased in 2010 compared to 2009 due to higher billed revenues, higher late payment charges and a higher net charge-off percentage.
- (e) Transmission expense increased in 2010 compared to 2009 primarily due to a settlement agreement with a third party and the establishment of a regulatory asset approved by the Kentucky Commission for the EKPC settlement in 2009, net of twelve months of amortization expense recorded in 2010.
- (f) Legal expenses decreased in 2009 compared to 2008 primarily due to OMU expenses in 2008. See Note 13, Commitments and Contingencies, for further information regarding the OMU settlement.
- (g) Pension expense decreased in 2010 compared to 2009 primarily due to favorable asset performance in 2009 and increased in 2009 compared to 2008 primarily due to unfavorable asset performance in 2008.

Loss on Impairment of Goodwill

Loss on impairment of goodwill decreased \$1,493 million in 2010 compared to 2009 and decreased \$313 million in 2009 compared to 2008. The Company recorded impairment in 2009 based on bids received from parties interested in purchasing the Company including PPL, and recorded impairment in 2008 based on the estimated discounted present value of the Company's future cash flows. See Note 7, Goodwill and Intangible Assets, for further information.

Equity in Earnings of Unconsolidated Venture

The \$3 million increase in equity in earnings of unconsolidated venture from 2009 to 2010 was primarily due to higher earnings from EEI resulting from increased market prices for electric energy and the \$29 million decrease from 2008 to 2009 was primarily due to lower earnings resulting from decreased market prices for electric energy.

Derivative Gain (Loss)

The \$1 million increase from 2009 to 2010 and \$55 million increase from 2008 to 2009 were primarily due to:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Reclassification of ineffective interest rate swap loss to a regulatory asset in 2010 (a)	\$ 21	\$ -
Reclassification of terminated interest rate swap loss to a regulatory asset in 2010 (a)	9	-
Interest expense related to interest rate swaps	2	(2)
Gain (loss) on interest rate swap	(31)	57
	<u>\$ 1</u>	<u>\$ 55</u>

(a) See Note 3, Rates and Regulatory Matters, for further discussion of the interest rate swap regulatory assets.

Interest Expense

The \$20 million increase from 2009 to 2010 and \$25 million decrease from 2008 to 2009 were primarily due to:

	Increase (Decrease)	
	2010 vs. 2009	2009 vs. 2008
Bond interest expense (a)	\$ 10	\$ (12)
Senior notes interest expense (b)	4	-
Interest rate swaps (c)	1	(8)
Other interest expense	5	(5)
	<u>\$ 20</u>	<u>\$ (25)</u>

(a) Bond interest expense increased in 2010 compared to 2009 due to the issuance of first mortgage bonds in November 2010. Bond interest expense decreased in 2009 compared to 2008 due to the repurchase of bonds in 2008. See Note 11, Long-Term Debt, for further information.

- (b) Senior notes were issued by LKE in November 2010. See Note 11, Long-Term Debt, for further information.
- (c) See Note 3, Rates and Regulatory Matters, and Note 5, Derivative Financial Instruments, for further information regarding interest rate swaps.

Interest Expense to Affiliated Companies

Interest expense to affiliate companies decreased by \$20 million in 2010 compared to 2009 primarily due to notes payable to Fidelity being paid in full in November 2010, as a result of the PPL acquisition and due to lower 2010 interest rates on variable rate notes payable to Fidelity. Interest expense to affiliate companies increased by \$17 million in 2009 compared to 2008 primarily due to increased intercompany debt outstanding.

Other Income (Expense) – Net

The \$15 million decrease in other income (expense) – net from 2009 to 2010 and \$12 million decrease in other expense – net from 2008 to 2009 were primarily due to:

	<u>Increase (Decrease)</u>	
	<u>2010 vs. 2009</u>	<u>2009 vs. 2008</u>
Gain on sale of the Company's property	\$ (3)	\$ (6)
Discontinuance of allowance for funds used during construction on ECR projects as a result of the FERC rate case	(3)	(2)
Depreciation expense on TC2 joint-use assets held for future use	(2)	(1)
Other	(7)	(3)
	<u>\$ (15)</u>	<u>\$ (12)</u>

Discontinued Operations

In July 2009, the Company completed the disposition of WKE's 25-year lease and operating agreements for the generating facilities of Big Rivers, a power-generating cooperative in western Kentucky and a coal-fired generating facility owned by the City of Henderson, Kentucky.

In November 2009, subsidiaries of the Company entered into agreements to sell their direct and indirect interests in Centro and Cuyana, two natural gas distribution companies in Argentina, to E.ON Spain and a subsidiary, both affiliates of E.ON AG. The transaction was completed on January 1, 2010, for a sale price of \$35 million.

The loss from discontinued operations after tax decreased \$147 million and \$22 million in 2010 and 2009, respectively, primarily due to the disposition of WKE's operations in July 2009. The \$46 million decrease in WKE's 2009 operations was partially offset by an impairment charge related to the Argentina operations totaling \$12 million.

The gain (loss) on disposal of discontinued operations after tax increased by \$74 million in 2010 primarily due to the \$69 million loss recognized for the disposal of the WKE operations in July 2009

and the revaluation of certain liabilities in 2010. The gain (loss) on disposal of discontinued operations before tax decreased in 2009 by \$69 million due to the disposal of the WKE operations in July 2009.

Income Tax Expense

See Note 10, Income Taxes, for a reconciliation of differences between the U.S. federal income tax expense at statutory rates and LKE's income tax expense.

2011 Outlook

LKE projects higher earnings in 2011 compared with 2010 as a result of higher retail revenues and lower financing costs, partially offset by higher operation and maintenance expenses and depreciation. Retail revenues are expected to increase as a result of the 2010 Kentucky rate cases and recoveries associated with its environmental investments. Operation and maintenance expenses and depreciation are expected to increase due to placing TC2 in service in January 2011. See Risk Factors for a discussion of the risk factors that may impact the 2011 outlook.

Financial Condition

Liquidity and Capital Resources

LKE expects to continue to have adequate liquidity available through operating cash flows, cash and cash equivalents and its credit facilities. LKE remarketed \$163 million of pollution control bonds in January 2011 and expects to remarket an additional \$25 million of pollution control bonds in November 2011. LKE currently has no other plans to access debt capital markets in 2011. See Note 21, Subsequent Events, for further information.

LKE's cash flows from operations and access to cost-effective bank and capital markets are subject to risks and uncertainties including, but not limited to, the following:

- changes in market prices for electricity;
- potential ineffectiveness of the trading, marketing and risk management policy and programs used to mitigate LKE's risk exposure to adverse electricity and fuel prices and interest rates;
- operational and credit risks associated with selling and marketing products in the wholesale power markets;
- unusual or extreme weather that may damage LKE's transmission and distribution facilities or affect energy sales to customers;
- unavailability of generating units (due to unscheduled or longer than anticipated generation outages, weather and natural disasters) and the resulting loss of revenues and additional costs of replacement electricity;
- ability to recover and timeliness and adequacy of recovery of costs associated with regulated utility business;
- costs of compliance with existing and new environmental laws;
- any adverse outcome of legal proceedings and investigations with respect to LKE's current and past business activities;
- deterioration in the financial markets that could make obtaining new sources of bank and capital markets funding more difficult and more costly; and

- a downgrade in LKE's credit ratings that could adversely affect its ability to access capital and increase the cost of credit facilities and any new debt.

See the Risk Factors section for further discussion of risks and uncertainties affecting LKE's cash flows.

At December 31, LKE had the following:

	Successor <u>2010</u>	Predecessor <u>2009</u>
Cash and cash equivalents	\$ 11	\$ 7
Available for sale debt securities (a)	<u>163</u>	<u>-</u>
	<u>\$ 174</u>	<u>\$ 7</u>
Current portion of long-term debt (b)	\$ 2	\$ 348
Current portion of long-term debt to affiliated company (c)	-	358
Notes payable to affiliated company (c)	-	851
Note payable (d)	<u>163</u>	<u>-</u>
	<u>\$ 165</u>	<u>\$ 1,557</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 18, Available for Sale Debt Securities, and Note 21, Subsequent Events, for further information.
- (b) 2009 amount represents LG&E's Jefferson County 2001 Series A and B and Trimble County 2001 Series A and B and KU's Carroll County 2002 Series A and B, 2004 Series A, 2006 Series B and 2008 Series A; Muhlenberg County 2002 Series A; and Mercer County 2000 Series A and 2002 Series A pollution control bonds subject to tender for purchase at the option of the holder and to mandatory tender for purchase upon the occurrence of certain events. The Successor has classified these bonds as long-term debt because the Utilities have the intent and ability to utilize their respective \$400 million credit facilities, which mature in December 2014, to fund any mandatory purchases. The Predecessor classified these bonds as the current portion of long-term debt due to the tender for purchase provisions. The Predecessor presentation and the Successor presentation are both appropriate under GAAP. See Note 1, Summary of Significant Accounting Policies and Note 11, Long-Term Debt, for further information.
- (c) 2009 amounts represent debt owed to E.ON affiliates, which was repaid in November 2010. See Note 12, Notes Payable and Other Short-Term Obligations, and Note 15, Related Party Transactions, for further information.
- (d) 2010 amount represents borrowings on LG&E's \$400 million revolving line of credit with a group of banks. See Note 12, Notes Payable and Other Short-Term Obligations, for further information.

A condensed table of cash flows for the following periods in 2010, 2009 and 2008 is presented below. The Predecessor period, January 1, 2010 through October 31, 2010, and the Successor period, November 1, 2010 through December 31, 2010, were aggregated without further adjustment for purposes of comparison with the same periods in 2009 and 2008.

	Combined	Successor	Predecessor		
	Year Ended December 31, 2010	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008	
Net cash provided by (used in) operating activities	\$ 514	\$ 26	\$ 488	\$ (204)	\$ 390
Net cash provided by (used in) investing activities	(637)	(211)	(426)	(706)	(957)
Net cash provided by (used in) financing activities	<u>127</u>	<u>167</u>	<u>(40)</u>	<u>902</u>	<u>568</u>
Change in cash and cash equivalents	<u>\$ 4</u>	<u>\$ (18)</u>	<u>\$ 22</u>	<u>\$ (8)</u>	<u>\$ 1</u>

Operating Activities

Net cash provided by operating activities increased by 352%, or \$718 million, in 2010 compared with 2009, primarily as a result of payments made in July 2009 for the WKE unwind, increased earnings excluding an impairment of goodwill and discontinued operation expenses, lower storm expenses and increased collections from the ECR mechanism. These increases in cash flow were partially offset by changes in working capital, refunds of prior year GSC over-collections, increased pension funding, higher interest payments due to an accelerated settlement with the previous owner and higher income tax payments.

Net cash provided by operating activities decreased by 152%, or \$594 million, in 2009 compared with 2008, primarily as a result of payments made in July 2009 for the WKE unwind, higher storm expenses and increased pension funding. These decreases in cash flow were partially offset by increased GSC recoveries and higher earnings excluding an impairment of goodwill, discontinued operation expenses and pension expense.

LKE expects to achieve relatively stable cash flows from operations during the next three years although future cash flows may be significantly impacted by changes in economic conditions or new environmental and tax regulations.

Investing Activities

The primary use of cash in investing activities is capital expenditures. See “Forecasted Uses of Cash” for details regarding projected capital expenditures for the years 2011 through 2013.

Net cash used in investing activities decreased by 10%, or \$69 million, in 2010 compared with 2009, primarily as a result of a decrease of \$127 million in capital expenditures and an increase of \$21 million in proceeds from the sale of discontinued operations. These increases in cash flow were partially offset by a \$61 million loan made to an affiliate, a decrease of \$8 million in restricted cash collections, a decrease of \$7 million in cash received on the settlement of derivatives and a decrease of \$3 million in cash received from the sale of assets.

Net cash used in investing activities decreased by 26%, or \$251 million, in 2009 compared with 2008, primarily as a result of a decrease of \$233 million in capital expenditures, an increase of \$15 million in cash received on the settlement of derivatives and an increase of \$9 million in restricted cash collections. These increases in cash flow were partially offset by a decrease of \$6 million in cash received from the sale of assets.

Financing Activities

Net cash provided by financing activities was \$127 million in 2010 compared with \$902 million in 2009. In spite of significant new debt issuances associated with the repayments to E.ON affiliates in connection with PPL's acquisition of the Company, the cash provided by financing in 2010 is lower as a result of new debt issuances exceeding repayments by a smaller amount and by higher dividends paid in 2010.

Net cash provided by financing activities was \$902 million in 2009 compared with \$568 million in 2008. The higher level of cash provided by financing in 2009 was the result of increased issuances of debt due to affiliates.

In the two months of 2010 following the acquisition, cash provided by financing activities of the Successor primarily consisted of the issuance of senior unsecured notes and first mortgage bonds totaling \$2,890 million after discounts, the issuance of intercompany notes totaling \$2,784 million to a PPL subsidiary to repay debt due to E.ON affiliates upon the closing of the sale, an equity contribution from PPL totaling \$1,565 million and a \$163 million drawing under a revolving line of credit. These amounts were offset by the repayment of \$4,319 million to E.ON affiliates upon the closing of the sale, the repayment of \$2,784 million to a PPL affiliate upon the issuance of the senior unsecured notes and first mortgage bonds, a \$100 million return of capital to PPL and the payment of \$32 million of debt issuance costs.

In 2010, cash used in financing activities by the Predecessor primarily consisted of the payment of \$900 million of maturing intercompany loans, \$87 million of dividends to E.ON entities and the net repayment of short-term debt due to affiliated companies totaling \$3 million. These amounts were partially offset by the issuance of new intercompany loans totaling \$950 million.

In 2009, cash used in financing activities primarily consisted of the issuance of intercompany loans totaling \$1,230 million, partially offset by \$255 million of maturing intercompany loans, dividends paid to E.ON entities totaling \$49 million and the repayment of \$22 million of short-term debt to affiliated companies.

In 2008, cash provided by financing activities primarily consisted of the issuance of \$575 million of intercompany notes to an E.ON affiliate, an increase in short-term debt to an affiliated company of \$237 million, the issuance of \$237 million of pollution control revenue bonds, all partially offset by repurchases or retirements of \$382 million and \$24 million of pollution control revenue bonds and medium term notes, respectively and the payment of \$68 million in dividends to E.ON entities.

LKE's debt financing activity in 2010 was:

	<u>Issuances (a)</u>	<u>Retirements</u>
Issuance of long-term debt	\$ 2,890	\$ -
Issuance of short-term note payable	163	-
Short-term borrowings from affiliated companies – net change	-	(3)
Other borrowings from affiliated companies	2,784	(2,784)
Borrowings from E.ON affiliates	950	(5,219)
Net change in debt financing	<u>\$ 6,787</u>	<u>\$ (8,006)</u>

(a) Issuances are net of pricing discounts, where applicable.

See Note 11, Long-Term Debt, for further information.

Working Capital Deficiency

As of December 31, 2009, the Company had a working capital deficiency of \$1,313 million, primarily due to short-term debt from affiliates totaling \$1,209 million and \$348 million of tax-exempt bonds which allow the investors to put the bonds back to the Company causing them to be classified as "Current portion of long-term debt." As of December 31, 2010, the Company no longer had a working capital deficiency because the short-term debt from affiliates was paid off in conjunction with the PPL acquisition financing, the \$348 million of tax-exempt bonds were no longer classified as "Other current liabilities" by the Successor because the Company has the intent and ability to utilize the Utilities' \$400 million credit facilities which expire in December 2014 to fund any mandatory purchases, and the \$163 million in repurchased pollution control bonds that were previously reported on a net basis by the Predecessor are now reported on a gross basis as available for sale debt securities by the Successor. See Note 1, Summary of Significant Accounting Policies, Note 11, Long-Term Debt, Note 18, Available for Sale Debt Securities, and Note 21, Subsequent Events, for further information.

Auction Rate Securities

Auctions for auction rate securities issued by LKE continued to fail throughout 2010. LKE held \$163 million of its own securities at December 31, 2010 and December 31, 2009, that at one time were auction rate securities. These pollution control bonds were reissued in January 2011. See Note 11, Long-Term Debt, Note 18, Available for Sale Debt Securities, and Note 21, Subsequent Events, for further discussion.

Forecasted Sources of Cash

LKE expects to continue to have adequate sources of cash available in the near term, including access to external financing, financing from affiliates and/or infusions of capital from PPL. Regulatory approvals are required for LG&E and KU to incur additional debt. The Virginia Commission and the FERC authorize the issuance of short-term debt while the Kentucky Commission, the Virginia Commission and the Tennessee Regulatory Authority authorize the issuance of long-term debt. In November 2009, LG&E and KU both received a two-year authorization from the FERC to borrow up to \$400 million in short-term funds. KU also has authorization from the Virginia Commission that expires at the end of 2011, allowing short-term borrowing of up to \$400 million. Short-term funds are made available to LG&E and KU via the Company's participation in an intercompany money pool agreement wherein

LKE and/or KU and/or LG&E make funds available to LG&E and KU at market-based rates (based on highly rated commercial paper issues) up to \$400 million. LKE also has an intercompany line of credit available up to \$300 million from a subsidiary of PPL and LG&E and KU each maintain \$400 million Revolving Credit Agreements discussed below. LKE currently believes these authorizations and facilities, together with the Company's credit facilities discussed below, provide the necessary flexibility to address any liquidity needs.

Credit Facilities

On November 1, 2010, LG&E and KU each entered into separate new \$400 million unsecured Revolving Credit Agreements with a group of banks. Under their respective new credit facilities, which expire December 31, 2014, LG&E and KU each have the ability to make cash borrowings and to request the lenders to issue letters of credit. Borrowings will generally bear interest at LIBOR-based rates plus a spread, depending upon the respective borrower's senior unsecured long-term debt rating. The new credit facilities contain financial covenants requiring the borrower's debt to total capitalization to not exceed 70% and other customary covenants. At December 31, 2010, LG&E's debt to total capitalization was 43% and KU's debt to total capitalization was 41%, as calculated pursuant to the respective credit agreements. Under certain conditions, each of LG&E and KU may request that its facility's capacity be increased by up to \$100 million. The new LG&E credit facility replaced three bilateral credit facilities totaling \$125 million and the new KU credit facility replaced a bilateral line of credit totaling \$35 million, each of which were terminated on November 1, 2010. LKE entered into a \$300 million demand note facility with a PPL subsidiary. The facility allows for cash borrowings at LIBOR-based rates plus a spread, depending upon LKE's senior unsecured long-term debt rating. As of December 31, 2010, there were no borrowings outstanding under the new LKE facility, \$163 million of borrowings outstanding under the new LG&E credit facility and no borrowings outstanding under KU's new credit facility, but there were \$198 million of letters of credit outstanding to support outstanding bonds totaling \$195 million under the KU credit facility. In January 2011, LG&E successfully remarketed \$163 million of its repurchased pollution control bonds and used the proceeds to repay the outstanding balance on LG&E's credit facility. LKE will utilize unused credit facility and money pool balances to fund working capital needs as they arise.

See Note 12, Notes Payable and Other Short-Term Obligations, for further information regarding the Company's credit facilities. See Note 11, Long-Term Debt, Note 18, Available for Sale Debt Securities, and Note 21, Subsequent Events, for further information regarding the Company's remarketed bonds.

Contributions from PPL

PPL may make capital contributions to LKE, which can be used for general corporate purposes.

Long-Term Debt

LKE currently does not plan to issue any new long-term debt in 2011. However, LKE remarketed \$163 million of pollution control bonds in January 2011 and expects to remarket an additional \$25 million of pollution control bonds in the second half of 2011. See Note 21, Subsequent Events, for further information.

Forecasted Uses of Cash

In addition to expenditures required for normal operating activities, such as fuel for electric generation, power purchased, payroll and taxes; LKE currently expects to incur future cash outflows for capital expenditures, various contractual obligations and the payment of dividends.

Capital Requirements

LKE's construction program is designed to ensure that there will be adequate capacity and reliability to meet the electric needs of its service area and to comply with environmental regulations. These needs are continually being reassessed and appropriate revisions are made, when necessary, in construction schedules. LKE plans to fund capital expenditures through operating cash flows, the credit facilities and, if needed, the issuance of long-term debt. LKE expects its capital expenditures for the three year period ending December 31, 2013, to total approximately \$2,975 million consisting primarily of the following:

Construction of environmental controls and capacity replacement	\$ 1,033
Construction of distribution and metering assets	649
Construction of coal combustion residual storage structures	436
Construction of generation assets	375
Construction of transmission assets	169
Recoverable environmental assets	115
Information technology projects	80
Redevelopment of Ohio Falls hydroelectric facility	67
Other projects	51
	<u>\$ 2,975</u>

The Company's capital program will focus primarily on compliance with existing or anticipated EPA environmental regulations, aging infrastructure and the need for increased storage capacity for coal combustion by-product materials over the next several years. This program may also be affected in varying degrees by factors such as electric energy demand load growth, changes in construction expenditure levels, rate actions by regulatory agencies, new legislation, changes in commodity prices and labor rates and other regulatory requirements. In particular, climate change initiatives, whether via legislative, regulatory or market channels, could restrict or disadvantage power generation from higher-carbon sources. Therefore, LKE has included estimates regarding significant additional capital expenditures related to pending environmental regulations and legislation. These estimates are subject to final regulations and least cost analysis based on engineering studies. To the extent financial markets see climate change as a potential risk, LKE may face reduced access to or increased costs in capital markets. Capital expenditures for LKE associated with such actions are preliminarily estimated to be in the \$3.0 to \$3.5 billion range over the next ten years, although final costs may substantially vary.

See the contractual obligations table below and Note 13, Commitments and Contingencies, for further information concerning current commitments.

Contractual Obligations

The following is provided to summarize contractual cash obligations for periods after December 31, 2010. LKE anticipates cash from operations and external financing will be sufficient to fund future obligations. See the Consolidated Statements of Capitalization.

	Payments Due by Period						Total
	2011	2012	2013	2014	2015	Thereafter	
Short-term debt (a)	\$ 163	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 163
Long-term debt (b)	2	-	-	-	900	2,935	3,837
Interest on long-term debt (c)	126	127	134	141	147	2,329	3,004
Operating leases (d)	14	12	10	8	5	4	53
Unconditional power purchase obligations (e)	29	32	32	33	32	372	530
Coal and natural gas purchase obligations (f)	774	309	256	191	191	49	1,770
Pension benefit plan obligation (g)	64	84	98	33	22	159	460
Postretirement benefit plan obligations (h)	13	14	14	15	15	81	152
Construction obligations (i)	230	10	4	-	-	-	244
Other obligations (j)	14	4	-	-	-	-	18
	<u>\$ 1,429</u>	<u>\$ 592</u>	<u>\$ 548</u>	<u>\$ 421</u>	<u>\$ 1,312</u>	<u>\$ 5,929</u>	<u>\$ 10,231</u>

This table does not reflect contingent obligations. See Note 13, Commitments and Contingencies, for further information on contingent obligations.

- (a) Represents borrowings which are due within one year.
- (b) Reflects principal maturities only based on legal maturity dates and includes the current portion of long-term debt.
- (c) Assumes interest payments through maturity. The payments herein are subject to change as payments for debt that is or becomes variable-rate have been estimated.
- (d) Represents future operating lease payments.
- (e) Represents future minimum payments under OVEC power purchase agreements through March 13, 2026.
- (f) Represents contracts to purchase coal, natural gas and natural gas transportation.
- (g) Represents projected cash flows for funding the pension benefit plans as calculated by the actuary. For pension funding information see Note 9, Pension and Other Postretirement Benefit Plans.
- (h) Represents projected cash flows for the postretirement benefit plan as calculated by the actuary. For postretirement funding information, see Note 9, Pension and Other Postretirement Benefit Plans.
- (i) Represents construction commitments, including commitments for the Ohio Falls refurbishment, the Brown SCR and the Trimble, Brown and Ghent landfill construction including associated material transport systems for coal combustion residuals.
- (j) Represents other contractual obligations including the accrued liability for the WKE – swap agreement and the SPP and TVA coordination agreements.

Pension and Postretirement Benefit Plans

See Application of Critical Accounting Policies and Estimates for discussion regarding discretionary contributions to the pension and postretirement benefit plans in 2011.

Dividends

Future dividends may be declared at the discretion of LKE's Board of Directors, payable to the sole member, PPL. As discussed in Note 12, Notes Payable and Other Short-Term Obligations, the Utilities ability to pay dividends are limited under a covenant in each of their \$400 million revolving line of credit facilities. This covenant restricts their debt to total capital ratio to not more than 70%. The Utilities 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. The Utilities 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.

Contributions to LG&E or KU

From time to time LKE may make capital contributions to LG&E or KU, which can be used for general corporate purposes.

Purchase, Redemption or Remarketing of Debt Securities

In January 2011, LG&E successfully remarketed \$163 million of its repurchased pollution control bonds, which were classified as "Available for sale debt securities" on the Consolidated Balance Sheets at December 31, 2010. LG&E used the proceeds from the remarketed bonds to repay the balance of its credit facility. LKE will continue to evaluate purchasing, redeeming or remarketing outstanding debt securities and may decide to take action depending upon prevailing market conditions and available cash.

See Note 11, Long-Term Debt, Note 18, Available for Sale Debt Securities, and Note 21, Subsequent Events, for further information regarding the Company's remarketed bonds. See Note 12, Notes Payable and Other Short-Term Obligations, for discussion regarding the Company's credit facilities.

Credit Ratings

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 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, another national rating agency provided an initial rating of the Company's pollution control bonds, senior notes and first mortgage bonds. See Note 11, Long-Term Debt, for a discussion of downgrade actions in 2009 and 2008 related to the pollution control bonds caused by a change in the rating of the entity insuring those 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 were to fall below investment grade. See Note 5, 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 December 31, 2010. At December 31, 2010, if LKE's credit ratings had been below investment grade, LKE would have been required to prepay or post an additional \$99 million of prepayments and 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.

Off-Balance Sheet Arrangements

LKE has very limited off-balance sheet activity. See Note 13, Commitment and Contingencies, for further discussion.

Risk Management

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. See Note 5, Derivative Financial Instruments, for information regarding risk management activities.

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 1, 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 5, Derivative Financial Instruments, for information regarding exposure and the risk management activities.

Liquidity Risk

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. See Financial Condition – Liquidity and Capital Resources for an expanded discussion of LKE's liquidity position and a discussion of its forecasted sources of cash.

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 Application of Critical Accounting Policies and Estimates – Defined Benefits for a discussion of the assumptions and sensitivities regarding the Company's defined benefit pension and postretirement benefit plans assumptions.

Interest Rate and Commodity Price Risk

LKE is subject to interest rate and commodity price risk related to on-going business operations. It currently manages commodity 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 December 31, 2010, the Company's annual exposure to increased interest expense, based on a 10% increase in interest rates, was less than \$1 million.

LKE manages price risk by conducting energy trading activities through forward financial transactions. The following chart sets forth the net fair value of LKE's commodity derivative contracts. See Note 5, Derivative Financial Instruments, for further information.

	Successor	Predecessor	
	December 31, 2010	October 31, 2010	December 31, 2009
Fair value of contracts outstanding at the beginning of the period	\$ -	\$ -	\$ 2
Contracts realized or otherwise settled during the period	-	3	10
Fair value of new contracts entered into during the period	-	(4)	1
Other changes in fair value (a)	(2)	1	(13)
Fair value of contracts outstanding at the end of the period	<u>\$ (2)</u>	<u>\$ -</u>	<u>\$ -</u>

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

Related Party Transactions

LKE and subsidiaries engage in related party transactions. See Note 15, Related Party Transactions, for further information.

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 entities doing business with LKE.

Acquisitions, Development and Divestitures

LKE has been constructing a new 760-Mw capacity base-load, coal-fired unit, TC2, which is jointly owned by LKE (75%), together with IMEA and IMPA (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 13, 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

The financial statements of LKE are prepared in compliance with GAAP. The application of these principles necessarily involves judgments regarding future events, including legal and regulatory challenges and anticipated recovery of costs. These judgments could materially impact the financial statements and disclosures based on varying assumptions, which may be appropriate to use. In addition, the financial and operating environment also may have a significant effect, not only on the operation of the business, but also on the results reported through the application of accounting measures used in preparing the financial statements and related disclosures, even if the nature of the accounting policies applied has not changed. LKE's senior management has reviewed the significant and critical accounting policies with the relevant governing bodies of the Company and its parent, as applicable.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used or if changes in the estimate that are reasonably possible could materially impact the financial statements. Management believes the following critical accounting policies reflect the significant estimates and assumptions used in the preparation of the Financial Statements.

Price Risk Management

See Financial Condition - Risk Management.

Regulatory Mechanisms

LG&E and KU are cost-based rate-regulated utilities. As a result, LKE's financial statements reflect the effects of regulatory actions. Regulatory assets are recognized for the effect of transactions or events where future recovery is probable in regulated customer rates. The effect of such accounting is to defer certain or qualifying costs that would otherwise be charged to expense. Likewise, regulatory liabilities are recognized for obligations expected to be returned through future regulated customer rates. The effect of such transactions or events would otherwise be reflected as income. In certain cases, regulatory liabilities are recorded based on the understanding with the regulator that current rates are being set to recover costs that are expected to be incurred in the future. The regulated entity is accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose. The accounting for regulatory assets and liabilities is based on specific ratemaking decisions or precedent for each transaction or event as prescribed by the FERC, the Kentucky Commission, the Virginia Commission or the Tennessee Regulatory Authority. See Note 3, Rates and Regulatory Matters, for additional detail regarding regulatory assets and liabilities.

Defined Benefits

LKE employees benefit from both funded and unfunded retirement benefit plans. See Note 1, Summary of Significant Accounting Policies, for information about policy changes between the Predecessor and Successor and the accounting for defined benefits including LKE's method of amortizing gains and losses. LKE makes various assumptions in arriving at pension and other postretirement benefit costs and obligations. The major assumptions include:

- LKE's selection of discount rates is based on the Mercer Pension Discount Yield Curve (Predecessor) and the Towers Watson Yield Curve (Successor).
- LKE's selection of rate of salary growth is based on historical data that includes employees' periodic pay increases and promotions, which are used to project employees' pension benefits at retirement.
- LKE determines the expected long-term return on plan assets based on the current level of expected return on risk free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class is then weighted based on the current asset allocation.
- LKE's management projects health care cost trends based on past health care costs, the near-term outlook and an assessment of likely long-term trends.

The performance of the capital markets affects the values of the assets that are held in trust to satisfy future obligations under the defined benefit pension plans. The return on investments within the plans was approximately 12% for the year ended December 31, 2010. The benefit plan assets and obligations of the Company are re-measured annually using a December 31 measurement date. Due to the PPL acquisition, the benefit plan assets and obligations were also re-measured at October 31, 2010. The Company's 2010 pension cost was approximately \$13 million less than 2009. The Company anticipates its 2011 pension cost will be approximately \$7 million less than the 2010 expense. The amount of future funding will depend upon the actual return on plan assets, the discount rate and other factors, but the Company funds its pension obligations in a manner consistent with the Pension Protection Act of 2006. The Company made discretionary contributions to its pension plans of \$45 million and \$33 million in 2010 and 2009, respectively. In January 2011, LKE contributed \$150 million to its pension plans. See Note 21, Subsequent Events, for further information.

See Note 9, Pension and Other Postretirement Benefit Plans, for further information on defined benefits including sensitivity analysis expressing potential changes in expected returns that would result from hypothetical changes to assumptions and estimates, expected rate of return assumptions and health care trends.

Asset Impairment

LKE performs a quarterly review to determine if an impairment analysis is required for long-lived assets that are subject to depreciation or amortization. This review identifies changes in circumstances indicating that a long-lived asset's carrying value may not be recoverable. An impairment analysis will be performed if warranted based on the review. For these long-lived assets, such events or changes in circumstances which may indicate an impairment analysis is required include:

- a significant decrease in the market price of an asset;

- a significant adverse change in the manner in which an asset is being used or in its physical condition;
- a significant adverse change in legal factors or in the business climate;
- an accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of an asset;
- a current-period operating or cash flow loss combined with a history of losses or a forecast that demonstrates continuing losses;
- a current expectation that, more likely than not, an asset will be sold or otherwise disposed of before the end of its previously estimated useful life; and
- a significant change in the physical condition of an asset.

For a long-lived asset, impairment is recognized when the carrying amount of the asset is not recoverable and exceeds its fair value. The carrying amount is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. If the asset is impaired, an impairment loss is recorded to adjust the asset's carrying value to its estimated fair value. Management must make significant judgments to estimate future cash flows including the useful lives of long-lived assets, the fair value of the assets and management's intent to use the assets. LKE did not recognize an impairment of any long-lived asset in 2010.

Effective with PPL's acquisition of LKE on November 1, 2010, LG&E and KU recorded \$389 million and \$607 million of goodwill, respectively. At December 31, 2010, LG&E's and KU's goodwill remained unchanged. GAAP requires goodwill to be tested for impairment on an annual basis or more frequently if events or circumstances indicate that assets may be impaired. The Utilities perform their annual goodwill impairment test in the fourth quarter. See Note 7, Goodwill and Intangible Assets, for further discussion.

Goodwill is tested for impairment using a two-step approach. In step 1, the Company identifies a potential impairment by comparing the estimated fair value of the Utilities (the goodwill reporting unit) to its carrying value, including goodwill, on the measurement date. If the estimated fair value exceeds its carrying amount, goodwill is not considered impaired. If the carrying amount exceeds the estimated fair value, the second step is performed to measure the amount of impairment loss, if any.

The second step requires a calculation of the implied fair value of goodwill. The implied fair value of goodwill is determined in the same manner as the amount of goodwill in a business combination. That is, the estimated fair value is allocated to all of LKE's assets and liabilities as if LKE had been acquired in a business combination and the estimated fair value of LKE was the price paid. The excess of the estimated fair value of LKE over the amounts assigned to its assets and liabilities is the implied fair value of goodwill. The implied fair value of goodwill is then compared with the carrying amount of that goodwill. If the carrying amount exceeds the implied fair value, an impairment loss is recognized in an amount equal to that excess. The loss recognized cannot exceed the carrying amount of the reporting unit's goodwill.

Determining the fair value of LKE is judgmental in nature and involves the use of significant estimates and assumptions. These estimates and assumptions can include revenue growth rates and operating margins used to calculate projected future cash flows, risk adjusted discount rates and future economic and market conditions.

The Successor tested goodwill for impairment in the fourth quarter of 2010 and no impairment was recognized. See Note 7, Goodwill and Intangible Assets, for further discussion.

Loss Accruals

LKE accrues losses for the estimated impacts of various conditions, situations or circumstances involving uncertain or contingent future outcomes. For loss contingencies, the loss must be accrued if (1) information is available that indicates it is probable that a loss has been incurred, given the likelihood of the uncertain future events and (2) the amount of the loss can be reasonably estimated. Accounting guidance defines “probable” as cases in which “the future event or events are likely to occur.” LKE does not record the accrual of contingencies that might result in gains, unless recovery is assured. LKE continuously assesses potential loss contingencies for environmental remediation, litigation claims, regulatory penalties, discontinued operations and other events.

The accounting aspects of estimated loss accruals include (1) the initial identification and recording of the loss, (2) the determination of triggering events for reducing a recorded loss accrual and (3) the ongoing assessment as to whether a recorded loss accrual is sufficient. All three of these aspects require significant judgment by LKE’s management. LKE uses its internal expertise and outside experts (such as lawyers and engineers), as necessary, to help estimate the probability that a loss has been incurred and the amount or range of the loss.

LKE has identified certain other events that could give rise to a loss, but that do not meet the conditions for accrual. Such events are disclosed, but not recorded, when it is reasonably possible that a loss has been incurred. Accounting guidance defines “reasonably possible” as cases in which “the future event or events occurring is more than remote, but less than likely to occur.” See Note 13, Commitments and Contingencies, for disclosure of other potential loss contingencies that have not met the criteria for accrual.

When an estimated loss is accrued, LKE identifies, where applicable, the triggering events for subsequently adjusting the loss accrual. The triggering events generally occur when the contingency has been resolved and the actual loss is incurred, or when the risk of loss has diminished or been eliminated.

The following are some of the triggering events that provide for the adjustment of certain recorded loss accruals:

- Allowances for uncollectible accounts are reduced when accounts are written off after prescribed collection procedures have been exhausted, a better estimate of the allowance is determined or underlying amounts are ultimately collected.
- Environmental and other litigation contingencies are reduced when the contingency is resolved, LKE makes actual payments, a better estimate of the loss is determined or the loss is no longer considered probable.

LKE reviews its loss accruals on a regular basis to assure that the recorded potential loss exposures are appropriate. This involves ongoing communication and analyses with internal and external legal counsel, engineers, operation management and other parties. This review may result in the increase or decrease of the loss accrual.

Asset Retirement Obligations

LKE is required to recognize a liability for legal obligations associated with the retirement of long-lived assets. The initial obligation is measured at its estimated fair value. An equivalent amount is recorded as

an increase in the value of the capitalized asset and allocated to expense over the useful life of the asset. Until the obligation is settled, the liability is increased, through the recognition of accretion expense in the Consolidated Statements of Income, for changes in the obligation due to the passage of time. An offsetting regulatory asset is recognized to reverse the depreciation and accretion expense related to the ARO such that there is no income statement impact. The regulatory asset is relieved when the ARO has been settled. An ARO must be recognized when incurred if the fair value of the ARO can be reasonably estimated.

In determining AROs, management must make significant judgments and estimates to calculate fair value. Fair value is developed using an expected present value technique based on assumptions of market participants that considers estimated retirement costs in current period dollars that are inflated to the anticipated retirement date and then discounted back to the date the ARO was incurred. Changes in assumptions and estimates included within the calculations of the fair value of AROs could result in significantly different results than those identified and recorded in the financial statements. Estimated ARO costs and settlement dates, which affect the carrying value of various AROs and the related assets, are reviewed periodically to ensure that any material changes are incorporated into the estimate of the obligations. Any change to the capitalized asset is amortized over the remaining life of the associated long-lived asset. See Note 4, Asset Retirement Obligations, for further information on AROs.

At December 31, 2010, LKE had AROs totaling \$103 million recorded on the Consolidated Balance Sheets. Of the total amount, \$64 million, or 62%, relates to LKE's ash ponds, landfills and natural gas mains. The most significant assumptions surrounding AROs are the forecasted retirement costs, the discount rates and the inflation rates. A variance in the forecasted retirement costs, the discount rates or the inflation rates could have a significant impact on the ARO liabilities.

The following chart reflects the sensitivities related to LKE's ARO liabilities for ash ponds, landfills and natural gas mains as of December 31, 2010:

	<u>Change in Assumption</u>	<u>Impact on ARO Liability</u>
Retirement cost	10%/(10)%	\$7/\$ (7)
Discount rate	0.25%/(0.25)%	\$(4)/\$3
Inflation rate	0.25%/(0.25)%	\$4/\$ (4)

Income Tax Uncertainties

Significant management judgment is required in developing LKE's provision for income taxes primarily due to the uncertainty related to tax positions taken or expected to be taken in tax returns and the determination of deferred tax assets, liabilities and valuation allowances.

Significant management judgment is required to determine the amount of benefit recognized related to an uncertain tax position. LKE evaluates its tax positions following a two-step process. The first step requires an entity to determine whether, based on the technical merits supporting a particular tax position, it is more likely than not (greater than a 50% chance) that the tax position will be sustained. This determination assumes that the relevant taxing authority will examine the tax position and is aware of all the relevant facts surrounding the tax position. The second step requires an entity to recognize in the financial statements the benefit of a tax position that meets the more-likely-than-not recognition criterion. The benefit recognized is measured at the largest amount of benefit that has a likelihood of

realization, upon settlement, that exceeds 50%. LKE's management considers a number of factors in assessing the benefit to be recognized, including negotiation of a settlement.

On a quarterly basis, LKE reassesses its uncertain tax positions by considering information known at the reporting date. Based on management's assessment of new information, LKE may subsequently recognize a tax benefit for a previously unrecognized tax position, de-recognize a previously recognized tax position or re-measure the benefit of a previously recognized tax position. The amounts ultimately paid upon resolution of issues raised by taxing authorities may differ materially from the amounts accrued and may materially impact LKE financial statements in the future.

The balance sheet classification of unrecognized tax benefits and the need for valuation allowances to reduce deferred tax assets also require significant management judgment. LKE classifies unrecognized tax benefits as current, to the extent management expects to settle an uncertain tax position, by payment or receipt of cash, within one year of the reporting date. Valuation allowances are initially recorded and reevaluated each reporting period by assessing the likelihood of the ultimate realization of a deferred tax asset. Management considers a number of factors in assessing the realization of a deferred tax asset, including the reversal of temporary differences, future taxable income and ongoing prudent and feasible tax planning strategies. Any tax planning strategy utilized in this assessment must meet the recognition and measurement criteria utilized by LKE to account for an uncertain tax position. See Note 10, Income Taxes, for the required disclosures.

At December 31, 2010, LKE's existing reserve exposure to either increases or decreases in unrecognized tax benefits during the next 12 months is less than \$1 million. This change could result from subsequent recognition, de-recognition and/or changes in the measurement of uncertain tax positions. The events that could cause these changes are direct settlements with taxing authorities, litigation, legal or administrative guidance by relevant taxing authorities and the lapse of an applicable statute of limitations.

Purchase Price Allocation

On November 1, 2010, PPL completed the acquisition of LKE and its subsidiaries. In accordance with accounting guidance on business combinations, the identifiable assets acquired and the liabilities assumed were measured at fair value at the acquisition date. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The excess of the purchase price over the estimated fair value of the identifiable net assets is recorded as goodwill.

The determination and allocation of fair value to the identifiable assets acquired and liabilities assumed was based on various assumptions and valuation methodologies requiring considerable management judgment, including estimates based on key assumptions of the acquisition and historical and current market data. The most significant variables in these valuations were the discount rates, the number of years on which to base cash flow projections, as well as the assumptions and estimates used to determine cash inflows and outflows. Although the assumptions applied were reasonable based on information available at the date of acquisition, actual results may differ from the forecasted amounts and the difference could be material.

For purposes of measuring the fair value of the majority of property, plant and equipment and regulatory assets acquired and regulatory liabilities assumed, LKE determined that fair value was equal to net book

value at the acquisition date, because LKE's operations are conducted in a regulated environment and the regulatory commissions allow for earning a rate of return on the book value of a majority of the regulated asset bases at rates determined to be fair and reasonable. As there is no current prospect for deregulation in LKE's operating area, it is expected that these operations will remain in a regulated environment for the foreseeable future, therefore management has concluded that the use of these assets in the regulatory environment represents their highest and best use and a market participant would measure the fair value of these assets using the regulatory rate of return as the discount rate, thus resulting in fair value equal to book value.

The fair value of intangible assets and liabilities (e.g. contracts that have favorable or unfavorable terms relative to market), including coal contracts and power purchase agreements, as well as emission allowances, have been reflected on the Consolidated Balance Sheets with offsetting regulatory assets or liabilities. Prior to the acquisition, LKE recovered the cost of the coal contracts, power purchases and emission allowances and this rate treatment will continue after the acquisition. As a result, management believes the regulatory assets and liabilities created to offset the fair value adjustments meet the recognition criteria established by existing accounting guidance and eliminate any ratemaking impact of the fair value adjustments. LKE's customer rates will continue to reflect these items (e.g. coal, purchased power, emission allowances) at their original contracted prices.

LKE also considered whether a separate fair value should be assigned to LKE's rights to operate within its various electric and natural gas distribution service areas but concluded that these rights only provided the opportunity to earn a regulated return and barriers to market entry, which in management's judgment is not considered a separately identifiable intangible asset under applicable accounting guidance; rather, it is considered going-concern value, or goodwill.

See Note 2, Acquisition by PPL and Note 7, Goodwill and Intangible Assets, for further information.

New Accounting Guidance

Recent accounting pronouncements affecting LKE are detailed in Note 1, Summary of Significant Accounting Policies.

Other Information

PPL's Audit Committee has approved the audit fees and audit-related services. The audit-related services include services in connection with regulatory filings, reviews of offering documents and registration statements and internal control reviews.

Management's Report of Internal Control Over Financial Reporting

Through December 31, 2010, the Company was not subject to the internal control and other requirements of the Sarbanes-Oxley Act of 2002 and associated rules (the "Act") and consequently is not required to evaluate the effectiveness of its internal control over financial reporting pursuant to Section 404 of the Act. However, management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process affected by those charged with governance, management and other personnel, designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. A company's internal control over financial reporting includes those policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2010, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control - Integrated Framework*. Management has concluded that, as of December 31, 2010, the Company's internal control over financial reporting was effective based on those criteria.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2010, has been audited by PricewaterhouseCoopers LLP, an independent accounting firm, as stated in its report which is included herein.

LG&E and KU Energy LLC
Consolidated Statements of Income
(millions)

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, <u>2009</u> <u>2008</u>	
Operating revenues	\$ 494	\$ 2,214	\$ 2,501	\$ 2,675
Operating expenses:				
Fuel for electric generation	138	723	762	859
Power purchased (Note 13)	15	102	136	153
Natural gas supply expenses	53	109	243	349
Other operation and maintenance expenses	143	607	678	604
Depreciation and amortization	<u>49</u>	<u>235</u>	<u>271</u>	<u>265</u>
Total operating expenses	<u>398</u>	<u>1,776</u>	<u>2,090</u>	<u>2,230</u>
Loss on impairment	<u>-</u>	<u>-</u>	<u>(1,493)</u>	<u>(1,806)</u>
Operating income (loss)	96	438	(1,082)	(1,361)
Equity in earnings of unconsolidated venture .	-	3	-	29
Derivative gain (loss) (Note 5)	-	19	18	(37)
Interest expense (Notes 5, 11 and 12)	20	21	21	46
Interest expense to affiliated companies (Notes 11, 12 and 15)	4	131	155	138
Other income (expense) - net	<u>(2)</u>	<u>(8)</u>	<u>5</u>	<u>17</u>
Income (loss) from continuing operations, before income taxes	70	300	(1,235)	(1,536)
Income tax expense (Note 10)	<u>25</u>	<u>109</u>	<u>82</u>	<u>78</u>
Income (loss) from continuing operations	<u>45</u>	<u>191</u>	<u>(1,317)</u>	<u>(1,614)</u>

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

LG&E and KU Energy LLC
Consolidated Statements of Income (continued)
(millions)

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, <u>2009</u> <u>2008</u>	
Discontinued operations (Note 19):				
Loss from discontinued operations				
before tax	\$ -	\$ (7)	\$ (222)	\$ (287)
Income tax benefit from discontinued operations	<u> -</u>	<u> 3</u>	<u> 71</u>	<u> 114</u>
Income (loss) from discontinued operations before noncontrolling interest.....	-	(4)	(151)	(173)
Gain (loss) on disposal of discontinued operations before tax	4	5	(114)	-
Income tax benefit (expense) from disposal of discontinued operations.....	<u> (2)</u>	<u> (2)</u>	<u> 45</u>	<u> -</u>
Gain (loss) on disposal of discontinued operations	<u> 2</u>	<u> 3</u>	<u> (69)</u>	<u> -</u>
Net income (loss).....	47	190	(1,537)	(1,787)
Noncontrolling interest - loss from discontinued operations	<u> -</u>	<u> -</u>	<u> (5)</u>	<u> (8)</u>
Net income (loss) attributable to member	<u>\$ 47</u>	<u>\$ 190</u>	<u>\$ (1,542)</u>	<u>\$ (1,795)</u>

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

LG&E and KU Energy LLC
Consolidated Statements of Retained Earnings (Deficit)
(millions)

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, <u>2009</u> <u>2008</u>	
Balance at beginning of period.....	\$ (2,654)	\$ (2,763)	\$ (1,172)	\$ 691
Effect of PPL acquisition.....	<u>2,654</u>	<u>-</u>	<u>-</u>	<u>-</u>
Balance at November 1, 2010	-	-	-	-
Net income (loss) attributable to member	47	190	(1,542)	(1,795)
Cash dividends declared (Note 15).....	<u>-</u>	<u>(81)</u>	<u>(49)</u>	<u>(68)</u>
Balance at end of period.....	<u>\$ 47</u>	<u>\$ (2,654)</u>	<u>\$ (2,763)</u>	<u>\$ (1,172)</u>

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

LG&E and KU Energy LLC
Consolidated Statements of Comprehensive Income (Loss)
(millions)

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, <u>2009</u> <u>2008</u>	
Net income (loss).....	\$ 47	\$ 190	\$ (1,537)	\$ (1,787)
Other comprehensive income (loss):				
Defined-benefit pension and postretirement plans, net of tax benefit (expense) of \$(3), \$13, \$(11) and \$31, respectively (Note 9)	6	(18)	18	(46)
Gain (loss) on derivative instruments, net of tax benefit (expense) of \$0, \$(7), \$(2) and \$0, respectively (Notes 1 and 5)	-	10	3	(2)
Equity investee's other comprehensive income (loss), net of tax benefit benefit of \$0, \$1, \$0 and \$0, respectively (Note 1)	-	(2)	-	-
Foreign currency translation adjustment, net of tax benefit of \$0, \$0, \$2 and \$2, respectively (Note 19)	-	-	(6)	(7)
Comprehensive income (loss)	<u>53</u>	<u>180</u>	<u>(1,522)</u>	<u>(1,842)</u>
Noncontrolling interest - loss from discontinued operations	-	-	(5)	(8)
Other comprehensive (income) loss allocable to noncontrolling interest:				
Foreign currency translation adjustment	-	-	4	4
Income tax benefit related to items of other comprehensive income	-	-	(1)	(1)
Comprehensive income (loss) attributable to member	<u>\$ 53</u>	<u>\$ 180</u>	<u>\$ (1,524)</u>	<u>\$ (1,847)</u>

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

LG&E and KU Energy LLC
Consolidated Balance Sheets
(millions)

	Successor December 31, 2010	Predecessor December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents.....	\$ 11	\$ 7
Accounts receivable (less allowance for doubtful accounts: 2010, \$17; 2009, \$4):		
Customer.....	160	145
Affiliated companies.....	2	-
Other.....	33	34
Unbilled revenues.....	170	141
Fuel, materials and supplies:		
Fuel (predominantly coal).....	163	158
Natural gas stored underground.....	60	56
Other materials and supplies.....	75	72
Notes receivable from affiliated companies.....	61	-
Income taxes receivable.....	40	8
Deferred income taxes - net (Note 10).....	66	10
Assets of discontinued operations (Note 19).....	-	90
Regulatory assets (Note 3).....	22	46
Available for sale debt securities.....	163	-
Other intangible assets.....	58	-
Prepayments and other current assets.....	26	28
Total current assets.....	1,110	795
Investment in unconsolidated venture (Note 1).....	31	21
Property, plant and equipment:		
Regulated utility plant – electric and natural gas.....	6,230	9,092
Non-regulated property, plant and equipment.....	4	19
Property, plant and equipment in service, gross.....	6,234	9,111
Accumulated depreciation.....	(31)	(3,560)
Construction work in progress.....	1,340	1,599
Property, plant and equipment - net.....	7,543	7,150

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

LG&E and KU Energy LLC
Consolidated Balance Sheets (continued)
(millions)

	Successor December 31, 2010	Predecessor December 31, 2009
Deferred debits and other assets:		
Regulatory assets (Notes 3 and 9):		
Pension and postretirement benefits	\$ 330	\$ 309
Other regulatory assets.....	259	242
Goodwill (Notes 2 and 7)	996	837
Cash surrender value of key man life insurance.....	39	38
Other intangible assets (Notes 2 and 7).....	356	-
Other assets	<u>55</u>	<u>37</u>
Total deferred debits and other assets.....	<u>2,035</u>	<u>1,463</u>
Total assets	<u>\$ 10,719</u>	<u>\$ 9,429</u>

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

LG&E and KU Energy LLC
Consolidated Balance Sheets (continued)
(millions)

	Successor December 31, 2010	Predecessor December 31, 2009
Liabilities and Equity		
Current liabilities:		
Current portion of long-term debt (Note 11).....	\$ 2	\$ 348
Current portion of long-term debt to affiliated company (Notes 11 and 12)	-	358
Notes payable to affiliated company (Notes 12 and 15)	-	851
Note payable.....	163	-
Accounts payable	189	222
Accounts payable to affiliated companies (Note 15)	3	43
Customer deposits	46	44
Accrued taxes	27	22
Liabilities of discontinued operations (Note 19)	-	7
Regulatory liabilities (Note 3)	92	42
Derivative liabilities (Note 5)	4	76
Accrued interest.....	17	5
Employee accruals.....	69	59
Other current liabilities.....	32	31
Total current liabilities	644	2,108
Long-term debt:		
Long-term debt (Note 11).....	3,823	416
Long-term debt to affiliated companies (Notes 11 and 15).....	-	3,063
Total long-term debt	3,823	3,479
Deferred credits and other liabilities:		
Deferred income taxes (Note 10)	240	87
Accumulated provision for pensions (Note 9).....	449	540
Investment tax credits (Note 10)	150	152
Asset retirement obligations (Note 4)	103	65
Regulatory liabilities (Note 3):		
Accumulated cost of removal of utility plant	623	594
Other regulatory liabilities	394	69
Derivative liabilities (Note 5).....	32	28
Other liabilities	250	83
Total deferred credits and other liabilities.....	2,241	1,618

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

LG&E and KU Energy LLC
Consolidated Balance Sheets (continued)
(millions)

	Successor December 31, 2010	Predecessor December 31, 2009
Equity:		
Membership units, without par value – authorized 10,000,000 units, outstanding 1,001 units	\$ -	\$ 774
Additional paid-in capital	3,958	4,224
Retained earnings:		
Retained earnings (deficit)	47	(2,763)
Accumulated other comprehensive income (loss) (Note 17)	<u>6</u>	<u>(43)</u>
Total member’s equity	4,011	2,192
Noncontrolling interest	<u>-</u>	<u>32</u>
Total equity	<u>4,011</u>	<u>2,224</u>
Total liabilities and equity	<u>\$ 10,719</u>	<u>\$ 9,429</u>

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

LG&E and KU Energy LLC
Consolidated Statements of Cash Flows
(millions)

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008	
Cash flows from operating activities:				
Net income	\$ 47	\$ 190	\$ (1,537)	\$ (1,787)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation and amortization	49	235	271	265
Deferred income taxes – net.....	52	67	46	(14)
Investment tax credits (Note 10).....	-	(2)	(3)	(4)
Provision for pension and postretirement benefits	13	52	83	41
Loss on impairment of goodwill.....	-	-	1,493	1,806
Unrealized (gain) loss on derivatives.	-	14	(33)	48
Undistributed earnings of unconsolidated venture.....	-	(3)	11	1
Loss from discontinued operations – net of tax.....	(2)	1	225	181
Regulatory asset for unrealized gain on interest rate swaps (Note 5)	-	(22)	-	-
Other – net.....	3	2	(3)	(2)
Change in current assets and liabilities:				
Accounts receivable	(16)	12	69	14
Unbilled revenues	(70)	41	4	(13)
Fuel, materials and supplies	15	(28)	31	(69)
Regulatory assets	(2)	10	-	-
Other current assets.....	(3)	9	(3)	(1)
Accounts payable	(15)	(34)	(44)	25
Accounts payable to affiliates	4	(7)	(20)	35
Accrued taxes.....	(36)	16	(76)	(4)
Regulatory liabilities	14	(21)	-	-
Other current liabilities	(25)	49	1	(16)
Pension and postretirement funding (Note 9).....	(8)	(57)	(51)	(18)
Storm restoration regulatory asset.....	-	-	(101)	(26)
Other regulatory assets	-	15	40	(20)
Deferred income taxes – net.....	11	27	11	12
Other regulatory liabilities	2	(26)	(52)	10
Discontinued operations.....	-	13	(655)	(69)
Change in smelter contract liability.....	(15)	(51)	75	-
Other – net.....	8	(14)	14	(5)
Net cash provided by (used in) operating activities	<u>26</u>	<u>488</u>	<u>(204)</u>	<u>390</u>

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

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

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008	
Cash flows from investing activities:				
Construction expenditures.....	\$ (152)	\$ (447)	\$ (703)	\$ (931)
Construction expenditures – discontinued operations	-	-	(23)	(28)
Proceeds from sales of discontinued operations.....	-	21	-	-
Proceeds from sale of assets.....	-	-	3	9
Change in restricted cash.....	2	-	10	1
Loans to affiliates	(61)	-	-	-
Cash settlement on derivatives	-	-	7	(8)
Net cash provided by (used in) investing activities	<u>(211)</u>	<u>(426)</u>	<u>(706)</u>	<u>(957)</u>
Cash flows from financing activities:				
Issuance of long-term debt (Note 11).....	2,890	-	-	78
Issuance of short-term note payable (Note 12).....	163	-	-	-
Short-term borrowings from affiliated company – net (Notes 11 and 15).....	-	(3)	(22)	237
Other borrowings from affiliated companies (Notes 11 and 15)	2,784	950	1,230	575
Repayments on other borrowings to affiliated companies (Notes 11, 12 and 15).....	(2,784)	(900)	(255)	-
Repayments to E.ON affiliates.....	(4,319)	-	-	-
Debt issuance costs.....	(32)	-	-	-
Retirement of long-term debt	-	-	-	(67)
Acquisition of outstanding bonds.....	-	-	-	(339)
Reissuance of reacquired bonds	-	-	-	159
Distributions to noncontrolling interests – discontinued operations	-	-	(2)	(7)
Payment of dividends (Note 15).....	-	(87)	(49)	(68)
Capital contribution from member (Note 2).....	1,565	-	-	-
Distribution to member	(100)	-	-	-
Net cash provided by (used in) financing activities	<u>167</u>	<u>(40)</u>	<u>902</u>	<u>568</u>
Change in cash and cash equivalents.....	(18)	22	(8)	1

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

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

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008	
Cash and cash equivalents at beginning of period	\$ 29	\$ 7	\$ 15	\$ 14
Cash and cash equivalents at end of period	<u>\$ 11</u>	<u>\$ 29</u>	<u>\$ 7</u>	<u>\$ 15</u>
Supplemental disclosures of cash flow information:				
Cash paid (received) during the year for:				
Interest – net of amount capitalized ...	\$ 41	\$ 153	\$ 161	\$ 163
Income taxes – net.....	(1)	9	(8)	61

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

LG&E and KU Energy LLC
Consolidated Statements of Capitalization
(millions)

	<u>Successor</u> December 31, 2010	<u>Predecessor</u> December 31, 2009
Long-term debt (Note 12):		
Louisville Gas and Electric Company:		
First mortgage bonds:		
First mortgage bond 2015 Series, due November 15, 2015, 1.625%	\$ 250	\$ -
First mortgage bond 2040 Series, due November 15, 2040, 5.125%	<u>285</u>	<u>-</u>
Total LG&E first mortgage bonds.....	<u>535</u>	<u>-</u>
Pollution control series:		
Jefferson Co. 2001 Series A, due September 1, 2026, variable % ..	22	22
Trimble Co. 2001 Series A, due September 1, 2026, variable %	28	28
Jefferson Co. 2000 Series A, due May 1, 2027, 5.375%	25	25
Jefferson Co. 2001 Series A, due September 1, 2027, variable % ..	10	10
Jefferson Co. 2001 Series B, due November 1, 2027, variable % ...	35	35
Trimble Co. 2001 Series B, due November 1, 2027, variable %	35	35
Trimble Co. 2000 Series A, due August 1, 2030, variable %	83	83
Trimble Co. 2002 Series A, due October 1, 2032, variable %	42	42
Louisville Metro 2007 Series A, due June 1, 2033, 5.625%	31	31
Louisville Metro 2007 Series B, due June 1, 2033, variable %	35	35
Trimble Co. 2007 Series A, due June 1, 2033, 4.60%	60	60
Louisville Metro 2003 Series A, due October 1, 2033, variable %	128	128
Louisville Metro 2005 Series A, due February 1, 2035, 5.75%	<u>40</u>	<u>40</u>
Total LG&E pollution control bonds including reacquired bonds	<u>574</u>	<u>574</u>
Less reacquired bonds	<u>-</u>	<u>163</u>
Total LG&E pollution control bonds	<u>574</u>	<u>411</u>

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

LG&E and KU Energy LLC
Consolidated Statements of Capitalization (continued)
(millions)

	Successor December 31, 2010	Predecessor December 31, 2009
Due to affiliates:		
Fidelia, due January 16, 2012, 4.33%, unsecured	\$ -	\$ 25
Fidelia, due April 30, 2013, 4.55%, unsecured	-	100
Fidelia, due August 15, 2013, 5.31%, unsecured	-	100
Fidelia, due November 23, 2015, 6.48%, unsecured	-	50
Fidelia, due July 25, 2018, 6.21%, unsecured	-	25
Fidelia, due November 26, 2022, 5.72%, unsecured	-	47
Fidelia, due April 13, 2031, 5.93%, unsecured	-	68
Fidelia, due April 13, 2037, 5.98%, unsecured	-	70
Total LG&E due to affiliates	-	485
Total LG&E debt outstanding	1,109	896

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

LG&E and KU Energy LLC
Consolidated Statements of Capitalization (continued)
(millions)

	Successor December 31, 2010	Predecessor December 31, 2009
Kentucky Utilities Company:		
First mortgage bonds:		
First mortgage bond 2015 Series, due November 1, 2015, 1.625%	\$ 250	\$ -
First mortgage bond 2020 Series, due November 1, 2020, 3.25%	500	-
First mortgage bond 2040 Series, due November 1, 2040, 5.125%	<u>750</u>	<u>-</u>
Total KU first mortgage bonds.....	<u>1,500</u>	<u>-</u>
Pollution control series:		
Mercer Co. 2000 Series A, due May 1, 2023, variable %	13	13
Carroll Co. 2007 Series A, due February 1, 2026, 5.75%	18	18
Carroll Co. 2002 Series A, due February 1, 2032, variable %	21	21
Carroll Co. 2002 Series B, due February 1, 2032, variable %	2	2
Mercer Co. 2002 Series A, due February 1, 2032, variable %	8	8
Muhlenberg Co. 2002 Series A, due February 1, 2032, variable %	2	2
Carroll Co. 2008 Series A, due February 1, 2032, variable %	78	78
Carroll Co. 2002 Series C, due October 1, 2032, variable %	96	96
Carroll Co. 2004 Series A, due October 1, 2034, variable %	50	50
Carroll Co. 2006 Series B, due October 1, 2034, variable %	54	54
Trimble Co. 2007 Series A, due March 1, 2037, 6.00%	<u>9</u>	<u>9</u>
Total KU pollution control bonds.....	<u>351</u>	<u>351</u>

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

LG&E and KU Energy LLC
Consolidated Statements of Capitalization (continued)
(millions)

	Successor December 31, 2010	Predecessor December 31, 2009
Due to affiliates:		
Fidelia, due November 24, 2010, 4.24%, unsecured	\$ -	\$ 33
Fidelia, due January 16, 2012, 4.39%, unsecured	-	50
Fidelia, due April 30, 2013, 4.55%, unsecured	-	100
Fidelia, due August 15, 2013, 5.31%, unsecured	-	75
Fidelia, due December 19, 2014, 5.45%, unsecured	-	100
Fidelia, due July 8, 2015, 4.735%, unsecured	-	50
Fidelia, due December 21, 2015, 5.36%, unsecured	-	75
Fidelia, due October 25, 2016, 5.675%, unsecured	-	50
Fidelia, due April 24, 2017, 5.28%, unsecured	-	50
Fidelia, due June 20, 2017, 5.98%, unsecured.....	-	50
Fidelia, due July 25, 2018, 6.16%, unsecured	-	50
Fidelia, due August 27, 2018, 5.645%, unsecured	-	50
Fidelia, due December 17, 2018, 7.035%, unsecured.....	-	75
Fidelia, due July 29, 2019, 4.81%, unsecured	-	50
Fidelia, due October 25, 2019, 5.71%, unsecured	-	70
Fidelia, due November 25, 2019, 4.445%, unsecured	-	50
Fidelia, due February 7, 2022, 5.69%, unsecured	-	53
Fidelia, due May 22, 2023, 5.85%, unsecured.....	-	75
Fidelia, due September 14, 2028, 5.96%, unsecured.....	-	100
Fidelia, due June 23, 2036, 6.33%, unsecured.....	-	50
Fidelia, due March 30, 2037, 5.86%, unsecured	-	75
Total KU due to affiliates	<u>-</u>	<u>1,331</u>
Total KU debt outstanding	<u>1,851</u>	<u>1,682</u>
LKC:		
Medium term notes, due November 1, 2011, 7.47%	<u>2</u>	<u>2</u>
Total LKC debt outstanding	<u>2</u>	<u>2</u>

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

LG&E and KU Energy LLC
Consolidated Statements of Capitalization (continued)
(millions)

	Successor December 31, 2010	Predecessor December 31, 2009
LKE:		
Senior notes:		
Senior unsecured note, 2015 Series, due November 15, 2015, 2.125%	\$ 400	\$ -
Senior unsecured note, 2020 Series, due November 15, 2020, 3.75%	<u>475</u>	<u>-</u>
Total LKE senior notes.....	<u>875</u>	<u>-</u>
Due to affiliates:		
Fidelia, due April 30, 2010, 4.64%, unsecured	-	150
Fidelia, due June 28, 2010, variable, unsecured	-	100
Fidelia, due October 15, 2010, 7.01%, unsecured	-	75
Fidelia, due January 6, 2011, 7.784%, unsecured	-	50
Fidelia, due July 5, 2011, variable, unsecured.....	-	300
Fidelia, due April 24, 2012, variable, unsecured.....	-	50
Fidelia, due November 19, 2012, variable, unsecured.....	-	75
Fidelia, due November 26, 2012, variable, unsecured.....	-	50
Fidelia, due December 19, 2012, 5.52%, unsecured	-	100
Fidelia, due December 21, 2012, variable, unsecured	-	100
Fidelia, due January 15, 2014, 6.044%, unsecured	-	75
Fidelia, due June 20, 2014, variable, unsecured	-	50
Fidelia, due June 23, 2014, variable, unsecured	-	50
Fidelia, due October 27, 2014, variable, unsecured	-	50
E.ON North America, due October 27, 2014, 4.63%, unsecured	-	50
Fidelia, due March 25, 2015, variable, unsecured	-	75
Fidelia, due February 17, 2016, variable, unsecured	-	80
Fidelia, due December 20, 2016, variable, unsecured	-	50
Fidelia, due April 25, 2017, 5.71%, unsecured	<u>-</u>	<u>75</u>
Total LKE due to affiliates	<u>-</u>	<u>1,605</u>
Total LKE debt outstanding	<u>875</u>	<u>1,605</u>

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

LG&E and KU Energy LLC
Consolidated Statements of Capitalization (continued)
(millions)

	Successor December 31, 2010	Predecessor December 31, 2009
Total debt outstanding	\$ 3,837	\$ 4,185
Purchase accounting adjustments and discounts	(12)	-
Less current portion of long-term debt	2	706
Long-term debt	3,823	3,479
Equity:		
Membership units, without par value -		
Authorized 10,000,000 units, outstanding 1,001 units	-	774
Additional paid-in capital	3,958	4,224
Accumulated other comprehensive income (loss) (Note 17).....	6	(43)
Retained earnings (deficit).....	47	(2,763)
Total member's equity.....	4,011	2,192
Noncontrolling interest	-	32
Total equity.....	4,011	2,224
Total capitalization	\$ 7,834	\$ 5,703

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

LG&E and KU Energy LLC and Subsidiaries
Notes to Consolidated Financial Statements

Note 1 - Summary of Significant Accounting Policies

General

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

Business

LKE is a holding company with regulated utility operations through its subsidiaries, LG&E and KU. 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 PUHCA 2005.

Headquartered in Allentown, Pennsylvania, PPL is an energy and utility holding company that was incorporated in 1994. Through its subsidiaries, PPL owns or controls about 19,000 megawatts of generating capacity in the U.S., sells energy in key U.S. markets and delivers electricity and natural gas to about 5.3 million customers in the U.S. and the U.K.

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. LG&E and KU maintain their separate identities and serve customers in Kentucky under their respective names. KU also serves customers in Virginia under the Old Dominion Power name and it serves customers in Tennessee under the KU name.

LG&E provides electric service to approximately 395,000 customers in Louisville and adjacent areas in Kentucky, covering approximately 700 square miles in nine counties. KU provides electric service to approximately 514,000 customers in 77 counties in central, southeastern and western Kentucky, to approximately 30,000 customers in five counties in southwestern Virginia and to less than ten customers in Tennessee. KU also sells wholesale electric energy to 12 municipalities in Kentucky. During 2010, approximately 95% of the electricity generated by LG&E and 98% of that generated by KU was produced by their coal-fired electric generating stations. The remainder is generated by natural gas and oil fueled CTs and hydroelectric power plants. LG&E purchases, transports, distributes or stores natural gas for 320,000 customers in Kentucky.

LKC has been the primary holding company for the Company's non-utility businesses. Its businesses included:

- *WKE*. WKE had a 25-year lease of and operated the generating facilities of Big Rivers, a power generation cooperative in western Kentucky and a coal-fired facility owned by Henderson Municipal Power and Light, which is owned by the City of Henderson, Kentucky. The Company classified WKE as discontinued operations effective December 31, 2005 and it terminated the WKE lease and disposed of the operations in July 2009.

- *Argentine Natural Gas Distribution.* Through its Argentine natural gas distribution operations, LKC owned interests in entities which distribute natural gas to approximately one million customers in Argentina through two distribution companies (Centro and Cuyana). The Company classified its Argentine natural gas distribution operations as discontinued operations effective December 31, 2009 and it sold the operations on January 1, 2010.

For further discussion of the WKE lease and the Argentine natural gas distribution matters, see Note 13, Commitments and Contingencies and Note 19, Discontinued Operations.

Servco provides services to affiliated entities, including LKE, LG&E, KU, LKC and LEM, at cost, as permitted under PUHCA 2005.

Consolidation and Basis of Accounting

The consolidated financial statements include the following companies: LKE, LG&E, KU, LEM, Servco and 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.

LKE's basis of accounting incorporates the business combinations guidance of the FASB ASC as of the date of the acquisition, which requires the recognition and measurement of identifiable assets acquired and liabilities assumed at fair value as of the acquisition date. LKE's financial statements and accompanying footnotes have been segregated to present pre-acquisition activity as the Predecessor and post-acquisition activity as the Successor. Predecessor covers the time period prior to November 1, 2010. Successor 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 below, and 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, for information regarding the acquisition and the purchase accounting adjustments.

Changes in Classification

Certain reclassification entries have been made to the Predecessor's previous years' financial statements to conform to the 2010 presentation with no impact on total assets, liabilities and capitalization or previously reported net income and cash flows. These reclassifications consist mainly of those necessary to present the Company's Argentine natural gas distribution businesses as discontinued operations and to identify amounts for prior periods that are separately disclosed in the financial statements. See Note 19, Discontinued Operations, for further information.

Regulatory Accounting

LG&E and KU are cost-based rate-regulated utilities. As a result, the financial statements reflect the effects of regulatory actions. Regulatory assets are recognized for the effect of transactions or events where future recovery is probable in regulated customer rates. The effect of such accounting is to defer

certain or qualifying costs that would otherwise be charged to expense. Likewise, regulatory liabilities may be recognized for obligations expected to be returned through future regulated customer rates. The effect of such transactions or events would otherwise be reflected as income, or, in certain cases, regulatory liabilities are recorded based on the understanding with the regulator that current rates are being set to recover costs that are expected to be incurred in the future. The regulated entity is accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose. Offsetting regulatory assets or liabilities for fair value purchase accounting adjustments have also been recorded to eliminate any ratemaking impact of the fair value adjustments. The accounting for regulatory assets and liabilities is based on specific ratemaking decisions or precedent for each transaction or event as prescribed by the FERC, the Kentucky Commission, the Virginia Commission or the Tennessee Regulatory Authority. See Note 3, Rates and Regulatory Matters, for additional detail regarding regulatory assets and liabilities.

Management's Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported assets and liabilities, the disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Derivative Financial Instruments

LKE enters into interest rate swap contracts to hedge exposure to variability in expected cash flows associated with existing debt instruments. LKE enters into energy trading contracts to manage price risk and to maximize the value of power sales from the physical assets it owns.

Interest rate swap contracts and energy trading contracts meet the definition of a derivative and are reflected on the Consolidated Balance Sheets at fair value in accordance with the derivatives and hedging guidance of the FASB ASC. Beginning in the third quarter of 2010, the change in fair value of interest rate swap contracts is recorded as regulatory assets or liabilities based on an Order from the Kentucky Commission in the 2010 rate case whereby the cost of a terminated swap was allowed to be recovered in base rates. Prior to the third quarter, interest rate swaps designated as effective cash flow hedges had resulting gains and losses recorded within other comprehensive income and common equity. The ineffective portion of interest rate swaps designated as cash flow hedges was previously recorded to earnings monthly, as was the entire change in the market value of the ineffective swaps. The energy trading contracts are non-hedging derivatives and the change in value is recognized in earnings on a mark-to-market basis.

Interest rate swap contracts are recorded by the Successor as "Other current liabilities" or non-current "Derivative liabilities" on the Consolidated Balance Sheets. The current and non-current interest rate swap liabilities are calculated by dividing the total interest rate swap liability by the number of years remaining on the contract at the end of the period. The Predecessor classified all interest rate swap liabilities as non-current "Derivative liabilities" on the Consolidated Balance Sheets. The Predecessor and Successor presentation are both appropriate under GAAP. The Predecessor and Successor determine the classification of energy trading contracts based on the settlement date of the individual contracts. Energy trading contracts classified as current are recognized in "Prepayments and other current assets" or "Other current liabilities" on the Consolidated Balance Sheets. Energy trading contracts classified as non-current are recognized in "Other assets" or long-term "Derivative liabilities" on the Consolidated

Balance Sheets. Cash inflows and outflows related to derivative instruments are included as a component of operating activity on the Consolidated Statements of Cash Flows due to the underlying nature of the hedged items.

The Company does not net collateral against derivative instruments.

See Note 5, Derivative Financial Instruments, and Note 6, Fair Value Measurements, for further information on derivative instruments.

Revenue and Accounts Receivable

The operating revenues line item in the Consolidated Statements of Income contains revenues from the following:

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31,	
			2009	2008
Residential	\$ 219	\$ 886	\$ 1,020	\$ 1,044
Industrial and commercial	209	997	1,112	1,159
Municipals	15	88	91	92
Other retail	42	212	227	213
Wholesale	9	31	51	167
	\$ 494	\$ 2,214	\$ 2,501	\$ 2,675

Revenue Recognition

Revenues are recorded based on service rendered to customers through month-end. Operating revenues are recorded based on energy deliveries through the end of the calendar month. Unbilled retail revenues result because customers' meters are read and bills are rendered throughout the month, rather than all being read at the end of the month. Unbilled revenues for a month are calculated by multiplying an estimate of unbilled kWh by the estimated average cents per kWh.

Accounts Receivable

Accounts receivable are reported in the Consolidated Balance Sheets at the gross outstanding amount adjusted for an allowance for doubtful accounts.

Allowance for Doubtful Accounts

The allowance for doubtful accounts included in "Accounts receivable – customer accounts" is based on the ratio of the amounts charged-off during the last twelve months to the retail revenues billed over the same period, multiplied by the retail revenues billed over the last four months. Accounts with no payment activity are charged-off after four months, although collection efforts continue thereafter. The allowance for doubtful accounts included in "Accounts receivable – other" accounts receivable is composed of accounts aged more than four months. Accounts are written off as management determines them uncollectible.

The changes in the allowance for doubtful accounts were:

	Successor	Predecessor		
	December 31, 2010	October 31, 2010	December 31, 2009	December 31, 2008
Balance at beginning of period (a) \$	-	\$ 4	\$ 4	\$ 4
Charged to income	10	(10)	(8)	(6)
Charged to balance sheets	7	10	8	6
Balance at end of period	\$ 17	\$ 4	\$ 4	\$ 4

(a) Successor beginning balance reflects revaluation of accounts receivable due to purchase accounting.

Cash

Cash Equivalents

All highly liquid investments with an original maturity of three months or less are considered to be cash equivalents.

Restricted Cash

Bank deposits and other cash equivalents that are restricted by agreement or that have been clearly designated for a specific purpose are classified as restricted cash. The change in restricted cash is reported as an investing activity on the Consolidated Statements of Cash Flows. On the Consolidated Balance Sheets, the current portion of restricted cash is included in “Prepayments and other current assets”, and the non-current portion is included in “Other assets”. LKE’s December 31, 2010, balance of restricted cash is \$23 million, consisting primarily of cash collateral posted to counterparties related to LKE’s interest rate swap contracts.

Fair Value Measurements

LKE values certain financial assets and liabilities at fair value. Generally, the most significant fair value measurements relate to derivative assets and liabilities, investments in securities including investments in the pension and postretirement benefit plans and reacquired bonds, Predecessor share performance plan liabilities and cash and cash equivalents. LKE uses, as appropriate, a market approach (generally, data from market transactions), an income approach (generally, present value techniques) and/or a cost approach (generally, replacement cost) to measure the fair value of an asset or liability. These valuation approaches incorporate inputs such as observable, independent market data and/or unobservable data that management believes are predicated on the assumptions that market participants would use to price an asset or liability. These inputs may incorporate, as applicable, certain risks such as nonperformance risk, which includes credit risk.

LKE prioritizes fair value measurements for disclosure by grouping them into one of three levels in the fair value hierarchy. The highest priority is given to measurements using level 1 inputs. The appropriate level assigned to a fair value measurement is based on the lowest level input that is significant to the fair value measurement in its entirety. The three levels of the fair value hierarchy are as follows:

- Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 - Other inputs that are directly or indirectly observable in the marketplace.
- Level 3 - Unobservable inputs which are supported by little or no market activity.

Assessing the significance of a particular input requires judgment that considers factors specific to the asset or liability. As such, LKE's assessment of the significance of a particular input may affect how the assets and liabilities are classified within the fair value hierarchy. See Note 5, Derivative Financial Instruments, and Note 6, Fair Value Measurements, for further information on fair value measurements.

Investments

Investments in Debt Securities

At December 31, 2010 and December 31, 2009, LKE had \$163 million of bonds classified as "Long-term debt" on the Consolidated Balance Sheets that LKE reacquired. The Successor has classified these bonds as "Available for sale debt securities" because management intended to remarket the bonds at a later date. The Predecessor classified the reacquired bonds as an offset to "Long-term debt" because the Company was no longer obligated to any third party investors. The Successor presentation and the Predecessor presentation are both appropriate under GAAP.

Available for sale debt securities are carried at fair value and are classified as current assets on the Consolidated Balance Sheets. Unrealized gains and losses on all available for sale debt securities are reported, net of tax, in other comprehensive income or recognized in earnings when the decline in fair value below cost is determined to be other-than-temporary impairment. For 2010, LKE had no unrealized gains or losses on available for sale debt securities.

The criteria for determining whether a decline in fair value of a debt security is other than temporary and whether the other-than-temporary impairment is recognized in earnings or reported in other comprehensive income when the debt security is in an unrealized position is as follows:

- if there is intent to sell the security or a requirement to sell the security before recovery, the other-than-temporary impairment is recognized currently in earnings;
- if there is no intent to sell the security or requirement to sell the security before recovery, the portion of the other-than-temporary impairment that is considered a credit loss is recognized currently in earnings and the remainder of the other-than-temporary impairment is reported in other comprehensive income, net of tax; or
- if there is no intent to sell the security or requirement to sell the security before recovery and there is no credit loss, the unrealized loss is reported in other comprehensive income, net of tax.

See Note 21, Subsequent Events, for the current status of reacquired bonds.

Equity Method Investment

LKE's equity method investment, included in "Investment in unconsolidated venture" on the Consolidated Balance Sheets, consists of its investment in EEI. LKE owns 20% of the common stock of EEI, which owns and operates a 1,002 Mw summer capacity coal-fired plant and a 74 Mw summer capacity 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 investment interest in EEI, it is not the primary beneficiary and is therefore not consolidated into the Company's financial statements. LKE's investment in EEI is accounted for under the equity method of accounting and as of December 31, 2010 and 2009, totaled \$30 million and \$21 million, respectively. LKE's direct exposure to loss as a result of its involvement with EEI is generally limited to the value of its investment. See Note 2, Acquisition by PPL, for further discussion regarding purchase accounting adjustments recognized for LKE's investment in EEI.

The results of operations and financial position of EEI, LKE's equity method investment, are summarized below.

Condensed income statement information for the years ended December 31 is as follows:

	2010 (unaudited)	2009	2008
Net sales	\$ 343	\$ 297	\$ 514
Net income	16	10	142
LKE's equity in earnings of EEI	3	1	30

Condensed balance sheet information as of December 31 is as follows:

	2010 (unaudited)	2009
Current assets	\$ 62	\$ 84
Long-lived assets	181	178
Total assets	<u>\$ 243</u>	<u>\$ 262</u>
Current liabilities	\$ 113	\$ 166
Long-term liabilities	72	50
Equity	58	46
Total liabilities and equity	<u>\$ 243</u>	<u>\$ 262</u>

Cost Method Investment

LKE's cost method investment, included in "Investment in unconsolidated venture" on the Consolidated Balance Sheets, consists of the Utilities' investment in OVEC. The Utilities and ten other electric utilities are owners of OVEC, which is located in Piketon, Ohio. OVEC owns and operates two coal-fired power plants, Kyger Creek Station in Ohio and Clifty Creek Station in Indiana with combined nameplate generating capacities of 2,390 Mw. OVEC's power is currently supplied to the Utilities and 12 other companies affiliated with the various owners. Pursuant to current contractual agreements, the Utilities own 8.13% of OVEC's common stock and are contractually entitled to 8.13% of OVEC's output. Based on nameplate generating capacity, this would be approximately 194Mw.

As of December 31, 2010 and 2009, LKE's investment in OVEC totaled less than \$1 million. LKE is not the primary beneficiary of OVEC; therefore, it is not consolidated into the Company's financial statements and is accounted for under the cost method of accounting. The direct exposure to loss as a result of the Company's involvement with OVEC is generally limited to the value of its investment; however, LKE may be conditionally responsible for a pro-rata share of certain OVEC obligations. See Note 2, Acquisition by PPL, and Note 13, Commitments and Contingencies, for further discussion regarding purchase accounting adjustments recognized, ownership interest and power purchase rights.

Long-Lived and Intangible Assets

Regulated Utility Plant

Regulated utility plant was stated at original cost for the Predecessor and adjusted to the net book value on November 1, 2010, the acquisition date, for the Successor. LKE determined that fair value was equal to net book value at the acquisition date since LKE's operations are conducted in a regulated environment. Original cost includes payroll-related costs such as taxes, fringe benefits and administrative and general costs. Construction work in progress has been included in the rate base for determining retail customer rates. LKE has not recorded significant allowance for funds used during construction in accordance with the FERC.

The cost of plant retired or disposed of in the normal course of business is deducted from plant accounts and such cost is charged to the reserve for depreciation. When complete operating units are disposed of, appropriate adjustments are made to the reserve for depreciation and gains and losses, if any, are recognized.

Capitalized Software Cost

Included in "Property, plant and equipment" on the Consolidated Balance Sheets are capitalized costs of software projects that were developed or obtained for internal use. These capitalized costs are amortized ratably over the expected lives of the projects when they become operational, generally not to exceed five years. Following are capitalized software costs and the accumulated amortization:

Successor		Predecessor	
December 31, 2010		December 31, 2009	
Carrying Amount	Accumulated Amortization (a)	Carrying Amount	Accumulated Amortization
\$ 84	\$ 2	\$ 119	\$ 35

- (a) The accumulated amortization as of November 1, 2010, was netted against the carrying amount of the software as the fair value was determined to be equal to net book value for property, plant and equipment.

Amortization expense of capitalized software costs was as follows:

Successor	Predecessor	
November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008
\$ 2	\$ 12	\$ 14 \$ 12

The amortization of capitalized software is included in “Depreciation and amortization” on the Consolidated Statements of Income.

Depreciation and Amortization

Utility depreciation is provided on the straight-line method over the estimated service lives of depreciable plant. The amounts provided as a percentage of depreciable plant follows:

Year	Percentage
2010	4.7%
2009	2.8%
2008	3.0%

Of the amount provided for depreciation, the following were related to the retirement, removal and disposal costs of long lived assets:

Year	Percentage
2010	0.7%
2009	0.5%
2008	0.5%

Goodwill, Intangible Assets and Asset Impairment

LKE performs a quarterly review to determine if an impairment analyses is required for long-lived assets that are subject to depreciation or amortization. This review identifies changes in circumstances indicating that a long-lived asset’s carrying value may not be recoverable. An impairment analysis will be performed if warranted, based on the review.

For a long-lived asset to be held and used, impairment exists when the carrying amount exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. If the asset is impaired, an impairment loss is recorded to adjust the asset’s carrying amount to its fair value.

As the result of PPL’s acquisition, LKE recorded the fair value of its coal contracts, emission allowances, EEI investment and OVEC power purchase contract. The difference between the fair value and the cost for these assets is being amortized over their useful lives based upon the pattern in which the economic benefits of the intangible assets are consumed or otherwise used. See Note 2, Acquisition by PPL, for methods used to determine the long-lived intangible assets’ fair values. When determining the useful life of an intangible asset, including intangible assets that are renewed or extended, LKE considers the expected use of the asset, the expected useful life of other assets to which the useful life of

the intangible asset may relate and legal, regulatory, or contractual provisions that may limit the useful life. See Note 7, Goodwill and Intangible Assets, for the fair value amounts and amortization periods. The current intangible assets and long-term intangible assets are included in “Other intangible assets” on the Consolidated Balance Sheets.

The Predecessor reported emission allowances in “Other materials and supplies” on the Consolidated Balance Sheets. The emission allowances were not amortized; rather, they were expensed when consumed. The Predecessor did not recognize the coal contracts or the OVEC power purchase contract as these intangible assets were not derivatives. In connection with PPL’s acquisition of LKE, the carrying value of goodwill as of October 31, 2010, was eliminated.

In connection with PPL’s acquisition of LKE, LG&E and KU recorded goodwill, representing the excess of the purchase price paid over the estimated fair value of the assets acquired and liabilities assumed in the acquisition of the businesses. Goodwill is tested annually for impairment during the fourth quarter, or more frequently if management determines that a triggering event may have occurred that would more likely than not reduce the fair value of an operating unit below its carrying value. Goodwill impairment charges are not subject to rate recovery. See Note 7, Goodwill and Intangible Assets, for further discussion regarding the Company’s goodwill and current test results.

Asset Retirement Obligations

LKE recognizes various legal obligations associated with the retirement of long-lived assets as liabilities in the financial statements. Initially this obligation is measured at fair value. An equivalent amount is recorded as an increase in the value of the capitalized asset and allocated to expense over the useful life of the asset. Until the obligation is settled, the liability is increased, through the recognition of accretion expense in the Consolidated Statements of Income, for changes in the obligation due to the passage of time. An offsetting regulatory asset is recognized to reverse the depreciation and accretion expense related to the ARO such that there is no income statement impact. The regulatory asset is relieved when the ARO has been settled. Estimated ARO costs and settlement dates, which affect the carrying value of various AROs and the related assets, are reviewed periodically to ensure that any material changes are incorporated into the latest estimate of the obligations. See Note 4, Asset Retirement Obligations, for further information on AROs.

Defined Benefits

LKE employees benefit from both funded and unfunded retirement benefit plans. An asset or liability is recorded to recognize the funded status of all defined benefit plans with an offsetting entry to regulatory assets or regulatory liabilities on LG&E and KU. Consequently, the funded status of all defined benefit plans is fully recognized on the Consolidated Balance Sheets.

The expected return on plan assets is determined based on the current level of expected return on risk free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class is then weighted based on the current asset allocation.

The discount rate used for pensions, postretirement and post-employment plans by the Predecessor was determined using the Mercer Yield Curve. The expected return on assets assumption was 7.75%. Gains and losses in excess of 10% of the greater of the plan's projected benefit obligation or market value of assets were amortized on a straight-line basis over the average future service period of active participants. The market-related value of assets was equal to the fair market value of the assets.

The discount rate used by the Successor was determined by the Towers Watson Yield Curve based on the individual plan cash flows. The expected return on assets was reduced from 7.75% to 7.25%. The amortization period for the recognition of gains and losses for retirement plans was changed to reflect the Successor's amortization policy. Under the Successor's method, gains and losses in excess of 10% but less than 30% of the greater of the plan's projected benefit obligation or market-related value of assets, are amortized on a straight-line basis over the average future service period of active participants. Gains and losses in excess of 30% of the plan's projected benefit obligation or market-related value of assets are amortized on a straight-line basis over a period equal to one-half of the average future service period of active participants. The market-related value of assets for the qualified retirement plans will be equal to a five year smoothed asset value. Gains and losses in excess of the expected return will be phased-in over a five year period, prospectively from November 1, 2010.

See Note 9, Pension and Other Postretirement Benefit Plans, for further information.

Other

Loss Accruals

Potential losses are accrued when information is available that indicates it is "probable" that a loss has been incurred, given the likelihood of uncertain future events and the amount of the loss can be reasonably estimated. Accounting guidance defines "probable" as cases in which "the future event or events are likely to occur." LKE continuously assesses potential loss contingencies for environmental remediation, litigation claims, regulatory penalties and other events.

LKE does not record the accrual of contingencies that might result in gains unless recovery is assured.

Income Taxes

For the periods ended on or before October 31, 2010, a consolidated federal income tax return is filed by LKE's former direct parent, E.ON US Investments Corp. On November 1, 2010, LKE became a part of PPL's consolidated U.S. federal income tax return.

Significant management judgment is required in developing LKE's provision for income taxes primarily due to the uncertainty related to tax positions taken or expected to be taken in tax returns and the determination of deferred tax assets, liabilities and valuation allowances.

LKE evaluates tax positions following a two-step process. The first step requires an entity to determine whether, based on the technical merits supporting a particular tax position, it is more likely than not (greater than a 50% chance) that the tax position will be sustained. This determination assumes that the relevant taxing authority will examine the tax position and is aware of all the relevant facts surrounding the tax position. The second step requires an entity to recognize in the financial statements the benefit of a tax position that meets the more-likely-than-not recognition criterion. The benefit recognized is

measured at the largest amount of benefit that has a likelihood of realization, upon settlement, that exceeds 50%. The amounts ultimately paid upon resolution of issues raised by taxing authorities may differ materially from the amounts accrued and may materially impact the financial statements of LKE.

Deferred income taxes reflect the net future tax effects of temporary differences between the carrying amounts of assets and liabilities for accounting purposes and their basis for income tax purposes, as well as the tax effects of net operating losses and tax credit carryforwards.

LKE records valuation allowances to reduce deferred tax assets to the amounts that are more likely than not to be realized. LKE considers the reversal of temporary differences, future taxable income and ongoing prudent and feasible tax planning strategies in initially recording and subsequently reevaluating the need for valuation allowances. If LKE determines that it is able to realize deferred tax assets in the future in excess of recorded net deferred tax assets, adjustments to the valuation allowances increase income by reducing tax expense in the period that such determination is made. Likewise, if LKE determines that it is not able to realize all or part of net deferred tax assets in the future, adjustments to the valuation allowances would decrease income by increasing tax expense in the period that such determination is made.

The provision for LKE's deferred income taxes for regulated assets and liabilities is based upon the ratemaking principles reflected in rates established by the regulators. The difference in the provision for deferred income taxes for regulated assets and liabilities and the amount that otherwise would be recorded under GAAP is deferred and included on the Consolidated Balance Sheets in "Regulatory liabilities".

LKE defers investment tax credits when the credits are utilized and amortizes the deferred amounts over the average lives of the related assets.

See Note 10, Income Taxes, for further discussion regarding income taxes.

Leases

LKE evaluates whether arrangements entered into contain leases for accounting purposes.

Materials and Supplies

Fuel, natural gas stored underground and other materials and supplies inventories are accounted for using the average-cost method.

Fuel and Natural Gas Costs

The cost of fuel for electric generation is charged to expense as used and the cost of natural gas supply is charged to expense as delivered to the distribution system. LG&E operates under a Kentucky Commission approved PBR mechanism related to natural gas procurement activity. See Note 3, Rates and Regulatory Matters, for a description of the FAC and GSC.

Debt

The Company's long-term debt includes \$348 million of pollution control bonds, which are subject to tender for purchase at the option of the holder and to mandatory tender for purchase on the occurrence of certain events. The Successor has classified these bonds as long term because the Company has the intent and ability to utilize the Utilities' aggregate \$800 million credit facilities, which mature in December 2014, to fund any mandatory purchases. The Predecessor classified these bonds as current portion of long-term debt due to the tender for purchase provisions. The Successor presentation and the Predecessor presentation are both appropriate under GAAP. See Note 11, Long-Term Debt, and Note 12, Notes Payable and Other Short-Term Obligations, for more information on the Company's debt and credit facilities.

Unamortized Debt Expense

Debt expense is capitalized and amortized over the lives of the related note or bond issues using the straight-line method, which approximates the effective interest method. Depending on the type of expense, the Successor capitalized debt expenses in long-term other regulatory assets or long-term other assets to align with the term of the debt the expenses were related. The Predecessor capitalized debt expenses in current or long-term other regulatory assets or other current or long-term other assets based on the amount of expense expected to be recovered within the next year through rate recovery. Both the Predecessor and the Successor amortize debt expenses over the lives of the related bond issues. The Predecessor presentation and the Successor presentation are both appropriate under regulatory practices and GAAP.

Guarantees

Generally, the initial measurement of a guarantee liability is the fair value of the guarantee at its inception. However, there are certain guarantees excluded from the scope of accounting guidance and other guarantees that are not subject to the initial recognition and measurement provisions of accounting guidance. See Note 13, Commitments and Contingencies, for further discussion of recorded and unrecorded guarantees.

Recent Accounting Pronouncements

The following recent accounting pronouncement affected LKE:

Fair Value Measurements

In January 2010, the FASB issued guidance related to fair value measurement disclosures requiring separate disclosure of amounts of significant transfers in and out of level 1 and level 2 fair value measurements and separate information about purchases, sales, issuances and settlements within level 3 measurements. This guidance is effective for the interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about the roll-forward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. This guidance has no impact on the Company's results of operations, financial position, liquidity or disclosures.

Note 2 - Acquisition by PPL

On November 1, 2010, PPL completed its acquisition of LKE and its subsidiaries. The push-down basis of accounting was used to record the fair value adjustments of assets and liabilities on LKE and its subsidiaries at the acquisition date.

The fair value of the consideration paid by PPL to E.ON for LKE was as follows:

Aggregate enterprise consideration	\$	7,614
Less: funds made available to E.ON U.S. LLC to repay pre-acquisition affiliate indebtedness		4,349
Less: fair value of assumption of long-term debt outstanding, net		772
Cash consideration paid for E.ON U.S. LLC equity interest	\$	<u>2,493</u>

The allocation of the purchase price to the fair value of assets acquired and liabilities assumed is as follows:

Current assets	\$	1,035
Investments		31
Property, plant and equipment		7,469
Other intangible assets		361
Regulatory and other non-current assets		689
Current liabilities (excluding current portion of long-term debt)		(516)
Affiliated debt		(4,349)
Debt (current and non-current)		(934)
Other non-current liabilities		(2,289)
Net identifiable assets acquired		<u>1,497</u>
Goodwill		<u>996</u>
Purchase price		2,493
Capital contribution on November 1, 2010		<u>1,565</u>
Total investment on November 1, 2010	\$	<u>4,058</u>

Goodwill represents value paid for the rate regulated businesses of LG&E and KU, which are located in a defined service area with a constructive regulatory environment, which provides for future investment, earnings and cash flow growth, as well as the talented and experienced workforce. LG&E's and KU's franchise values are being attributed to the going concern value of the business, and thus were recorded as goodwill rather than a separately identifiable intangible asset. None of the goodwill recognized is deductible for income tax purposes or included in customer rates.

Adjustments to LKE's assets and liabilities that contributed to goodwill are as follows:

The fair value adjustment on the EEI investment was calculated using the discounted cash flow valuation method. The result was an increase in LKE's value of the investment in EEI; the fair value of EEI was calculated to be \$30 million. LKE's carrying value for EEI was \$12 million and a fair value adjustment of \$18 million was recorded. The fair value adjustment to EEI is amortized over the expected remaining useful life of plant and equipment at EEI, which is estimated to be over 20 years.

The pollution control bonds, excluding the reacquired bonds, had a fair value of \$770 million compared to a carrying value of \$762 million on November 1, 2010, which resulted in an adjustment of \$8 million. All variable bonds were valued at par while the fixed rate bonds were valued with a yield curve based on average credit spreads for similar bonds.

As a result of the purchase accounting associated with the acquisition, the following items had a fair value adjustment but no effect on goodwill as the offset was either a regulatory asset or liability. The regulatory asset or liability has been recorded to eliminate any ratemaking impact of the fair value adjustments:

- The value of OVEC was determined to be \$126 million based upon an announced transaction by another owner. LKE's stock was valued at approximately \$1 million and the power purchase agreement has been valued at \$125 million. An intangible asset was recorded with the offset to regulatory liability and will be amortized using the units of production method until the power purchase agreement ends in March 2026.
- LKE recorded an emission allowance intangible asset and regulatory liability as the result of adjusting the fair value of the emission allowances at LG&E and KU. The emission allowance intangible of \$17 million represents allocated and purchased SO₂ and NO_x emission allowances that are unused as of the valuation date or allocated for use in future years. LKE had previously recorded emission allowances as other materials and supplies. To conform to PPL's accounting policy all emission allowances are now recorded as intangible assets. The emission allowance intangible asset is amortized as the emission allowances are consumed, which is expected to occur through 2040.
- LKE recorded a coal contract intangible asset of \$269 million and a non-current liability of \$33 million on the Consolidated Balance Sheets. An offsetting regulatory asset was recorded for those contracts with unfavorable terms relative to market. An offsetting regulatory liability was recorded for those contracts that had favorable terms relative to market. All coal contracts held by the Utilities, wherein they had entered into arrangements to buy amounts of coal at fixed prices from counterparties at a future date, were fair valued. The intangible assets and other liabilities, as well as the regulatory assets and liabilities, are being amortized over the same terms as the related contracts, which expire through 2016.
- Adjustments on November 1, 2010 were made to record LKE pension assets at fair value, remeasure its pension and postretirement benefit obligations at current discount rates and eliminate accumulated other comprehensive income (loss). An increase of \$4 million in the liability balances of the Utilities was recorded, due to the lowering of the discount rate; this was credited to their respective pension and postretirement liability balances with offsetting adjustments made to the related regulatory assets and liabilities

The fair value of intangible assets and liabilities (e.g. contracts that have favorable or unfavorable terms relative to market), including coal contracts and power purchase agreements, as well as emission allowances, have been reflected on the Consolidated Balance Sheets with offsetting regulatory assets or liabilities. Prior to the acquisition, LKE recovered the cost of the coal contracts, power purchases and emission allowances and this rate treatment will continue after the acquisition. As a result, management believes the regulatory assets and liabilities created to offset the fair value adjustments meet the recognition criteria established by existing accounting guidance and eliminate any ratemaking impact of the fair value adjustments. LKE's customer rates will continue to reflect these items (e.g. coal, purchased power, emission allowances) at their original contracted prices.

LKE also considered whether a separate fair value should be assigned to LKE's rights to operate within its various electric and natural gas distribution service areas but concluded that these rights only provided the opportunity to earn a regulated return and barriers to market entry, which in management's judgment is not considered a separately identifiable intangible asset under applicable accounting guidance; rather, it is considered going-concern value, or goodwill.

Note 3 - Rates and Regulatory Matters

LG&E and KU are subject to the jurisdiction of the Kentucky Commission and the FERC 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 and as such, its 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. No regulatory assets or regulatory liabilities recorded at the time base rates were determined 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, were recorded on the Consolidated Balance Sheets with offsetting regulatory assets or liabilities. Prior to the acquisition, LKE recovered in customer rates the cost of the coal contracts, power purchases and emission allowances and this rate treatment will continue after the recognition criteria established by existing accounting guidance and eliminate any ratemaking impact of the fair value adjustments. LKE's customer rates will continue to reflect these items (e.g. coal, purchased power, emission allowances) 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.

2010 Purchase and Sale Agreement with PPL

On April 28, 2010, E.ON U.S. announced that a Purchase and Sale Agreement (the "Agreement") had been entered into among E.ON US Investments Corp., PPL and E.ON.

The transaction was subject to customary closing conditions, including the expiration or termination of the applicable waiting period under the Hart-Scott-Rodino Act, receipt of required regulatory approvals (including state regulators in Kentucky, Virginia and Tennessee and the FERC) and the absence of injunctions or restraints imposed by governmental entities.

Change of control and financing-related applications were filed on May 28, 2010, with the Kentucky Commission and on June 15, 2010, with the Virginia Commission and the Tennessee Regulatory Authority. An application with the FERC was filed on June 28, 2010. During the second quarter of 2010, a number of parties were granted intervenor status in the Kentucky Commission proceedings and data request filings and responses occurred. Early termination of the Hart-Scott-Rodino waiting period was received on August 2, 2010.

A hearing in the Kentucky Commission proceedings was held on September 8, 2010, at which time a unanimous settlement agreement was presented. In the settlement, LG&E and KU committed that no base rate increases would take effect before January 1, 2013. The LG&E and KU rate increases that took effect on August 1, 2010, were not impacted by the settlement. Under the terms of the settlement, the Utilities retain the right to seek approval for the deferral of “extraordinary and uncontrollable costs.” Interim rate adjustments will continue to be permissible during that period for existing fuel, environmental and demand-side management cost trackers. The agreement also substitutes an acquisition savings shared deferral mechanism for the requirement that the Utilities file a synergies plan with the Kentucky Commission. This mechanism, which will be in place until the earlier of five years or the first day of the year in which a base rate increase becomes effective, permits the Utilities to earn up to a 10.75% return on equity. Any earnings above a 10.75% return on equity will be shared with customers on a 50%/50% basis. On September 30, 2010, the Kentucky Commission issued an Order approving the transfer of ownership of LG&E and KU via the acquisition of E.ON U.S. by PPL, incorporating the terms of the submitted settlement. On October 19, 2010 and October 21, 2010, respectively, Orders approving the acquisition of E.ON U.S. by PPL were received from the Virginia Commission and the Tennessee Regulatory Authority. The Commissions’ Orders contained a number of other commitments with regard to operations, workforce, community involvement and other matters.

In mid-September 2010, LG&E and KU and other applicants in the FERC change of control proceeding reached an agreement with the protesters, whereby such protests have been withdrawn. The agreement, which was filed for consideration with the FERC, includes various conditional commitments, such as a continuation of certain existing undertakings with protesters in prior cases, an agreement not to terminate certain KU municipal customer contracts prior to January 2017, an exclusion of any transaction-related costs from wholesale energy and tariff customer rates to the extent that the Company agreed not to seek the same transaction-related cost from retail customers and agreements to coordinate with protesters in certain open or ongoing matters. A FERC Order approving the transaction was received on October 26, 2010 and the transaction was completed November 1, 2010.

2010 Kentucky Rate Cases

In January 2010, LG&E and KU filed applications with the Kentucky Commission requesting increases in electric base rates of approximately 12%, or \$95 million and \$135 million annually, respectively. In addition, LG&E requested an increase in its natural gas base rates of approximately 8%, or \$23 million annually. In June 2010, LG&E and KU and all of the intervenors, except the AG, agreed to stipulations providing for increases in LG&E’s electric base rates of \$74 million annually, LG&E’s natural gas base rates of \$17 million annually and KU’s electric base rates of \$98 million annually, 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, including a return on equity range of 9.75-10.75%. The new rates became effective on August 1, 2010.

Virginia Rate Case

In June 2009, KU filed an application with the Virginia Commission requesting an increase in electric base rates for its Virginia jurisdictional customers in an amount of \$12 million annually 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 base rate revenue increases of \$11 million annually 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 amounts in excess of the ultimate approved rates.

FERC Wholesale Rate Case

In September 2008, KU filed an application with the FERC for increases in electric base rates applicable to wholesale power sales contracts or interchange agreements involving, collectively, twelve Kentucky municipalities. The application requested a shift from an all-in stated unit charge rates to an unbundled formula rate, including an annual adjustment mechanism. In 2009, the FERC issued an Order approving a settlement among the parties in the case, incorporating increases of approximately 3% from prior rates and a return on equity of 11%. In May 2010, KU submitted to the FERC the proposed current 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.

By mutual agreement, the parties' settlement of the 2008 application left outstanding the issue of whether KU must allocate to the municipal customers a portion of renewable resources it may be required to procure on behalf of its retail ratepayers. An Order was issued by the FERC in July 2010, indicating that KU is not required to allocate a portion of any renewable resources to the twelve municipalities, thus resolving the remaining issue.

2008 Kentucky Rate Case

In July 2008, LG&E and KU filed an application with the Kentucky Commission requesting increases in electric and natural gas base rates. In January 2009, LG&E, KU, the AG, the KIUC and all other parties to the rate cases filed a settlement agreement with the Kentucky Commission, under which LG&E's natural gas base rates increased by \$22 million annually and LG&E's and KU's electric base rates decreased by \$13 million and \$9 million annually, respectively. An Order approving the settlement agreement was received in February 2009. The new rates were implemented effective February 6, 2009.

Regulatory Assets and Liabilities

The following regulatory assets and liabilities were included in the Consolidated Balance Sheets as of December 31:

	Successor	Predecessor
	2010	2009
Current regulatory assets:		
GSC and PBR (a)	\$ 4	\$ 3
ECR (b)	5	35
FAC (b)	3	1
Coal contracts (c)	5	-
MISO exit (d)	-	3
Other (d) (e)	5	4
Total current regulatory assets	<u>\$ 22</u>	<u>\$ 46</u>
Non-current regulatory assets:		
Pension and postretirement benefits (f)	\$ 330	\$ 309
Other non-current regulatory assets:		
Storm restoration (d)	122	126
Mark-to-market impact of interest rate swaps (g)	34	-
ARO (h)	9	60
Unamortized loss on bonds (d)	34	34
Swap termination (d)	9	-
Coal contracts (c)	22	-
Unamortized debt expense	9	-
MISO exit (d)	6	13
Other (e)	14	9
Subtotal other non-current regulatory assets	<u>259</u>	<u>242</u>
Total non-current regulatory assets	<u>\$ 589</u>	<u>\$ 551</u>
Current regulatory liabilities:		
Coal contracts	\$ 47	\$ -
GSC	9	34
ECR	12	-
FAC	2	-
DSM	10	7
Emission allowances	12	-
Other (i)	-	1
Total current regulatory liabilities	<u>\$ 92</u>	<u>\$ 42</u>

	Successor 2010	Predecessor 2009
Non-current regulatory liabilities:		
Accumulated cost of removal of utility plant	\$ 623	\$ 594
Other non-current regulatory liabilities:		
Coal contracts	213	-
OVEC power purchase contract	124	-
Deferred income taxes – net	40	50
Postretirement benefits	10	9
Other (i)	7	10
Subtotal other non-current regulatory Liabilities	394	69
Total non-current regulatory liabilities	\$ 1,017	\$ 663

- (a) The GSC and natural gas PBR regulatory assets have separate recovery mechanisms with recovery within eighteen months.
- (b) The FAC and ECR regulatory assets have separate recovery mechanisms with recovery within twelve months.
- (c) Offsetting regulatory asset for fair value purchase accounting adjustment. See Note 2, Acquisition by PPL, for information on the purchase accounting adjustments.
- (d) These regulatory assets are recovered through base rates.
- (e) Other regulatory assets include:
- The Virginia levelized fuel factor, which is a separate recovery mechanism with recovery within twelve months.
 - Mill Creek Ash Pond costs, which were recovered through base rates
 - The CMRG and KCCS contributions, an EKPC FERC transmission settlement agreement and rate case expenses, which are 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 Note 2, Acquisition by PPL, for information on the purchase accounting adjustments.
- (f) LG&E and KU generally recover this asset through pension expense included in the calculation of Kentucky 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 5, Derivative Financial Instruments, for further discussion.
- (h) When an asset with an ARO is retired, the related ARO regulatory asset will be offset against the associated ARO regulatory liability, ARO asset and ARO liability.
- (i) Other regulatory liabilities includes the Virginia levelized fuel factor, emission allowance purchase accounting offset, MISO exit and a change in accounting method for FERC jurisdictional spare parts.

GSC

LG&E's natural gas rates contain a GSC, whereby increases and decreases in the cost of natural gas supply are reflected in LG&E's rates, subject to approval by the Kentucky Commission. The GSC procedure prescribed by Order of the Kentucky Commission provides for quarterly rate adjustments to reflect the expected cost of natural gas supply in that quarter. In addition, the GSC contains a mechanism whereby any over- or under-recoveries of natural gas supply cost from prior quarters is to be refunded to or recovered from customers through the adjustment factor determined for subsequent quarters.

LG&E's GSC was modified in 1997 to incorporate a natural gas procurement incentive mechanism. Since November 1, 1997, LG&E has operated under this PBR mechanism related to its natural gas procurement activities. LG&E's rates are adjusted annually to recover (or refund) its portion of the expense (or savings) incurred during each PBR year (12 months ending October 31). Pursuant to the extension of LG&E's natural gas supply cost PBR mechanism effective November 1, 2001, the sharing mechanism under the PBR requires savings and expenses to be shared 25% with shareholders and 75% with customers up to 4.5% of the benchmarked natural gas costs. Savings and expenses in excess of 4.5% of the benchmarked natural gas costs are shared 50% with shareholders and 50% with customers. The current natural gas supply cost PBR mechanism was extended through 2010 without further modification. In December 2009, LG&E filed an application with the Kentucky Commission to extend and modify its existing natural gas cost PBR. The current PBR was set to expire at the end of October 2010. In April 2010, the Kentucky Commission issued an Order approving a five year extension and the requested minor modifications to the PBR effective November 2010.

During the PBR years ending in 2010, 2009 and 2008, LG&E achieved \$8 million, \$7 million and \$11 million in savings, respectively. In 2010, 2009 and 2008, of the total savings amount, LG&E's portion was approximately \$2 million, \$2 million and \$3 million, respectively, and the customers' portion was approximately \$6 million in 2010, \$5 million in 2009 and \$8 million in 2008.

ECR

LG&E and KU recover the costs of complying with the Federal Clean Air Act pursuant to Kentucky Revised Statute 278-183 as amended and those federal, state or local environmental requirements which apply to coal combustion wastes and by-products from facilities utilized for production of energy from coal, through the ECR mechanism. The amount of the regulatory asset or liability is the amount that has been under- or over-recovered due to timing or adjustments to the mechanism.

The Kentucky Commission requires reviews of the past operations of the environmental surcharge for six-month and two-year billing periods to evaluate the related charges, credits and rates of return, as well as to provide for the roll-in of ECR amounts to base rates each two-year period. In December 2010, the Kentucky Commission initiated a six-month review of the Utilities' environmental surcharge for the billing period ending October 2010. An order is expected in the second quarter of 2011. Also, in December 2010, an Order was issued approving the charges and credits billed through the ECR during the six-month period ending April 2010, as well as approving billing adjustments for under-recovered costs and the rate of return on capital. In May 2010, an Order was issued approving the amounts billed through the ECR during the six-month period ending October 2009 and the rate of return on capital and allowing recovery of the under-recovery position in subsequent monthly filings. In December 2009, an Order was issued approving the charges and credits billed through the ECR during the two-year period

ending April 2009, an increase in the jurisdictional revenue requirement, a base rate roll-in and a revised rate of return on capital. In July 2009, an Order was issued approving the charges and credits billed through the ECR during the six-month period ending October 2008, as well as approving billing adjustments for under-recovered costs and the rate of return on capital. In August 2008, an Order was issued approving the charges and credits billed through the ECR during the six-month periods ending April 2008 and October 2007 and the rate of return on capital. In March 2008, an Order was issued approving the charges and credits billed through the ECR during the six-month and two-year periods ending October 2006 and April 2007, respectively, as well as approving billing adjustments, roll-in adjustments to base rates, revisions to the monthly surcharge filing and the rates of return on capital.

In June 2009, LG&E and KU filed applications for a new ECR plan with the Kentucky Commission seeking approval to recover investments in environmental upgrades and operations and maintenance costs at their generating facilities. During 2009, LG&E and KU reached a unanimous settlement with all parties to the case and the Kentucky Commission issued an Order approving their application. Recovery on customer bills through the monthly ECR surcharge for these projects began with the February 2010 billing cycle. At December 31, 2009, KU had a regulatory asset of \$28 million, which changed to a regulatory liability in the first quarter of 2010, as a result of these roll-in adjustments to base rates. At December 31, 2010, the regulatory liability balance was \$7 million.

In February 2009, the Kentucky Commission approved a settlement agreement in the rate case which provides for an authorized return on equity applicable to the ECR mechanism of 10.63% effective with the February 2009 expense month filing, which represents a slight increase over the previously authorized 10.50%. The 10.63% return on equity for the ECR mechanism was affirmed in the 2010 rate case.

FAC

LG&E's and KU's retail electric rates contain an FAC, whereby increases and decreases in the cost of fuel for electric generation are reflected in the rates charged to retail electric customers. The FAC allows LG&E and KU to adjust billed amounts for the difference between the fuel cost component of base rates and the actual fuel cost, including transportation costs. Refunds to customers occur if the actual costs are below the embedded cost component. Additional charges to customers occur if the actual costs exceed the embedded cost component. The amount of the regulatory asset or liability is the amount that has been under- or over-recovered due to timing or adjustments to the mechanism.

The Kentucky Commission requires public hearings at six-month intervals to examine past fuel adjustments and at two-year intervals to review past operations of the fuel clause and transfer of the then current fuel adjustment charge or credit to the base charges. In December 2010, May 2010, November 2009, January 2009 and May/June 2008, the Kentucky Commission issued Orders approving the charges and credits billed through the FAC for the six-month periods ending April 2010, August 2009, April 2009, April 2008 and October 2007, respectively. In January 2009, the Kentucky Commission initiated a routine examination of the FAC for the two-year period November 1, 2006 through October 31, 2008. The Kentucky Commission issued an Order in June 2009, approving the charges and credits billed through the FAC during the review period.

KU also employs an FAC mechanism for Virginia customers using an average fuel cost factor based primarily on projected fuel costs. The Virginia levelized fuel factor allows fuel recovery based on projected fuel costs for the coming year plus an adjustment for any over- or under-recovery of fuel

expenses from the prior year. At December 31, 2010 and 2009, KU had a regulatory asset of \$5 million and less than \$1 million, respectively.

In February 2010, KU filed an application with the Virginia Commission seeking approval of a decrease in its fuel cost factor beginning with service rendered in April 2010. An Order was issued in April 2010, resulting in an agreed upon decrease of 23% from the fuel factor in effect for April 2009 through March 2010.

In February 2009, KU filed an application with the Virginia Commission seeking approval of a 29% increase in its fuel cost factor beginning with service rendered in April 2009. In February 2009, the Virginia Commission issued an Order allowing the requested change to become effective on an interim basis. The Virginia Staff testimony filed in April 2009 recommended a slight decrease in the factor filed by KU. The Company indicated the Virginia Staff proposal was acceptable. A hearing was held in May 2009, with general resolution of remaining issues. In May 2009, the Virginia Commission issued an Order approving the revised fuel factor, representing an increase of 24%, effective May 2009.

In February 2008, KU filed an application with the Virginia Commission seeking approval of a decrease in its fuel cost factor applicable during the billing period, April 2008 through March 2009. The Virginia Commission allowed the new rates to be in effect for the April 2008 customer billings. In April 2008, the Virginia Commission Staff recommended a change to the fuel factor KU filed in its application, to which KU agreed. Following a public hearing and an Order in May 2008, the recommended change became effective in June 2008, resulting in a decrease of 0.482 cents/kWh from the factor in effect for the April 2007 through March 2008 period.

Coal Contracts

In November 2010, purchase accounting adjustments were recorded for the fair value of LG&E's and KU's coal contracts. Offsetting regulatory assets or liabilities for fair value purchase accounting adjustments eliminate any ratemaking impact of the fair value adjustments.

MISO

Following receipt of applicable FERC, Kentucky Commission and other regulatory Orders, related to proceedings that had been underway since July 2003, LG&E and KU withdrew from the MISO effective September 1, 2006. Since the exit from the MISO, LG&E and KU have been operating under a FERC approved OATT. LG&E and KU now contract with the TVA to act as their transmission reliability coordinator and SPP to function as the independent transmission operator, pursuant to FERC requirements. The contractual obligations with TVA extend through August 2011 and with SPP through August 2012.

LG&E and KU and the MISO agreed upon overall calculation methods for the contractual exit fee to be paid by the utilities following their withdrawal. In October 2006, LG&E and KU paid a combined \$33 million to the MISO and made related FERC compliance filings. The Utilities' payments of these exit fees were with reservation of their rights to contest the amount, or components thereof, following a continuing review of the fee's calculation and supporting documentation. LG&E and KU and the MISO resolved their dispute regarding the calculations of the exit fees and, in November 2007, filed applications with the FERC for approval of recalculation agreements. In March 2008, the FERC approved the parties' recalculations of the exit fees and the approved agreements providing LG&E and

KU with recovery of a combined \$6 million, of which \$2 million was immediately recovered in 2008, with the remainder to be recovered over the seven years from 2008 through 2014 for credits realized from other payments the MISO will receive, plus interest.

In accordance with Kentucky Commission Orders approving the MISO exit, LG&E and KU established regulatory assets for the MISO exit fee, net of former MISO administrative charges collected via base rates through the base rate case test year ended April 30, 2008. The net MISO exit fee is subject to adjustment for possible future MISO credits and a regulatory liability for certain revenues associated with former MISO administrative charges, which were collected via base rates until February 6, 2009. The approved 2008 base rate case settlement provided for MISO administrative charges collected through base rates from May 1, 2008 to February 6, 2009 and any future adjustments to the MISO exit fee, to be established as a regulatory liability until the amounts can be amortized in future base rate cases. This regulatory liability balance as of October 31, 2009, was included in the base rate case application filed on January 29, 2010. MISO exit fee credit amounts subsequent to October 31, 2009, will continue to accumulate as a regulatory liability until they can be amortized in future base rate cases.

In November 2008, the FERC issued Orders in industry-wide proceedings relating to MISO RSG calculation and resettlement procedures. RSG charges are amounts assessed to various participants active in the MISO trading market which generally seek to compensate for uneconomic generation dispatch due to regional transmission or power market operational considerations, with some customer classes eligible for payments, while others may bear charges. The FERC Orders approved two requests for significantly altered formulas and principles, each of which the FERC applied differently to calculate RSG charges for various historical and future periods. Based upon the 2008 FERC Orders, LG&E and KU established reserves during the fourth quarter of 2008 of a combined \$2 million relating to potential RSG resettlement costs for the period ended December 31, 2008. However, in May 2009, after a portion of the resettlement payments had been made, the FERC issued an Order on the requests for rehearing on one November 2008 Order which changed the effective date and reduced almost all of the previously accrued RSG resettlement costs. Therefore, these costs were reversed and receivables were established for amounts already paid of \$1 million for LG&E and KU, which the MISO began refunding back to LG&E and KU in June 2009 and which were fully collected by September 2009. In June 2009, the FERC issued an Order in the rate mismatch RSG proceeding, stating it will not require resettlements of the rate mismatch calculation from April 1, 2005 to November 4, 2007. Accruals had previously been recorded in 2008 for the rate mismatch issue for the time period April 25, 2006 to August 9, 2007, but no accruals had been recorded for the time period November 5, 2007 to November 9, 2008 based on the prior Order. Accordingly, the accruals for the former time period were reversed and accruals for the latter time period were recorded in June 2009, with a net effect of \$1 million for LG&E and KU, substantially all of which was paid by September 2009.

In August 2009, the FERC determined that the MISO had failed to demonstrate that its proposed exemptions to real-time RSG charges were just and reasonable. In November 2009, the MISO made a compliance filing incorporating the rulings of the FERC Orders and a related task force, with a primary open issue being whether certain of the tariff changes are applied prospectively only or retroactively to approximately January 6, 2009.

In November 2009, the Utilities filed an application with the FERC to approve certain independent transmission operator arrangements to be effective upon the expiration of their current contract with SPP in September 2010. The application sought authority for LG&E and KU to function after such date as the administrators of their own OATT for most purposes. However, due to the lack of FERC approval

for such an approach and the approaching expiration of the SPP contract, the Utilities determined the approach was no longer reasonably achievable without unacceptable delay and uncertainty. In July 2010, the Utilities entered into a new agreement with SPP to provide independent transmission operator services for a specified, limited time and removed its application for authority of administering its own OATT. The TVA, which currently acts as reliability coordinator, has also been retained under the existing service contract. The new agreement extends TVA services to August 2011 with no alterations or changes to the party's duties or responsibilities.

In August 2010, the FERC issued three Orders accepting most facets of several MISO RSG compliance filings. The FERC ordered the MISO to issue refunds for RSG charges that were imposed by the MISO on the assumption that there were rate mismatches for the period beginning November 5, 2007 through the present. There is no financial statement impact to the Company from this Order, as the MISO had anticipated that the FERC would require these refunds and had preemptively included them in the resettlements paid in 2009. The FERC denied the MISO's proposal to exempt certain resources from RSG charges, effective prospectively. The FERC accepted portions and rejected portions of the MISO's proposed RSG rate Redesign Proposal, which will be effective when the software is ready for implementation subject to further compliance filings. The impact of the Redesign Proposal on the Company cannot be estimated at this time.

Pension and Postretirement Benefits

LG&E and KU account for pension and postretirement benefits in accordance with the compensation – retirement benefits guidance of the FASB ASC. This guidance requires employers to recognize the over-funded or under-funded status of a defined benefit pension and postretirement plan as an asset or liability on the Consolidated Balance Sheets and to recognize through other comprehensive income the changes in the funded status in the year in which the changes occur. Under the regulated operations guidance of the FASB ASC, LG&E and KU can defer recoverable costs that would otherwise be charged to expense or equity by non-regulated entities. Current rate recovery in Kentucky and Virginia is based on the compensation – retirement benefits guidance of the FASB ASC. Regulators have been clear and consistent with their historical treatment of such rate recovery; therefore, the Company has recorded a regulatory asset representing the change in funded status of its pension plans that is expected to be recovered. LG&E has recorded a regulatory asset representing the change in funded status of its postretirement benefit plan that is expected to be recovered and KU has recorded a regulatory liability representing the change in funded status of its postretirement benefit plan. The regulatory asset and liability will be adjusted annually as prior service cost and actuarial gains and losses are recognized in net periodic benefit cost.

Storm Restoration

In January 2009, a significant ice storm passed through LKE's service areas causing approximately 404,000 customer outages, followed closely by a severe wind storm in February 2009, causing approximately 81,000 customer outages. Applications were filed with the Kentucky Commission in April 2009, requesting approval to establish regulatory assets and defer for future recovery, approximately \$107 million in incremental operation and maintenance expenses related to the storm restoration. In September 2009, the Kentucky Commission issued Orders allowing the establishment of regulatory assets of up to \$107 million based on actual costs for storm damages and service restoration due to the January and February 2009 storms. In September 2009, regulatory assets of \$101 million were

established for actual costs incurred and approval was received in LG&E's and KU's 2010 base rate cases to recover these assets over a ten year period, beginning August 1, 2010.

In September 2008, high winds from the remnants of Hurricane Ike passed through the service area causing significant outages and system damage. In October 2008, applications were filed with the Kentucky Commission requesting approval to establish regulatory assets and defer for future recovery, approximately \$27 million of expenses related to the storm restoration. In December 2008, the Kentucky Commission issued an Order allowing the establishment of regulatory assets of up to \$27 million, based on actual costs for storm damages and service restoration due to Hurricane Ike. In December 2008, regulatory assets of \$26 million were established for actual costs incurred and LG&E and KU received approval in their 2010 base rate cases to recover these assets over a ten year period, beginning August 1, 2010.

Interest Rate Swaps

LG&E's interest rate swaps are accounted for on a fair value basis in accordance with the derivatives and hedging guidance of the FASB ASC. Beginning in the third quarter of 2010, the unrealized gains and losses of the effective and ineffective interest rate swaps are included in a regulatory asset based on an Order from the Kentucky Commission in the 2010 rate case whereby the cost of a terminated swap was allowed to be recovered in base rates. Previously, interest rate swaps designated as effective cash flow hedges had resulting gains and losses recorded within other comprehensive income and common equity. The ineffective portion of interest rate swaps designated as cash flow hedges was previously recorded to earnings monthly, as was the entire change in the market value of the ineffective swaps. LG&E is able to recover the unrealized gains and losses on the interest rate swaps under its existing rate recovery structure as the interest expense on the swaps is realized.

Unamortized Loss on Bonds

The costs of early extinguishment of debt, including call premiums, legal and other expenses and any unamortized balance of debt expense are amortized using the straight-line method, which approximates the effective interest method, over the life of either the replacement debt (in the case of refinancing) or the original life of the extinguished debt.

CMRG and KCCS Contributions

In July 2008, LG&E and KU, along with Duke Energy Kentucky, Inc. and Kentucky Power Company, filed an application with the Kentucky Commission requesting approval to establish regulatory assets related to contributions to the CMRG for the development of technologies for reducing carbon dioxide emissions and the KCCS to study the feasibility of geologic storage of carbon dioxide. The filing companies proposed that these contributions be treated as regulatory assets to be deferred until recovery is provided in the next base rate case of each company, at which time the regulatory assets will be amortized over the life of each project: four years with respect to the KCCS and ten years with respect to the CMRG. LG&E and KU jointly agreed to provide \$2 million over two years to the KCCS and up to \$2 million over ten years to the CMRG. In October 2008, an Order approving the establishment of the requested regulatory assets was received. LG&E and KU received approval from the Kentucky Commission in the Utilities' 2010 Kentucky base rate case to recover these regulatory assets over the requested period beginning August 1, 2010.

Rate Case Expenses

LG&E and KU incurred \$1 million each in expenses related to the development and support of the 2008 Kentucky base rate cases. The Kentucky Commission approved the establishment of a regulatory asset for these expenses and authorized amortization over three years beginning in March 2009.

LG&E and KU incurred \$1 million and \$2 million, respectively, in expenses related to the development and support of the 2010 Kentucky base rate cases. The Kentucky Commission approved the establishment of a regulatory asset for these expenses and authorized amortization over three years beginning in August 2010.

FERC Jurisdictional Pension Costs

Other regulatory assets include pension costs of \$5 million incurred by KU and allocated to its FERC jurisdictional ratepayers. KU will seek recovery of this asset in the next FERC rate proceeding.

Deferred Storm Costs

Based on an Order from the Kentucky Commission in June 2004, KU reclassified from maintenance expense to a regulatory asset \$4 million related to costs not reimbursed from the 2003 ice storm. These costs were amortized through June 2009. KU earned a return of these amortized costs, which were included in jurisdictional operating expenses.

DSM

DSM consists of energy efficiency programs which are intended to reduce peak demand and delay the investment in additional power plant construction, provide customers with tools and information to become better managers of their energy usage and prepare for potential future legislation governing energy efficiency. The rates of LG&E and KU contain a DSM provision which includes a rate mechanism that provides for concurrent recovery of DSM costs and provides an incentive for implementing DSM programs. The provision allows LG&E and KU to recover revenues from lost sales associated with the DSM programs based on program plan engineering estimates and post-implementation evaluations.

In July 2007, LG&E and KU filed an application with the Kentucky Commission requesting an order approving enhanced versions of the existing DSM programs along with the addition of several new cost effective programs. The total annual budget for these programs is approximately \$26 million. In March 2008, the Kentucky Commission issued an Order approving the application, with minor modifications. LG&E and KU filed revised tariffs in April 2008, under authority of this Order, which were effective in May 2008.

Emission Allowances

In November 2010, purchase accounting adjustments were recorded for the fair market value of LG&E's and KU's SO₂, NO_x ozone season and NO_x annual emission allowances. Offsetting regulatory assets or liabilities for fair value purchase accounting adjustments eliminate any ratemaking impact of the fair value adjustments. LG&E and KU are granted SO₂ emission allowances through 2040 and NO_x ozone season and NO_x annual emission allowances through 2011.

Accumulated Cost of Removal of Utility Plant

As of December 31, 2010 and 2009, the Utilities segregated the cost of removal, previously embedded in accumulated depreciation, of \$623 million and \$594 million, respectively, in accordance with FERC Order No. 631. For reporting purposes on the Consolidated Balance Sheets, the Utilities presented this cost of removal as a “Regulatory liability” pursuant to the regulated operations guidance of the FASB ASC.

OVEC Power Purchase Contract

In November 2010, purchase accounting adjustments were recorded for the fair value of the power purchase agreement between the Utilities and OVEC. Offsetting regulatory liabilities for fair value purchase accounting adjustments eliminate any ratemaking impact of the fair value adjustments.

Deferred Income Taxes – Net

These regulatory liabilities represent the future revenue impact from the reversal of deferred income taxes required for unamortized investment tax credits, the allowance for funds used during construction and deferred taxes provided at rates in excess of currently enacted rates.

Other Regulatory Matters

Kentucky Commission Report on Storms

In November 2009, the Kentucky Commission issued a report following review and analysis of the effects and utility response to the September 2008 wind storm and the January 2009 ice storm and possible utility industry preventative measures relating thereto. The report suggested a number of proposed or recommended preventative or responsive measures, including consideration of selective hardening of facilities, altered vegetation management programs, enhanced customer outage communications and similar measures. In March 2010, LG&E and KU filed a joint response reporting on their actions with respect to such recommendations. The response indicated implementation or completion of substantially all of the recommendations, including, among other matters, on-going reviews of system hardening and vegetation management procedures, certain test or pilot programs in such areas and fielding of enhanced operational and customer outage-related systems.

Wind Power Agreements

In August 2009, LG&E and KU filed a notice of intent with the Kentucky Commission indicating their intent to file an application for approval of wind power purchase contracts and cost recovery mechanisms. The contracts were executed in August 2009 and were contingent upon LG&E and KU receiving acceptable regulatory approvals. Pursuant to the proposed 20-year contracts, LG&E and KU would jointly purchase respective assigned portions of the output of two Illinois wind farms totaling an aggregate 109.5 Mw. In September 2009, the Utilities filed an application and supporting testimony with the Kentucky Commission. In October 2009, the Kentucky Commission issued an Order denying the Utilities’ request to establish a surcharge for recovery of the costs of purchasing wind power. The Kentucky Commission stated that such recovery constitutes a general rate adjustment and is subject to the regulations of a base rate case. The Kentucky Commission Order provided for the request for approval of the wind power agreements to proceed independently from the request to recover the costs

thereof via surcharges. In November 2009, LG&E and KU filed for rehearing of the Kentucky Commission's Order and requested that the matters of approval of the contract and recovery of the costs thereof remain the subject of the same proceeding. During December 2009, the Kentucky Commission issued data requests on this matter. In March 2010, LG&E and KU delivered notices of termination under provisions of the wind power contracts. The Utilities also filed a motion with the Kentucky Commission noting the termination of the contracts and seeking withdrawal of their application in the related regulatory proceeding. In April 2010, the Kentucky Commission issued an Order allowing LG&E and KU to withdraw their pending application.

Trimble County Asset Purchase and Depreciation

In July 2009, the Utilities notified the Kentucky Commission of the proposed sale from the Utilities of certain ownership interests in certain existing Trimble County generating station assets which were anticipated to provide joint or common use in support of the jointly-owned TC2 generating unit under construction at the station. The undivided ownership interests sold provide KU an ownership interest in these common assets proportional to its interest in TC2 and the assets' role in supporting both TC1 and TC2. In December 2009, the Utilities completed the sale transaction at a price of \$48 million, representing the current net book value of the assets multiplied by the proportional interest being sold.

In August 2009, the Utilities jointly filed an application with the Kentucky Commission to approve new depreciation rates for applicable jointly-owned TC2-related generating, pollution control and other plant equipment and assets. During December 2009, the Kentucky Commission extended the data discovery process through January 2010 and authorized the Utilities on an interim basis to begin using the depreciation rates for TC2 as proposed in the application. In March 2010, the Kentucky Commission issued a final Order approving the use of the proposed depreciation rates on a permanent basis.

TC2 CCN Application and Transmission Matters

An application for a CCN for construction of TC2 was approved by the Kentucky Commission in November 2005. CCNs for two transmission lines associated with TC2 were issued by the Kentucky Commission in September 2005 and May 2006. All regulatory approvals and rights of way for one transmission line have been obtained.

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.

Completion of the transmission lines are also subject to standard construction permit, environmental authorization and real property or easement acquisition procedures. Certain Hardin County landowners have raised challenges to the transmission line in some of these forums as well.

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.

Settlement discussions with the Hardin County property owners involved in the appeals of the condemnation proceedings have been unsuccessful to date. During the fourth quarter of 2008, LG&E and KU entered into settlements with certain Meade County landowners and obtained dismissals of prior litigation they brought challenging the same transmission line.

As a result of the aforementioned unresolved litigation delays encountered in obtaining access to certain properties in Hardin County, KU obtained easements to allow construction of temporary transmission facilities, bypassing those properties while the litigated issues are resolved. In September 2009, the Kentucky Commission issued an Order stating that a CCN was necessary for two segments of the proposed temporary facilities. In December 2009, the Kentucky Commission granted the CCNs for the relevant segments and the property owners have filed various motions to intervene, stay and appeal certain elements of the Kentucky Commission's recent Orders. In January 2010, in respect of two of such proceedings, the Franklin County circuit court issued Orders denying the property owners' request for a stay of construction and upholding the prior Kentucky Commission denial of their intervenor status.

Consistent with the regulatory authorizations and the favorable outcome of the legal proceedings, the Utilities completed construction activities on the permanent transmission line easements. During 2010, the Utilities placed the transmission line into operation. While the Utilities are not currently able to predict the ultimate outcome and possible financial effects of the remaining legal proceedings, the Utilities do not believe the matter involves relevant or continuing risks to operations.

Utility Competition in Virginia

The Commonwealth of Virginia passed the Virginia Electric Utility Restructuring Act in 1999. This act gave customers the ability to choose their electric supplier and capped electric rates through December 2010. KU subsequently received a legislative exemption from the customer choice requirements of this law. In April 2007, however, the Virginia General Assembly amended the Virginia Electric Utility Restructuring Act, thereby terminating this competitive market and commencing re-regulation of utility rates. The new act ended the cap on rates at the end of 2008. Pursuant to this legislation, the Virginia Commission adopted regulations revising the rules governing utility rate increase applications. As of January 2009, a hybrid model of regulation is being applied in Virginia. Under this model, utility rates are reviewed every two years. KU's exemption from the requirements of the Virginia Electric Utility Restructuring Act in 1999, however, discharges KU from the requirements of the new hybrid model of regulation. In lieu of submitting an annual information filing, KU has the option of requesting a change in base rates to recover prudently incurred costs by filing a traditional base rate case. KU is also subject to other utility regulations in Virginia, including, but not limited to, the recovery of prudently incurred fuel costs through an annual fuel factor charge and the submission of integrated resource plans.

Arena

In August 2006, LG&E filed an application with the Kentucky Commission requesting approval for the sale of property to the Louisville Arena Authority which was granted in a September 2006 Order. In November 2006, LG&E completed certain agreements pursuant to its August 2006 Memorandum of Understanding with the Louisville Arena Authority regarding the proposed construction of an arena in

downtown Louisville. LG&E entered into a relocation agreement with the Louisville Arena Authority providing for reimbursement to LG&E of the costs to be incurred in relocating certain LG&E facilities related to the arena transaction of approximately \$63 million. As of December 31, 2010, approximately \$62 million of the total costs have been received. The relocation work was substantially completed during 2009, with follow up work continuing in 2010 and 2011. The parties further entered into a property sale contract providing for LG&E's sale of a downtown site to the Louisville Arena Authority which was completed for \$9 million in September 2008.

Market-Based Rate Authority

In July 2006, the FERC issued an Order in LG&E's and KU's market-based rate proceedings accepting their further proposal to address certain market power issues the FERC claimed would arise upon an exit from the MISO. In particular, LG&E and KU received permission to sell power at market-based rates at the interface of balancing areas in which it may be deemed to have market power, subject to a restriction that such power will not be collusively re-sold back into such balancing areas. However, restrictions exist on sales by LG&E and KU of power at market-based rates in the LG&E and KU and Big Rivers balancing areas. In June 2007, the FERC issued Order No. 697 implementing certain reforms to market-based rate regulations, including restrictions similar to those previously in place for LG&E's and KU's power sales at balancing area interfaces. In December 2008, the FERC issued Order No. 697-B potentially placing additional restrictions on certain power sales involving areas where market power is deemed to exist. As a condition of receiving and retaining market-based rate authority, LG&E and KU must comply with applicable affiliate restrictions set forth in the FERC regulation. During September 2008, LG&E and KU submitted a regular triennial update filing under market-based rate regulations.

In June 2009, the FERC issued Order No. 697-C which generally clarified certain interpretations relating to power sales and purchases at balancing area interfaces or into balancing areas involving market power. In July 2009, the FERC issued an Order approving LG&E's and KU's September 2008 application for 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 balancing area, which termination should ultimately allow a filing to request a determination that LG&E and KU no longer are deemed to have market power in such balancing area.

LG&E and KU conduct certain of their wholesale power sales activities in accordance with existing market-based rate authority principles and interpretations. Future FERC proceedings relating to Orders 697 or market-based rate authority could alter the amount of sales made at market-based versus cost-based rates. LG&E's and KU's sales under market-based rate authority totaled \$21 million and less than \$1 million, respectively, for the year ended December 31, 2010.

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 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. LG&E and KU are members of the SERC, which acts as LG&E's and KU's RRO. During December 2009 and April, July and August 2010, LG&E and KU submitted ten self-reports relating to various standards, which self-reports remain

in the early stages of RRO review and therefore, LG&E and KU are unable to estimate the outcome of these matters. Mandatory reliability standard settlements commonly also include non-penalty elements, including compliance steps and mitigation plans. Settlements with SERC proceed to NERC and the FERC review before becoming final. While LG&E and KU believe they are in compliance with the mandatory reliability standards, events of potential non-compliance may be identified from time-to-time. LG&E and KU cannot predict such potential violations or the outcome of self-reports described above.

Natural Gas Customer Choice Study

In April 2010, the Kentucky Commission commenced a proceeding to investigate natural gas retail competition programs, their regulatory, financial and operational aspects and potential benefits, if any, of such programs to Kentucky consumers. A number of entities, including LG&E, were parties to the proceeding. In December 2010, the Kentucky Commission issued an Order in the proceeding declining to endorse natural gas competition at the retail level, noting the existence of a number of transition or oversight costs and an uncertain level of economic benefits in such programs. With respect to existing natural gas transportation programs available to large commercial or industrial users, the Order indicates that the Kentucky Commission will review the utilities' current tariff structures, user thresholds and other terms and conditions of such programs, as part of such utilities' next regular natural gas rate cases.

Integrated Resource Planning

Integrated resource planning ("IRP") regulations in Kentucky require major utilities to make triennial IRP filings with the Kentucky Commission. In April 2008, LG&E and KU filed their 2008 joint IRP with the Kentucky Commission. The IRP provides historical and projected demand, resource and financial data and other operating performance and system information. The Kentucky Commission issued a staff report and Order closing this proceeding in December 2009. Pursuant to the Virginia Commission's December 2008 Order, KU filed its IRP in July 2009. The filing consisted of the 2008 Joint IRP filed by LG&E and KU with the Kentucky Commission along with additional data. The Virginia Commission has not established a procedural schedule for this proceeding. The Utilities expect to file their next IRP in April 2011.

PUHCA 2005

PPL, LG&E's and KU's ultimate parent, is a holding company under PUHCA 2005. PPL, its utility subsidiaries, including LG&E and KU, and certain of its non-utility subsidiaries, are subject to extensive regulation by the FERC with respect to numerous matters, including electric utility facilities and operations, wholesale sales of power and related transactions, accounting practices, issuances and sales of securities, acquisitions and sales of utility properties, payments of dividends out of capital and surplus, financial matters and inter-system sales of non-power goods and services. PPL, LG&E and KU believe they have adequate authority, including financing authority, under existing FERC Orders and regulations to conduct their business and will seek additional authorization when necessary.

EPAAct 2005

The EPAAct 2005 was enacted in August 2005. Among other matters, this comprehensive legislation contains provisions mandating improved electric reliability standards and performance; granting enhanced civil penalty authority to the FERC; providing economic and other incentives relating to transmission, pollution control and renewable generation assets; increasing funding for clean coal

generation incentives; repealing the Public Utility Holding Company Act of 1935; enacting PUHCA 2005; and expanding FERC jurisdiction over public utility holding companies and related matters via the Federal Power Act and PUHCA 2005.

In February 2006, the Kentucky Commission initiated an administrative proceeding to consider the requirements of the EAct 2005, Subtitle E Section 1252, Smart Metering, which concerns time-based metering and demand response and Section 1254, Interconnections. EAct 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 EAct 2005 and to commence consideration of Section 1254 standards within one year after the enactment of EAct 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 EAct 2005 Section 1252 and Section 1254 standards should not be adopted. However, all five Kentucky Commission jurisdictional utilities were required to file real-time pricing pilot programs for their large commercial and industrial customers. LG&E and KU developed real-time pricing pilot programs 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 within approximately eight months. 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 an LG&E 2004 rate case settlement agreement and as referred to in the Kentucky Commission EAct 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 100 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.

Hydro Upgrade

In October 2005, LG&E received from the FERC a new license to upgrade, operate and maintain the Ohio Falls Hydroelectric Project. The license is for a period of 40 years, effective November 2005. LG&E began refurbishing the facility to add approximately 20 Mw of generating capacity in 2004 and plans to spend approximately \$89 million from 2011 to 2014.

Green Energy Riders

In February 2007, LG&E and KU filed a Joint Application and Testimony for Proposed Green Energy Riders. In May 2007, a Kentucky Commission Order was issued authorizing LG&E and KU to establish Small and Large Green Energy Riders, allowing customers to contribute funds to be used for the purchase of renewable energy credits. During November 2009, LG&E and KU filed an application to both continue and modify the existing Green Energy Programs. In February 2010, the Kentucky Commission approved the application, as filed.

Home Energy Assistance Program

In July 2007, LG&E and KU filed applications with the Kentucky Commission for the establishment of a Home Energy Assistance program. During September 2007, the Kentucky Commission approved the five-year programs as filed, effective in October 2007. The programs were scheduled to terminate in September 2012 and are funded through a \$0.10 per month meter charge. Effective February 6, 2009, as a result of the settlement agreement in the 2008 base rate case, the programs are funded through a \$0.15 per month meter charge. As a condition in the settlement in the change of control proceeding before the Kentucky Commission in the PPL acquisition, the programs were extended to September 2015.

Collection Cycle Revision

As part of its base rate case filed on July 29, 2008, LG&E proposed to change the due date for customer bill payments from 15 days to 10 days to align its collection cycle with KU. In addition, in its rate case filed on July 29, 2008, KU proposed to include a late payment charge if payment is not received within 15 days from the bill issuance date to align with LG&E. The settlement agreement approved in the rate case in February 2009 changed the due date for customer bill payments to 12 days after bill issuance for both LG&E and KU and permitted KU's implementation of a late payment charge if payment is not received within 15 days from the bill issuance date.

Depreciation Study

In December 2007, LG&E and KU filed depreciation studies with the Kentucky Commission as required by previous Orders. In August 2008, the Kentucky Commission issued Orders consolidating the depreciation studies with the base rate case proceedings. The approved settlement agreements in the rate cases established new depreciation rates effective February 2009. KU also filed the depreciation study with the Virginia Commission which approved the implementation of the new depreciation rates effective February 2009. Approval by the Virginia Commission does not preclude the rates from being raised as an issue by any party in KU's future base rate cases in Virginia.

Brownfield Development Rider Tariff

In March 2008, LG&E and KU received Kentucky Commission approval for a Brownfield Development Rider, which offers a discounted rate to electric customers who meet certain usage and location requirements, including taking new service at a Brownfield site, as certified by the appropriate Kentucky state agency. The rider permits special contracts with such customers which provide for a series of declining partial rate discounts over an initial five-year period of a longer service arrangement. The tariff is intended to promote local economic redevelopment and efficient usage of utility resources by aiding potential reuse of vacant Brownfield sites.

Interconnection and Net Metering Guidelines

In May 2008, the Kentucky Commission on its own motion initiated a proceeding to establish interconnection and net metering guidelines in accordance with amendments to existing statutory requirements for net metering of electricity. The jurisdictional electric utilities and intervenors in this case presented proposed interconnection guidelines to the Kentucky Commission in October 2008. In a January 2009 Order, the Kentucky Commission issued the Interconnection and Net Metering Guidelines – Kentucky that were developed by all parties to the proceeding. LG&E and KU do not expect any

financial or other impact as a result of this Order. In April 2009, LG&E and KU filed revised net metering tariffs and application forms pursuant to the Kentucky Commission’s Order. The Kentucky Commission issued an Order in April 2009, which suspended for five months all net metering tariffs filed by the jurisdictional electric utilities. This suspension was intended to allow sufficient time for review of the filed tariffs by the Kentucky Commission Staff and intervening parties. In June 2009, the Kentucky Commission Staff held an informal conference with the parties to discuss issues related to the net metering tariffs filed by LG&E and KU. Following this conference, the intervenors and LG&E and KU resolved all issues and LG&E and KU filed revised net metering tariffs with the Kentucky Commission. In August 2009, the Kentucky Commission issued an Order approving the revised tariffs.

EISA 2007 Standards

In November 2008, the Kentucky Commission initiated an administrative proceeding to consider new standards as a result of the Energy Independence and Security Act of 2007 (“EISA 2007”), part of which amends the Public Utility Regulatory Policies Act of 1978 (“PURPA”). There are four new PURPA standards and one non-PURPA standard applicable to electric utilities. The proceeding also considers two new PURPA standards applicable to natural gas utilities. EISA 2007 requires state regulatory commissions and non-regulated utilities to begin consideration of the rate design and smart grid investments no later than December 19, 2008 and to complete the consideration by December 19, 2009. The Kentucky Commission established a procedural schedule that allowed for data discovery and testimony through July 2009. In October 2009, the Kentucky Commission held an informal conference for the purpose of discussing issues related to the standard regarding the consideration of Smart Grid investments. A public hearing has not been scheduled in this matter.

Note 4 - Asset Retirement Obligations

A summary of the Company’s net ARO assets, ARO liabilities and regulatory assets established under the asset retirement and environmental obligations guidance of the FASB ASC follows:

	ARO Net Assets	ARO Liabilities	Regulatory Assets
As of December 31, 2008, Predecessor	\$ 9	\$ (63)	\$ 57
ARO accretion and depreciation	(2)	(4)	5
ARO settlements	-	1	(2)
Removal cost incurred	-	1	-
As of December 31, 2009, Predecessor	7	(65)	60
ARO accretion and depreciation	-	(4)	4
Reclassification for retired assets	(2)	-	2
ARO revaluation - change in estimates	51	(54)	3
Removal cost incurred	-	1	-
As of October 31, 2010, Predecessor	56	(122)	69
ARO accretion and depreciation	(2)	-	2
Purchase accounting - fair value adjustment	43	19	(62)
As of December 31, 2010, Successor	<u>\$ 97</u>	<u>\$ (103)</u>	<u>\$ 9</u>

As of September 30, 2010, the Company performed a revaluation of its AROs as a result of recently proposed environmental legislation and improved ability to forecast asset retirement costs due to recent construction and retirement activity.

In November 2010, the Company recorded a purchase accounting adjustment to fair value AROs due to the PPL acquisition.

Pursuant to regulatory treatment prescribed under the regulated operations guidance of the FASB ASC, an offsetting regulatory credit was recorded in "Depreciation and amortization" in the Consolidated Statements of Income for the Successor of \$2 million in 2010 and \$4 million for the Predecessor for the ARO accretion and depreciation expense. The offsetting regulatory credit recorded was \$4 million in 2009 and 2008 for the ARO accretion and depreciation expense. The ARO liabilities are offset by cash settlements that have not yet been applied. Therefore, ARO net assets, ARO liabilities and regulatory assets balances do not net to zero.

LKE's AROs are primarily related to the final retirement of assets associated with generating units and natural gas mains and wells. LKE transmission and distribution lines largely operate under perpetual property easement agreements which do not generally require restoration upon removal of the property. Therefore, under the asset retirement and environmental obligations guidance of the FASB ASC, no material asset retirement obligations are recorded for transmission and distribution assets.

Note 5 - 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 December 31, 2010, LKE's potential annual exposure to increased interest expense, based on a 10% increase in interest rates, was less than \$1 million.

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 financial instruments is intended to mitigate risk, earnings and cash flow volatility and is not speculative in nature.

LKE's interest rate swap agreements range in maturity through 2033, with aggregate notional amounts of \$179 million as of December 31, 2010 and December 31, 2009. Under these swap agreements, LKE paid fixed rates averaging 4.52% and received variable rates based on LIBOR or the Securities Industry and Financial Markets Association's municipal swap index averaging 0.23% and 0.20% at December 31, 2010 and December 31, 2009, respectively. 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 2010 rate case, whereby the cost of a terminated swap was allowed to be recovered in base rates.

The fair value of the interest rate swaps is determined by a quote from the counterparty. This value is verified monthly by LKE 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 LKE. LKE considered the impact of its own credit risk and that of counterparties by evaluating credit ratings and financial information, adjusting market valuations to reflect such credit risks. LKE and all counterparties had strong investment grade ratings at December 31, 2010. In addition, LKE and certain counterparties have agreed to post margin if the credit exposure exceeds certain thresholds. Cash collateral related to interest rate swaps at December 31, 2010 and December 31, 2009, was \$19 million and \$17 million, respectively. Cash collateral for interest rate swaps is classified as a “Long-term asset” in the accompanying Consolidated Balance Sheets.

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

<u>Balance Sheet Location</u>	Fair Value	
	<u>Successor</u>	<u>Predecessor</u>
	December 31, 2010	December 31, 2009
Current derivative liability	\$ 2	\$ -
Long-term derivative liability	32	28
	<u>\$ 34</u>	<u>\$ 28</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. The tables below show the pre-tax amount and income statement location of derivative gains and losses for the change in the mark-to-market value of the interest rate swaps, realized losses and the change in the ineffective portion of the interest rate swaps deemed highly effective during the periods ended December 31, 2010, October 31, 2010, December 31, 2009 and December 31, 2008, including the impact of reclassifying these amounts to regulatory assets during the period ended October 31, 2010. For the period ended October 31, 2010, LKE recorded a pre-tax gain of less than \$1 million in interest expense to reflect the change in the ineffective portion of the interest rate swaps deemed highly effective and recorded pre-tax gains of \$21 million and \$9 million, respectively, to reflect the reclassification of the ineffective swaps and the terminated swap to a regulatory asset:

Gain (Loss) Recognized in Income	Location	Successor	Predecessor		
		November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009	2008
Change in the ineffective portion deemed highly effective	Interest expense	\$ -	\$ -	\$ 1	\$ (8)
Reclassification to regulatory assets of unrealized gain on interest rate swaps	Derivative gain (loss)	-	21	-	-
Unrealized gain (loss) on ineffective swaps	Derivative gain (loss)	-	(10)	21	(35)
Reclassification to regulatory assets of unrealized loss on terminated swap	Derivative gain (loss)	-	9	-	-
Realized gain (loss) on swaps	Derivative gain (loss)	-	(1)	(3)	(2)
		<u>\$ -</u>	<u>\$ 19</u>	<u>\$ 19</u>	<u>\$ (45)</u>

No gain or loss on hedging interest rate swaps was recognized in other comprehensive income for the periods ended December 31, 2010 and October 31, 2010. The gain on interest rate swaps recognized in other comprehensive income for the year ended December 31, 2009 was \$5 million and the loss on interest rate swaps recognized in other comprehensive income for the year ended December 31, 2008, was \$8 million. For the period ended October 31, 2010, the gain on derivatives reclassified from accumulated other comprehensive income to regulatory assets was \$23 million.

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. No amount was amortized from accumulated other comprehensive income to income in the period ended December 31, 2010, and in the periods ended October 31, 2010, December 31, 2009 and December 31, 2008, amortization was less than \$1 million each year.

A decline of 100 basis points in the current market interest rates would reduce the fair value of LKE's interest rate swaps by \$28 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.

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 2010 or 2009. Changes in market pricing, interest rate and volatility assumptions were made during both years.

The table below shows the fair value and balance sheet location of energy trading and risk management derivative contracts:

Non-Hedging Derivatives:	Fair Value	
	Successor December 31, 2010	Predecessor December 31, 2009
Asset derivative		
Prepayments and other current assets (a)	\$ -	\$ 2
Liability derivative		
Other current liabilities	\$ 2	\$ 2

(a) The amount recorded in prepayments and other current assets totals less than \$1 million

Assets and liabilities from long-term energy trading and risk management derivative contracts total less than \$1 million at December 31, 2010 and were zero at December 31, 2009.

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 cash deposits, letters of credit and parental company guarantees as security from counterparties. The Company uses 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 December 31, 2010 100% of the trading and risk management commitments were with counterparties rated BBB-/Baa3 equivalent or better. The Company has

reserved against counterparty credit risk based on LKE's own creditworthiness (for net liabilities) and its counterparty's creditworthiness (for net assets). The Company applies historical default rates within varying credit ratings over time provided by S&P or Moody's. At December 31, 2010 and December 31, 2009, counterparty credit reserves related to energy trading and risk management contracts were zero and less than \$1 million, respectively.

The net volume of electricity based financial derivatives outstanding at December 31, 2010 and December 31, 2009, was 998,300 Mwh and 631,200 Mwh, respectively. Cash collateral related to the energy trading and risk management contracts at December 31, 2010 and December 31, 2009 was \$3 million and \$2 million, respectively. Cash collateral related to the energy trading and risk management contracts is recorded in "Prepayments and other current assets" on the 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 in the Consolidated Statements of Income.

The following table presents the effect of market-traded forward contract derivatives not designated as hedging instruments on income:

Gain (Loss) Recognized in Income	Location	Successor	Predecessor		
		November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008	
Realized gain	Electric revenues	\$ -	\$ 3	\$ 11	\$ 4
Unrealized gain (loss)	Electric revenues	(2)	-	(2)	2
		<u>\$ (2)</u>	<u>\$ 3</u>	<u>\$ 9</u>	<u>\$ 6</u>

Credit Risk Related Contingent Features

Certain of LKE's derivative contracts contain credit contingent provisions which would permit the counterparties with which LKE is in a net liability position to require the transfer of additional collateral upon a decrease in LKE's credit rating. Some of these provisions would require LKE to transfer additional collateral or permit the counterparty to terminate the contract if LKE's credit rating were to fall below investment grade. Some of these provisions also allow the counterparty to require additional collateral upon each decrease in the credit rating at levels that remain above investment grade. In either case, if LKE's credit rating 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 LKE on derivative instruments in net liability positions.

Additionally, certain of LKE's derivative contracts contain credit contingent provisions that require LKE to provide "adequate assurance" of performance if the other party has reasonable grounds for insecurity regarding LKE's 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, LKE uses 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 December 31, 2010, was \$25 million, of which LKE had posted collateral of \$19 million in the normal course of business. At December 31, 2010, if the credit contingent provisions underlying these derivative instruments were triggered due to a credit downgrade below investment grade, LKE would have been required to post an additional \$6 million of collateral to its counterparties.

See Note 6, Fair Value Measurements, Note 13, Commitments and Contingencies and Note 19, Discontinued Operations, for a discussion of the WKE sales contract.

Note 6 - Fair Value Measurements

The Company adopted the fair value guidance in the FASB ASC in two phases. Effective January 1, 2008, the Company adopted it for all financial instruments and non-financial instruments accounted for at fair value on a recurring basis and effective January 1, 2009, the Company adopted it for all non-financial instruments accounted for at fair value on a non-recurring basis. 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 carrying values and estimated fair values of the Company’s non-trading financial instruments as of December 31, 2010 and December 31, 2009, follow:

	Successor		Predecessor	
	December 31, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Long-term bonds	\$ 3,825	\$ 3,607	\$ 764	\$ 764
Long-term debt to affiliated company	-	-	3,421	3,553
Derivative liabilities – interest rate swaps	32	32	28	28
Derivative liabilities – smelter contract	-	-	75	75

The long-term fixed rate pollution control bond valuations reflect prices quoted by investment banks, which are active in the market for these instruments. First mortgage bond valuations reflect prices quoted from a third party service. The fair value of the long-term debt due to affiliated companies is determined using an internal valuation model that discounts the future cash flows of each loan at current market rates as determined based on quotes from investment banks that are actively involved in capital markets for utilities and factor in the Company’s credit ratings and default risk. 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. The fair values of cash and cash equivalents, accounts 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.

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. The Company classified its liability for the E.ON share performance plan within level 2 because it is valued using a model that considers the quoted market price of E.ON's common shares traded on the Frankfurt Stock Exchange as well as the performance of E.ON stock compared to the change in the Dow Jones STOXX Utilities Index (Total Return EUR). See Note 5, Derivative Financial Instruments, for further information. See Note 20, Share Performance Plan, for discussion of the PPL stock based compensation plan.

Prior to its termination in 2009, the Company classified its liability for WKE's long-term sales contracts within level 3. The contracts were with an electric cooperative and two aluminum smelters. The valuation was calculated on a monthly basis using market prices from Platts' (provider of daily price assessments used as benchmarks in both physical and futures markets) on-line pricing service for the current and forward four years and a forecast for the outer years where market prices are not available. The outer year pricing was extrapolated from an annual forecast from the Energy Information Administration for NGHH pricing based on historical ratios of around-the-clock electricity prices to NGHH prices.

After the termination of WKE's lease with Big Rivers, the Company had an obligation through the end of 2010 to pay one of the aluminum smelters it had previously served the difference between the electricity prices charged by WKE under the previous long-term sales contract and the electricity prices charged by its current electricity supplier. The valuation was calculated on a quarterly basis using monthly Northern East Central Area Reliability Cinergy Hub forward prices by peak-type. As of December 31, 2010, the swap was terminated. See Note 13, Commitments and Contingencies and Note 19, Discontinued Operations, 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>December 31, 2010</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Financial assets:				
Cash and cash equivalents	\$ 11	\$ -	\$ -	\$ 11
Short-term investments - municipal debt securities	163	-	-	163
Restricted cash:				
Energy trading and risk management contract cash collateral	3	-	-	3
Interest rate swaps cash collateral	19	-	-	19
Total financial assets	\$ 196	\$ -	\$ -	\$ 196
Financial liabilities:				
Energy trading and risk management contracts	\$ -	\$ 2	\$ -	\$ 2
Interest rate swaps	-	34	-	34
Total financial liabilities	\$ -	\$ 36	\$ -	\$ 36
<u>December 31, 2009</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Financial assets:				
Energy trading and risk management contract cash collateral	\$ 2	\$ -	\$ -	\$ 2
Energy trading and risk management contracts	-	2	-	2
Interest rate swap cash collateral	17	-	-	17
Total financial assets	\$ 19	\$ 2	\$ -	\$ 21
Financial liabilities:				
Energy trading and risk management contracts	\$ -	\$ 2	\$ -	\$ 2
Interest rate swaps	-	28	-	28
Smelter contract	-	-	75	75
E.ON share performance plan	-	2	-	2
Total financial liabilities	\$ -	\$ 32	\$ 75	\$ 107

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 periods:

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31,	
			2009	2008
Balance at beginning of period	\$ 24	\$ 75	\$ 908	\$ 832
Realized losses included in earnings	-	6	5	-
Unrealized losses included in earnings	-	2	108	581
Unrealized gains included in earnings	(3)	(5)	(1,026)	(505)
Issuances	-	-	106	-
Settlements	(21)	(54)	(26)	-
Balance at end of period	<u>\$ -</u>	<u>\$ 24</u>	<u>\$ 75</u>	<u>\$ 908</u>

See Note 2, Acquisition by PPL, for discussion of fair value of other assets and liabilities for purchase accounting.

Note 7 - Goodwill and Intangible Assets

In connection with PPL's acquisition of LKE, the carrying value of LKE's goodwill as of October 31, 2010, was eliminated and new goodwill was recorded on November 1, 2010, as a result of the acquisition. In addition, as of November 1, 2010, certain intangible assets were adjusted to their fair value and new intangible assets were recorded. See Note 2, Acquisition by PPL, for further information.

Goodwill

Goodwill is attributable to the Company's regulated utilities, LG&E and KU as these are the two operating companies and constitute substantially all of LKE's assets. The following table sets forth the carrying amount of goodwill as of and for the two years ended December 31, 2010.

	Cost	Accumulated Impairment	Net
Goodwill, January 1, 2009	\$ 4,136	\$ (1,806)	\$ 2,330
Impairment loss	-	(1,493)	(1,493)
Balance at December 31, 2009 and October 31, 2010	4,136	(3,299)	837
Disposition of goodwill, November 1, 2010 (a)	(4,136)	3,299	(837)
Purchase accounting adjustments (b)	996	-	996
Balance at December 31, 2010	<u>\$ 996</u>	<u>\$ -</u>	<u>\$ 996</u>

- (a) Predecessor goodwill as of October 31, 2010 was eliminated as of November 1, 2010, in purchase accounting.
- (b) Recognized as a result of the Company's acquisition by PPL on November 1, 2010. Represents the purchase accounting allocation process established as of November 1, 2010, in conjunction with PPL's acquisition of LKE. See Note 2, Acquisition by PPL, for further information.

The Company performs its required annual goodwill impairment test in the fourth quarter. Impairment tests are performed between the annual tests when the Company determines that a triggering event has occurred that would, more likely than not, reduce the fair value of a reporting unit below its carrying value. The goodwill impairment test is comprised of a two-step process. In step 1, the Company identifies a potential impairment by comparing the estimated fair value of the regulated utilities (the goodwill reporting unit) to their carrying value, including goodwill, on the measurement date. If the estimated fair value exceeds its carrying amount, goodwill is not considered impaired. If the fair value is less than the carrying value, then step 2 is performed to measure the amount of impairment loss, if any. The step 2 calculation compares the implied fair value of the goodwill to the carrying value of the goodwill. The implied fair value of goodwill is equal to the excess of the regulated utilities' estimated fair value over the fair values of its identified assets and liabilities. If the carrying value of goodwill exceeds the implied fair value of goodwill, an impairment loss is recognized in an amount equal to that excess (but not in excess of the carrying value).

In connection with PPL's acquisition of LKE on November 1, 2010, the carrying value of LKE's goodwill as of October 31, 2010, was eliminated. New goodwill was recorded on November 1, 2010 on LG&E and KU for \$389 million and \$607 million, respectively. The allocation of the goodwill was based on the net asset value of each company. The goodwill represents value paid for the rate regulated business located in a defined service area with a constructive regulatory environment, which provides for investment, future earnings and cash flow growth, as well as the talented and experienced workforce. LG&E's and KU's franchise values are being attributed to the going concern value of the business and thus, were recorded as goodwill rather than a separately identifiable intangible asset. None of the goodwill recognized is deductible for income tax purposes or included in customer rates.

For the 2010 annual impairment test, the primary valuation technique used was an income methodology based on management's estimates of forecasted cash flows for the Utilities, with those cash flows discounted to present value using rates commensurate with the risks of those cash flows. Management also took into consideration the acquisition price paid by PPL. The discounted cash flows for LG&E and KU were based on discrete financial forecasts developed by management for planning purposes and consistent with those given to PPL. Cash flows beyond the discrete forecasts were estimated using a terminal-value calculation, which incorporated historical and forecasted financial trends for each of LG&E and KU. No impairment resulted from the fourth quarter test, as the determined fair value of the Utilities was greater than its carrying value.

For the 2009 annual impairment test, the estimated fair value of the Utilities was based on a combination of the income approach, which estimates the fair value of the reporting unit based on discounted future cash flows and the market approach, which estimates the fair value of the reporting unit based on market comparables. The discounted cash flows for LG&E and KU were based on discrete financial forecasts developed by management for planning purposes and consistent with those given to E.ON. Cash flows beyond the discrete forecasts were estimated using a terminal-value calculation, which incorporated historical and forecasted financial trends for each of LG&E and KU and considered long-term earnings

growth rates for publicly-traded peer companies. The level 3 income-approach valuations included a cash flow discount rate of 6.3% and a terminal-value growth rate of 1.1%. In addition, subsequent to 2009 but prior to the issuance of the 2009 financial statements, discussions were held with interested parties for the possible sale of the Company, including the regulated utilities. Data from this process was used for evaluating the carrying value of goodwill as of December 31, 2009.

Based on information represented by bids received from interested parties, including PPL, the Company completed a goodwill impairment analysis as of December 31, 2009. Step 1 of the impairment test indicated a possible impairment, so the Company completed step 2. The implied fair value of goodwill in the step 2 calculation was determined in the same manner utilized to estimate the amount of goodwill recognized in a business combination. The Company concluded that the fair values of LG&E and KU assets and liabilities equaled their book values, due to the regulatory environment in which they operate. The Kentucky and Virginia Commissions allow LG&E and KU to earn returns on the book values of their regulated asset bases at rates the Commissions determine to be fair and reasonable. Since there is no current prospect for deregulation, the Company assumed LG&E and KU will remain in a regulated environment for the foreseeable future. As a result of the impairment analysis described above, the Company recorded a 2009 goodwill impairment charge of \$1.493 billion.

The primary factors contributing to the goodwill impairment charges in 2009 were the significant economic downturn, which caused a decline in the volume of projected sales of electricity to commercial customers and an increase in the implied discount rate due to higher risk premiums. In addition, a lower control premium was assumed, based on observable market data.

Other Intangible Assets

The gross carrying amount and the accumulated amortization of other intangible assets were as follows:

	<u>Successor</u>	
	<u>December 31, 2010</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
Subject to amortization:		
Coal contracts (a)	\$ 269	\$ 9
Land rights (b)	14	-
Emission allowances (c)	18	2
OVEC power purchase agreement (d)	126	2
Total intangible assets	<u>\$ 427</u>	<u>\$ 13</u>

- (a) The gross carrying amount represents the fair value of coal contracts recognized as a result of the 2010 acquisition by PPL. The weighted average amortization period of these contracts is 3 years. See Note 2, Acquisition by PPL, for further information.
- (b) The gross carrying amount represents the fair value of land rights recognized as a result of adopting PPL's accounting policies in the Successor period. The weighted average amortization period of these rights is 14 years. See Note 1, Summary of Significant Accounting Policies, for further information.

- (c) The gross carrying amount represents the fair value of emission allowances recognized as a result of the 2010 acquisition by PPL, as well as the reclassification of amounts from inventory to intangible assets as a result of adopting PPL's accounting policies in the Successor period. The weighted average amortization period of these emission allowances is 3 years. See Note 2, Acquisition by PPL, for further information.
- (d) The gross carrying amount represents the fair value of the OVEC power purchase contract recognized as a result of the 2010 acquisition by PPL. The weighted average amortization period of the power purchase agreement is 8 years. See Note 2, Acquisition by PPL, for further information.

Current intangible assets and long-term intangible assets are included in "Other intangible assets" in their respective areas on the Consolidated Balance Sheets in 2010. Intangible assets resulting from purchase accounting adjustments are not recoverable in rates.

Amortization expense, excluding consumption of emission allowances, was \$11 million for the Successor in 2010. The estimated aggregate amortization expense for each of the next five years is as follows:

	Estimated Expense in Period Ended				
	2011	2012	2013	2014	2015
Aggregate amortization expense	\$ 88	\$ 48	\$ 52	\$ 47	\$ 50

Note 8 - Concentrations of Credit and Other Risk

Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed to perform as contracted. Concentrations of credit risk (whether on- or off-balance sheet) relate to groups of customers or counterparties that have similar economic or industry characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

LG&E's customer receivables arise from deliveries of electricity and natural gas. Electric revenues represented 77%, 72% and 69% of LG&E's revenues for 2010, 2009 and 2008, respectively. Natural gas revenues represented 23%, 28% and 31% of LG&E's revenues for 2010, 2009 and 2008, respectively. All of KU's customer receivables arise from deliveries of electricity. During 2010, LG&E's ten largest electric and natural gas customers accounted for less than 11% and less than 14% of total volumes, respectively. Volumes associated with the ten largest natural gas customers were predominantly for transportation service. During 2010, KU's ten largest customers accounted for less than 19% of volumes.

Effective November 2008, LG&E and its employees represented by the IBEW Local 2100 signed a three-year collective bargaining agreement. This agreement provides for negotiated increases or changes to wages, benefits or other provisions. The employees represented by this bargaining agreement comprise approximately 68% of LG&E's workforce at December 31, 2010.

Effective August 4, 2009, KU and its employees represented by the IBEW Local 2100 entered into a three-year collective bargaining agreement. The agreement provides for negotiated increases or changes to wages, benefits or other provisions and for annual wage re-openers. KU and its employees represented by the USWA Local 9447-01 entered into a three-year collective bargaining agreement in August 2008. This agreement provides for negotiated increases or changes to wages, benefits or other

provisions and for annual wage re-openers. The employees represented by these two bargaining units comprise approximately 15% of KU's workforce at December 31, 2010.

Note 9 - Pension and Other Postretirement Benefit Plans

LKE employees benefit from both funded and unfunded retirement benefit plans. Its defined benefit pension plans cover employees hired by December 31, 2005. Employees hired after this date participate in the Retirement Income Account ("RIA"), a defined contribution plan. The postretirement plan includes health care benefits that are contributory, with participants' contributions adjusted annually. The Company uses December 31 as the measurement date for its plans.

Obligations and Funded Status

The following tables provide a reconciliation of the changes in the defined benefit plans' obligations, the fair value of assets and the funded status of the plans for November 1, 2010 through December 31, 2010, for the Successor, and for January 1, 2010 through October 31, 2010, and January 1, 2009 through December 31, 2009, for the Predecessor:

	Pension Benefits			Other Postretirement Benefits		
	Successor	Predecessor		Successor	Predecessor	
	2010	2010	2009	2010	2010	2009
Change in benefit obligation:						
Benefit obligation at beginning of period	\$ 1,230	\$ 1,085	\$ 1,013	\$ 206	\$ 199	\$ 185
WKE's obligation previously in discontinued operations	-	-	33	-	-	7
Service cost	4	17	22	1	3	4
Interest cost	11	54	63	1	9	11
Plan amendments	-	-	-	-	-	1
Curtailement gain or (loss)	-	-	1	-	-	(3)
Settlement loss	-	-	2	-	-	-
Benefits paid, net of retiree contributions	(8)	(42)	(62)	(2)	(9)	(12)
Actuarial (gain) loss and other	(8)	116	13	(2)	4	6
Benefit obligation at end of period	\$ 1,229	\$ 1,230	\$ 1,085	\$ 204	\$ 206	\$ 199

	Pension Benefits			Other Postretirement Benefits		
	Successor	Predecessor		Successor	Predecessor	
	2010	2010	2009	2010	2010	2009
Change in plan assets:						
Fair value of plan assets at beginning of period	\$ 764	\$ 696	\$ 577	\$ 42	\$ 37	\$ 24
WKE's fair value of plan assets previously in discontinued operations	-	-	21	-	-	1
Actual return on plan assets	22	65	126	1	3	5
Employer contributions	-	46	35	8	11	19
Benefits paid, net of retiree contributions	(8)	(42)	(62)	(2)	(9)	(12)
Administrative expenses and other	-	(1)	(1)	-	-	-
Fair value of plan assets at end of period	<u>\$ 778</u>	<u>\$ 764</u>	<u>\$ 696</u>	<u>\$ 49</u>	<u>\$ 42</u>	<u>\$ 37</u>
Funded status at end of period	<u>\$ (451)</u>	<u>\$ (466)</u>	<u>\$ (389)</u>	<u>\$ (155)</u>	<u>\$ (164)</u>	<u>\$ (162)</u>

Amounts Recognized in the Consolidated Balance Sheets

The following tables provide the amounts recognized in the Consolidated Balance Sheets and information for plans with benefit obligations in excess of plan assets for November 1, 2010 through December 31, 2010, for the Successor, and for January 1, 2010 through October 31, 2010, and January 1, 2009 through December 31, 2009, for the Predecessor:

	Pension Benefits			Other Postretirement Benefits		
	Successor	Predecessor		Successor	Predecessor	
	2010	2010	2009	2010	2010	2009
Regulatory assets	\$ 314	\$ 334	\$ 293	\$ 16	\$ 17	\$ 16
Regulatory liabilities	-	-	-	(10)	(9)	(9)
Accrued benefit liability (current)	(2)	(3)	(7)	(1)	(1)	(4)
Accrued benefit liability (non-current)	(449)	(463)	(382)	(154)	(163)	(158)

Amounts recognized in regulatory assets and liabilities for November 1, 2010 through December 31, 2010, for the Successor, and for January 1, 2010 through October 31, 2010, and January 1, 2009 through December 31, 2009, for the Predecessor:

	Pension Benefits			Other Postretirement Benefits		
	Successor	Predecessor		Successor	Predecessor	
	2010	2010	2009	2010	2010	2009
Transition obligation	\$ -	\$ -	\$ -	\$ 3	\$ 4	\$ 5
Prior service cost	30	32	37	6	6	8
Accumulated loss (gain)	284	302	256	(3)	(2)	(6)
Total regulatory assets	\$ 314	\$ 334	\$ 293	\$ 6	\$ 8	\$ 7

Amounts recognized in accumulated other comprehensive income for November 1, 2010 through December 31, 2010, for the Successor, and for January 1, 2010 through October 31, 2010, and January 1, 2009 through December 31, 2009, for the Predecessor:

	Pension Benefits			Other Postretirement Benefits		
	Successor	Predecessor		Successor	Predecessor	
	2010	2010	2009	2010	2010	2009
Prior service (cost)	\$ -	\$ (18)	\$ (21)	\$ -	\$ (1)	\$ 1
Accumulated gain (loss)	8	(94)	(59)	1	2	(1)
Total accumulated other comprehensive income	\$ 8	\$ (112)	\$ (80)	\$ 1	\$ 1	\$ -

Additional information for plans with accumulated benefit obligations in excess of plan assets for November 1, 2010 through December 31, 2010, for the Successor, and for January 1, 2010 through October 31, 2010, and January 1, 2009 through December 31, 2009, for the Predecessor:

	Pension Benefits			Other Postretirement Benefits		
	Successor	Predecessor		Successor	Predecessor	
	2010	2010	2009	2010	2010	2009
Benefit obligation	\$ 1,229	\$ 1,230	\$ 1,085	\$ 204	\$ 206	\$ 199
Accumulated benefit obligation	1,043	1,039	919	-	-	-
Fair value of plan assets	778	764	696	49	42	37

The amounts recognized in regulatory assets and liabilities for November 1, 2010 through December 31, 2010, for the Successor, and for January 1, 2010 through October 31, 2010, and January 1, 2009 through December 31, 2009, for the Predecessor:

	Pension Benefits			Other Postretirement Benefits		
	Successor	Predecessor		Successor	Predecessor	
	2010	2010	2009	2010	2010	2009
Net (gain) loss arising during the period	\$ (14)	\$ 59	\$ (49)	\$ (1)	\$ 4	\$ 3
Amortization of prior service (cost)	(1)	(5)	(7)	-	(1)	(2)
Amortization of transitional obligation	-	-	-	-	(2)	(2)
Amortization of (loss) gain	(5)	(13)	(21)	-	-	1
Total amounts recognized in regulatory assets and liabilities	<u>\$ (20)</u>	<u>\$ 41</u>	<u>\$ (77)</u>	<u>\$ (1)</u>	<u>\$ 1</u>	<u>\$ -</u>

The amounts recognized in accumulated other comprehensive income for November 1, 2010 through December 31, 2010, for the Successor, and for January 1, 2010 through October 31, 2010, and January 1, 2009 through December 31, 2009, for the Predecessor:

	Pension Benefits			Other Postretirement Benefits		
	Successor	Predecessor		Successor	Predecessor	
	2010	2010	2009	2010	2010	2009
Prior service cost recognized due to curtailment	\$ -	\$ -	\$ (2)	\$ -	\$ -	\$ (1)
Settlement recognition of net loss	-	-	(2)	-	-	-
Net (gain) loss arising during period	(8)	37	(17)	(1)	(1)	(1)
Amortization of prior service cost	-	(2)	(2)	-	-	-
Amortization of loss	-	(3)	(4)	-	-	-
Total amounts recognized in accumulated other comprehensive income	<u>\$ (8)</u>	<u>\$ 32</u>	<u>\$ (27)</u>	<u>\$ (1)</u>	<u>\$ (1)</u>	<u>\$ (2)</u>

For discussion of the pension and postretirement regulatory assets and liabilities, see Note 3, Rates and Regulatory Matters.

Components of Net Periodic Benefit Cost

The following tables provide the components of net periodic benefit cost for pension and other postretirement benefit plans for November 1, 2010 through December 31, 2010, for the Successor, and for January 1, 2010 through October 31, 2010, and January 1, 2009 through December 31, 2009, for the Predecessor:

	Pension Benefits		Other Postretirement Benefits	
	Successor	Predecessor	Successor	Predecessor
	2010	2010	2010	2010
Service cost	\$ 4	\$ 17	\$ 1	\$ 3
Interest cost	11	54	1	9
Expected return on plan assets	(9)	(45)	-	(2)
Amortization of prior service costs	1	7	-	2
Amortization of actuarial loss	5	16	-	-
Amortization of transitional obligation	-	-	-	1
Net periodic benefit cost	<u>\$ 12</u>	<u>\$ 49</u>	<u>\$ 2</u>	<u>\$ 13</u>

The following tables provide the components of net periodic benefit cost for pension and other postretirement benefit plans for the years ended December 31, 2009 and 2008 for the Predecessor:

	Pension Benefits		Other Postretirement Benefits	
	2009	2008	2009	2008
	Service cost	\$ 20	\$ 19	\$ 4
Interest cost	62	60	11	11
Expected return on plan assets	(47)	(65)	(2)	(2)
Amortization of prior service cost	9	9	3	2
Amortization of actuarial (gain) loss	27	3	(1)	2
Amortization of transitional obligation	-	-	2	-
Net periodic benefit cost	<u>\$ 71</u>	<u>\$ 26</u>	<u>\$ 17</u>	<u>\$ 17</u>

The estimated amounts that will be amortized from regulatory assets and liabilities and accumulated other comprehensive income into net periodic benefit cost in 2011 are shown in the following table:

	Pension Benefits	Other Postretirement
Regulatory assets and liabilities:		
Net actuarial loss	\$ 22	\$ -
Prior service cost	5	2
Transitional obligation	-	2
Total regulatory assets and liabilities amortized during 2011	<u>\$ 27</u>	<u>\$ 4</u>
Accumulated other comprehensive income:		
Net actuarial loss	\$ -	\$ -
Prior service cost	-	-
Total accumulated other comprehensive income amortized during 2011	<u>\$ -</u>	<u>\$ -</u>

The weighted average assumptions used in the measurement of the Company's pension and postretirement benefit obligations are shown in the following table:

	Successor	Predecessor	
	2010	2010	2009
Discount rate – LG&E union plan	5.39%	5.32%	6.08%
Discount rate – WKE union plan	5.09%	5.00%	5.00%
Discount rate – nonunion plan	5.52%	5.46%	6.13%
Discount rate – SERP plan	5.11%	4.96%	5.79%
Discount rate – officer SERP plan	5.46%	5.41%	6.14%
Discount rate – restoration plan	5.66%	5.66%	6.31%
Discount rate – postretirement	5.12%	4.96%	5.82%
Rate of compensation increase	5.25%	5.25%	5.25%

For the first ten months of 2010, the discount rates used to determine the pension and postretirement benefit obligations and the period expense were determined using the Mercer Pension Discount Yield Curve. This model takes the plans' cash flows and matches them to a yield curve that provides the equivalent yields on zero-coupon corporate bonds for each maturity. The discount rate is the single rate that produces the same present value of cash flows. The selection of the various discount rates represents the equivalent single rate under a broad-market AA yield curve constructed by Mercer.

For the last two months of 2010, the Towers Watson Yield Curve was used to determine the discount rate. This model starts with an analysis of the expected benefit payment stream for its plans. This information is first matched against a spot-rate yield curve. A portfolio of Aa-graded non-callable (or callable with make-whole provisions) bonds, with a total amount outstanding in excess of \$667 billion, serves as the base from which those with the lowest and highest yields are eliminated to develop the ultimate yield curve. The results of this analysis are considered together with other economic data and movements in various bond indices to determine the discount rate assumption.

The weighted average assumptions used in the measurement of the Company's pension and postretirement net periodic benefit costs for November 1, 2010 through December 31, 2010, for the Successor, and for January 1, 2010 through October 31, 2010, and January 1, 2009 through December 31, 2009, for the Predecessor are shown in the following table:

	Successor	Predecessor		
	2010	2010	2009	2008
Discount rate – pension benefits	5.40%	6.11%	6.25%	6.66%
Discount rate – postretirement benefits	4.94%	5.82%	6.36%	6.56%
Expected long-term return on plan assets	7.25%	7.75%	8.25%	8.25%
Rate of compensation increase	5.25%	5.25%	5.25%	5.25%

To develop the expected long-term rate of return on assets assumption, the Company considered the current level of expected returns on risk free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the current asset allocation to develop the expected long-term rate of return on assets

assumption for the portfolio. The Company has determined that the 2011 expected long-term rate of return on assets assumption should be 7.25%.

The following describes the effects on pension benefits by changing the major actuarial assumptions discussed above:

- A 1% change in the assumed discount rate would have a \$133 million positive or negative impact to the 2010 accumulated benefit obligation and an approximate \$172 million positive or negative impact to the 2010 projected benefit obligation.
- A 25 basis point change in the expected rate of return on assets would have a \$2 million positive or negative impact to 2010 pension expense.
- A 25 basis point increase in the rate of compensation increase would have a \$11 million negative impact to the 2010 projected benefit obligation.

Assumed Health Care Cost Trend Rates

For measurement purposes, an 8% annual increase in the per capita cost of covered health care benefits was assumed for the first ten months of 2010. The rate was assumed to decrease gradually to 4.5% by 2029 and remain at that level thereafter. For the last two months of 2010, an 8% annual increase in the per capita cost of covered health care benefits was assumed and the rate was assumed to decrease gradually to 5.5% by 2019. For 2011, a 9% annual increase in the per capita cost of covered health care benefits is assumed and the rate is assumed to decrease gradually to 5.5% by 2019. This change in the length of the health care trend was made to conform to PPL's accounting policies.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 1% change in assumed health care cost trend rates would have resulted in an increase or decrease of less than \$1 million to the 2010 total of service and interest costs components and an increase or decrease of \$6 million in year end 2010 postretirement benefit obligations.

Expected Future Benefit Payments and Medicare Subsidy Receipts

The following list provides the amount of expected future benefit payments, which reflect expected future service costs and the estimated gross amount of Medicare subsidy receipts:

	<u>Pension Benefits</u>	<u>Other Postretirement Benefits</u>	<u>Medicare Subsidy Receipts</u>
2011	\$ 54	\$ 14	\$ 1
2012	51	14	-
2013	53	15	1
2014	54	15	-
2015	57	15	1
2016-2020	353	84	3

Plan Assets

The following table shows the pension plans' weighted average asset allocation by asset category at December 31:

	<u>Target Range</u>	<u>Successor 2010</u>	<u>Predecessor 2009</u>
Equity securities	45%-75%	56%	59%
Debt securities	30%-50%	37%	40%
Other	0%-10%	7%	1%
Total		<u>100%</u>	<u>100%</u>

The investment policy of the pension plans was developed in conjunction with financial and actuarial consultants, investment advisors and legal counsel. The goal of the investment policy is to preserve the capital of the pension plans' assets and maximize investment earnings. The return objective is to exceed the benchmark return for the policy index comprised of the following: Russell 3000 Index, MSCI-EAFE Index, Barclays Capital Aggregate and Barclays Capital U.S. Long Government/Credit Bond Index in proportions equal to the targeted asset allocation.

Evaluation of performance focuses on a long-term investment time horizon of at least three to five years or a complete market cycle. The assets of the pension plans are broadly diversified within different asset classes (equities, fixed income securities and cash equivalents).

To minimize the risk of large losses in a single asset class, no more than 5% of the portfolio will be invested in the securities of any one issuer with the exclusion of the U.S. government and its agencies. The equity portion of the fund is diversified among the market's various subsections to diversify risk, maximize returns and avoid undue exposure to any single economic sector, industry group or individual security. The equity subsectors include, but are not limited to, growth, value, small capitalization and international.

In addition, the overall fixed income portfolio may have an average weighted duration, or interest rate sensitivity which is within +/- 20% of the duration of the overall fixed income benchmark. Foreign bonds in the aggregate shall not exceed 10% of the total fund. The portfolio may include a limited investment of up to 20% in below investment grade securities provided that the overall average portfolio quality remains "AA" or better. The below investment grade securities include, but are not limited to, medium-term notes, corporate debt, non-dollar and emerging market debt and asset backed securities. The cash investments should be in securities that are either short maturities (not to exceed 180 days) or readily marketable with modest risk.

Derivative securities are permitted only to improve the portfolio's risk/return profile, to modify the portfolio's duration or to reduce transaction costs and must be used in conjunction with underlying physical assets in the portfolio. Derivative securities that involve speculation, leverage, interest rate anticipation, or any undue risk whatsoever are not deemed appropriate investments.

The investment objective for the postretirement benefit plan is to provide current income consistent with stability of principal and liquidity while maintaining a stable net asset value of \$1.00 per share. The postretirement funds are invested in a prime cash money market fund that invests primarily in a portfolio

of short-term, high-quality fixed income securities issued by banks, corporations and the U.S. government.

The Company has classified plan assets that are accounted for at fair value into the three levels of the fair value hierarchy, as defined by the fair value measurements and disclosures guidance of the FASB ASC. See Note 6, Fair Value Measurements, for further information.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

A description of the valuation methodologies used to measure plan assets at fair value is provided below:

Money market funds: These investments are public investment vehicles valued using \$1 for the net asset value. The money market funds are classified within level 2 of the valuation hierarchy.

Common/collective trusts: Valued based on the beginning of year value of the plan's interests in the trust plus actual contributions and allocated investment income (loss) less actual distributions and allocated administrative expenses. Quoted market prices are used to value investments in the trust, with the exception of the GAC. The fair value of certain other investments for which quoted market prices are not available are valued based on yields currently available on comparable securities of issuers with similar credit ratings. The common/collective trusts are classified within level 2 of the valuation hierarchy.

The preceding methods described may produce a fair value that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Company believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Prior to the acquisition, the GAC was considered an immediate participation guarantee contract which was not included in the fair value table. In accordance with the plan accounting guidance of the FASB ASC, the cost incurred to purchase the GAC prior to March 20, 1992, was permitted to be carried at contract value, since it is a contract with an insurance company and prior to the acquisition it was excluded from the table above. The cost incurred to fund the GAC after March 20, 1992, was carried at contract value in accordance with the plan accounting guidance of the FASB ASC, since it is a contract that incorporates mortality and morbidity risk. Contract value represents cost plus interest income less distributions for benefits and administrative expenses. To conform to PPL's accounting methods, the John Hancock GAC was classified in the fair value table as a level 3 and as "other" rather than "debt securities" in the asset allocation table for the period ended December 31, 2010.

The following table sets forth, by level within the fair value hierarchy, the plan's assets at fair value at December 31:

	Successor			Predecessor		
	Total 2010	Level 2	Level 3	Total 2009	Level 2	Level 3
Money market funds	\$ 8	\$ 8	\$ -	\$ 6	\$ 6	\$ -
Common/collective trusts	772	772	-	678	678	-
John Hancock – GAC	47	-	47	-	-	-
Total investments at fair value	<u>\$ 827</u>	<u>\$ 780</u>	<u>\$ 47</u>	<u>\$ 684</u>	<u>\$ 684</u>	<u>\$ -</u>

The following table sets forth a reconciliation of changes in the fair value of the plan's level 3 assets for the following period:

	Successor
Balance at November 1, 2010	\$ -
Purchases	1
Transfers into level 3	46
Balance at December 31, 2010	<u>\$ 47</u>

There are no assets categorized as level 1 as of December 31, 2010 and December 31, 2009.

Contributions

The Company made discretionary contributions to its pension plans of \$45 million in 2010 and \$33 million in 2009. Total contributions were \$46 million in 2010 and \$35 million in 2009. 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. The Company made contributions totaling \$150 million in January 2011. See Note 21, Subsequent Events, for further information.

The Company made contributions to its other postretirement benefit plan totaling \$19 million in 2010 and 2009. In 2011, the Company plans on making voluntary contributions to fund VEBA trusts to match the annual postretirement expense and funding the 401(h) plan up to the maximum amount allowed by law.

Pension Legislation

The Pension Protection Act of 2006 was enacted in August 2006. New rules regarding funding of defined benefit plans are generally effective for plan years beginning in 2008. Among other matters, this comprehensive legislation contains provisions applicable to defined benefit plans which generally (i) mandate full funding of current liabilities within seven years; (ii) increase tax-deduction levels regarding contributions; (iii) revise certain actuarial assumptions, such as mortality tables and discount rates; and (iv) raise federal insurance premiums and other fees for under-funded and distressed plans. The legislation also contains a number of provisions relating to defined-contribution plans and qualified and non-qualified executive pension plans and other matters. The Company's plans met the minimum funding requirements as defined by the Pension Protection Act of 2006 for years ended December 31, 2010 and 2009.

Thrift Savings Plans

The Company has thrift savings plans under section 401(k) of the Internal Revenue Code. Under these plans, eligible employees may defer and contribute to the plans a portion of current compensation in order to provide future retirement benefits. The Company makes contributions to the plans by matching a portion of the employees' contributions. The costs of this matching were approximately \$9 million and \$10 million for 2010 and 2009, respectively.

The Company also makes contributions to RIAs within its thrift savings plans for certain employees not covered by the noncontributory defined benefit pension plans. These employees consist of those hired after December 31, 2005. The Company makes these contributions based on years of service and the employees' wage and salary levels and makes them in addition to the matching contributions discussed above. The amounts contributed by the Company under this arrangement were \$1 million in 2010 and 2009.

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.

During 2010, KU recorded an income tax expense of less than \$1 million to recognize the impact of the elimination of the tax deduction related to the Medicare Retiree Drug Subsidy that becomes effective in 2013.

Specific provisions within Health Care Reform that may impact the Company include:

- Beginning in 2011, requirements extend dependent coverage up to age 26, remove the \$2 million lifetime maximum and eliminate cost sharing for certain preventative care procedures.
- Beginning in 2018, a potential excise tax is expected on high-cost plans providing health coverage that exceeds certain thresholds.

The Company has evaluated these provisions 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 requirement to extend dependent coverage up to age 26 is not expected to have a significant impact on active or retiree medical costs. The Company will continue to monitor the potential impact of any changes to the existing provisions and implementation guidance related to Health Care Reform on its benefit programs.

Note 10 - Income Taxes

LKE's federal income tax return is included in a United States consolidated income tax return filed by LKE's direct parent. Prior to October 31, 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 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. Adjustments for 2007, agreed to and recorded in January 2009, were comprised of \$5 million of depreciable temporary differences. 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 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 bonus depreciation, storms and other repairs, contributions in aid of construction and purchased natural gas adjustments. No net 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.

The following table shows additions and reductions of unrecognized tax benefits for the twelve months ended December 31:

	Successor <u>2010</u>	Predecessor <u>2009</u>
Balance at beginning of year	\$ 1	\$ 8
Additions based on tax positions related to current year	3	-
Reductions due to expiration of statute of limitations	<u>(1)</u>	<u>(7)</u>
Balance at end of year	<u>\$ 3</u>	<u>\$ 1</u>

No uncertain tax positions are scheduled to decrease within the next twelve months.

The amount LKE recognized as interest expense and interest accrued related to unrecognized tax benefits was less than \$1 million for the twelve month periods ended and as of December 31, 2010, 2009 and 2008. The interest expense and interest accrued is based on IRS and Kentucky Department of Revenue large corporate interest rates for underpayment of taxes. At the date of adoption, the Company accrued less than \$1 million in interest expense on uncertain tax positions. LKE records the interest as “Interest expense” and penalties, if any, as “Operating expenses” on the Consolidated Statements of Income and “Other current liabilities” on the Consolidated Balance Sheets, on a pre-tax basis. No penalties have been accrued by the Company through December 31, 2010.

Components of income tax expense are shown in the table below:

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31,	
			2009	2008
Current	\$ (27)	\$ 44	\$ 39	\$ 96
Deferred	52	67	46	(14)
Amortization of investment tax credits	-	(2)	(3)	(4)
Total income tax expense	\$ 25	\$ 109	\$ 82	\$ 78

In June 2006, LG&E and KU filed a joint application with the U.S. Department of Energy (“DOE”) requesting certification to be eligible for investment tax credits applicable to the construction of TC2. In November 2006, the DOE and the IRS announced that LG&E and KU were selected to receive the tax credits. A final IRS certification required to obtain the investment tax credits was received in August 2007. In September 2007, LG&E and KU received an Order from the Kentucky Commission approving the accounting of the investment tax credits, which includes a full depreciation basis adjustment for the amount of the credits. The LG&E and KU portion of the TC2 tax credits is \$125 million. Based on eligible construction expenditures incurred, the Company recorded investment tax credits of \$25 million and \$33 million in 2009 and 2008, respectively. As of December 31, 2009, the Company had recorded its maximum credits of \$125 million. The income tax expense impact from amortizing these credits over the life of the related property began when the facility was placed in service in January 2011.

In March 2008, certain environmental and preservation groups filed suit in federal court in North Carolina against the DOE and IRS claiming the investment tax credit program was in violation of certain environmental laws and demanded relief, including suspension or termination of the program. The plaintiffs voluntarily dismissed their complaint in August 2010.

Components of deferred income taxes included in the Consolidated Balance Sheets are shown below:

	<u>Successor</u> December 31, 2010	<u>Predecessor</u> December 31, 2009
Deferred income tax liabilities:		
Depreciation and other plant-related items	\$ 789	\$ 694
Regulatory assets and other	166	-
Accruals and other assets	57	72
Investments and other financial assets	<u>12</u>	<u>14</u>
Total deferred income tax liabilities	1,024	780
Deferred income tax assets:		
Net operating loss carryforward	319	371
Advanced coal and other tax credits	169	156
Regulatory liabilities and other	166	-
Pensions and similar obligations	69	93
Federal and state capital loss carryforward	60	7
Accruals and other liabilities	28	38
Income taxes due to customers	30	28
Investment tax credit	10	10
Investments and other financial assets	<u>5</u>	<u>7</u>
	856	710
Valuation allowance	<u>(6)</u>	<u>(7)</u>
Total deferred income tax assets	<u>850</u>	<u>703</u>
Net deferred income tax liabilities	<u>\$ 174</u>	<u>\$ 77</u>
Balance sheet classification:		
Deferred income taxes – net (current)	\$ (66)	\$ (10)
Deferred income taxes (non-current)	<u>240</u>	<u>87</u>
Net deferred income tax liabilities	<u>\$ 174</u>	<u>\$ 77</u>

Based on the Company's net deferred income tax liability position and the realization period for net operating loss carryforwards, the Company expects to have adequate levels of taxable income to realize its deferred income tax assets associated with the net operating losses. The net operating loss carryforwards start to expire in 2028. Alternative minimum tax credits of \$20 million do not expire, wind credits of \$11 million start to expire in 2016, investment tax credits of \$125 million start to expire in 2025 and other general business credits of \$13 million start to expire in 2018.

In January 2010, the Company completed the sale of its Centro and Cuyana natural gas distribution interests resulting in a \$106 million estimated capital loss. This and other remaining federal capital losses are expected to be realized within the carry forward period. Federal valuation reserves related to these losses were reversed as part of the purchase accounting valuation. Valuation reserves remain for state capital loss tax benefits.

The Company incurred losses in connection with the termination of the WKE lease. As a result, federal tax loss carryforwards were \$280 million and \$336 million as of December 31, 2010 and 2009, respectively, and state tax net operating loss carryforwards were \$39 million and \$35 million as of December 31, 2010 and 2009, respectively.

A reconciliation of differences between the income tax expense at the statutory U.S. federal income tax rate and the Company's actual income tax expense follows:

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31,	
			2009	2008
Statutory federal income tax expense	\$ 25	\$ 105	\$ (432)	\$ (538)
State income taxes – net of federal benefit	2	9	7	3
Equity investments	-	-	(3)	(8)
Reduction of income tax reserve	-	-	(4)	(3)
Investment and other tax credits	(1)	(2)	(3)	(4)
Reversal of excess deferred taxes	(1)	(2)	(3)	(2)
Goodwill impairment	-	-	523	632
Other differences – net	-	(1)	(3)	(2)
Income tax expense	<u>\$ 25</u>	<u>\$ 109</u>	<u>\$ 82</u>	<u>\$ 78</u>
Effective income tax rate	<u>35.7%</u>	<u>36.3%</u>	<u>(6.6)%</u>	<u>(5.1)%</u>

The Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010, enacted December 17, 2010, provided, among other provisions, certain incentives related to bonus depreciation and 100% expensing of qualifying capital expenditures. LKE benefited from these new provisions by reducing its 2010 current federal income tax expense. This reduction in federal taxable income for LKE does, however, result in a reduction of LKE's Section 199 Manufacturing deduction, which is based on manufacturing taxable income, and correspondingly increases income tax expense. The impact from these changes on 2010 was not material; however, LKE anticipates a significant reduction of taxable income in 2011 and 2012 and a corresponding loss of most, if not all, of the Section 199 Manufacturing deduction for the following two years.

Note 11 - Long-Term Debt

As summarized below, at December 31, 2010, long-term debt consists of first mortgage bonds, secured pollution control bonds, senior notes and a medium-term note. At December 31, 2009, long-term debt and the current portion of long-term debt consisted primarily of pollution control bonds, long-term loans from affiliated companies and a medium-term note. Utility debt issuance expense is capitalized in regulatory assets and amortized over the lives of the related bond issues for LG&E and KU consistent with regulatory practices. Non-utility issuance expense is amortized using the straight line method. Provided below is a summary of the long-term debt as of December 31:

	Successor 2010	Predecessor 2009
Current portion of long-term debt - medium term note	\$ 2	\$ -
Long-term debt - medium term note	-	2
Current portion of long-term debt to affiliates	-	358
Long-term debt to affiliated companies	-	3,063
Unsecured senior notes payable	875	-
Secured first mortgage bonds, net of debt discount and amortization of debt discount	2,035	-
Pollution control revenue bonds, collateralized by first mortgage bonds	925	762
Fair value adjustment from purchase accounting	8	-
Unamortized discount	(20)	-
Total long-term debt	3,825	4,185
Less current portion	2	706
Long-term debt, excluding current portion	<u>\$ 3,823</u>	<u>\$ 3,479</u>

	Stated Interest Rates	Maturities	Debt Amounts
<u>Successor</u>			
Outstanding at December 31, 2010:			
Current portion	7.471%	2011	\$ 2
Non-current portion	Variable – 6.00%	2015-2040	3,823
<u>Predecessor</u>			
Outstanding at December 31, 2009:			
Current portion	Variable - 7.01%	2010-2034	\$ 706
Non-current portion	Variable - 7.78%	2011-2037	3,479

As of December 31, 2009, long-term debt for LKE includes \$348 million classified as current portion because these bonds are subject to tender for purchase at the option of the holder and to mandatory tender for purchase upon the occurrence of certain events. These bonds include Jefferson County 2001 Series A and B; Trimble County 2001 Series A and B; Carroll County 2002 Series A and B, 2004 Series A, 2006 Series B and 2008 Series A; Muhlenberg County 2002 Series A; and Mercer County 2000 Series A and 2002 Series A. Maturity dates for these bonds range from 2023 to 2034. As of December 31, 2009, the bonds were classified as current portion of long-term debt because investors could put the

bonds back to the Company within a year. As of December 31, 2010, the bonds were reclassified as long-term debt. See Note 1, Summary of Significant Accounting Policies, for changes in classification.

Pollution control bonds are obligations of LG&E or KU, issued in connection with tax-exempt pollution control bonds by various counties in Kentucky. A loan agreement obligates LG&E or KU, as the case may be, to make debt service payments to the counties in amounts equal to the debt service due from the counties on the related pollution control bonds. Depending on the type of expense, the Successor capitalized debt expenses in long-term other regulatory assets or long-term other assets to align with the term of the debt the expenses were related. The Predecessor capitalized debt expenses in current or long-term other regulatory assets or other current or long-term other assets based on the amount of expense expected to be recovered within the next year through rate recovery. Both Predecessor and Successor amortized debt expenses over the lives of the related bond issues. The Predecessor presentation and the Successor presentation are both appropriate under regulatory practices and GAAP.

In October 2010, in order to secure their respective obligations with respect to the pollution control bonds, each of LG&E and KU issued first mortgage bonds to the pollution control bond trustees. The first mortgage bonds contain terms and conditions that are substantially parallel to the terms and conditions of the counties' debt, but provide that obligations are deemed satisfied to the extent of payments under the related loan agreement, and thus generally require no separate payment of principal and interest except under certain circumstances, including should LG&E or KU, as the case may be, default on the respective loan agreement. Also in October 2010, one national rating agency revised downward the short-term credit rating of the pollution control bonds and the Company's issuer rating as a result of the pending acquisition by PPL.

Several series of LKE's pollution control bonds are insured by monoline bond insurers whose ratings have been reduced due to exposures relating to insurance of sub-prime mortgages. At December 31, 2010, 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. Beginning in late 2007, the interest rates on these insured bonds began to increase due to investor concerns about the creditworthiness of the bond insurers. Since 2008, interest rates increased and the Company experienced "failed auctions" when there were insufficient bids for the bonds. 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	
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	December 31, 2009
LG&E	0.47%	0.43%	0.38%
KU	0.53%	0.51%	0.44%

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.

As of December 31, 2010, LKE continued to hold repurchased bonds in the amount of \$163 million. As of December 31, 2009, the repurchased bonds were reported net (excluded from long-term debt). As of December 31, 2010, the accounting treatment changed and the repurchased bonds were reported gross (included in long-term debt). See Note 1, Summary of Significant Accounting Policies, for changes in classification. See Note 18, Available for Sale Debt Securities, and Note 21, Subsequent Events, for details regarding the remarketing of the repurchased bonds on January 13, 2011.

As a result of downgrades of the monoline insurers by all of the rating agencies to levels below that of LG&E's or KU's rating, the debt ratings of LG&E's or KU's insured pollution control bonds are all based on LG&E's or KU's senior secured debt rating and are not influenced by the monoline bond insurer ratings.

Interest rate swaps are used to hedge certain underlying variable-rate debt obligations. The swaps exchange floating-rate interest payments for fixed rate interest payments to reduce the impact of interest rate changes on the pollution control bonds. As of December 31, 2010 and 2009, LKE had swaps with an aggregate notional value of \$179 million. Beginning in the third quarter of 2010, the unrealized gains and losses of the interest rate swaps are included in a regulatory asset, which offsets the long-term derivative liabilities. See Note 5, Derivative Financial Instruments, for further information.

In connection with the PPL acquisition, on November 1, 2010, LKE borrowed approximately \$968 million from a PPL subsidiary and received an equity contribution from PPL of \$1.5 billion in order to repay loans from subsidiaries of E.ON. LG&E and KU borrowed \$485 million and \$1,331 million, respectively, from a PPL subsidiary, in order to repay loans from a subsidiary of E.ON.

In November 2010, LG&E and KU issued first mortgage bonds totaling \$2,035 million and used the proceeds to repay the loans from a PPL subsidiary mentioned above 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 as described in the table below:

LG&E			First Mortgage
<u>First Mortgage Bonds</u>	<u>Principal</u>	<u>Discount Price</u>	<u>Bonds Proceeds (a)</u>
Series due 2015	\$ 250	99.647%	\$ 249
Series due 2040	285	98.912%	282
Total	<u>\$ 535</u>		<u>\$ 531</u>

KU			First Mortgage
<u>First Mortgage Bonds</u>	<u>Principal</u>	<u>Discount Price</u>	<u>Bonds Proceeds (a)</u>
Series due 2015	\$ 250	99.650%	\$ 249
Series due 2020	500	99.622%	498
Series due 2040	\$ 750	98.915%	\$ 742
Total	<u>1,500</u>		<u>1,489</u>

LKE First Mortgage Bonds	Principal	Discount Price	First Mortgage Bonds Proceeds (a)
Series due 2015	\$ 400	99.557%	\$ 398
Series due 2020	475	99.217%	471
Total	<u>\$ 875</u>		<u>\$ 869</u>

(a) Before expenses other than discount to purchaser

The first mortgage bonds and senior notes were issued by the respective issuer in accordance with the rules in Section 144A of the Securities Act of 1933. Each issuer has entered into a registration rights agreement in which it has 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 accrue at a rate of 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.

Redemptions and maturities of long-term debt for 2010 and 2009 are summarized below:

Year	Company	Description	Principal Amount	Rate	Secured/ Unsecured	Maturity
<u>Successor</u>						
2010	LG&E	Due to PPL Investment Corp.	\$ 485	4.33%-6.48%	Unsecured	2012-2037
2010	KU	Due to PPL Investment Corp.	1,331	4.24%-7.035%	Unsecured	2012-2037
2010	LKE	Due to E.ON affiliates	1,330	Variable-7.78%	Unsecured	2010-2037
2010	LG&E	Due to E.ON affiliates	485	4.33%-6.48%	Unsecured	2012-2037
2010	KU	Due to E.ON affiliates	1,331	4.24%-7.035%	Unsecured	2010-2037
<u>Predecessor</u>						
2010	LKE	Due to E.ON affiliates	75	7.01%	Unsecured	2010
2010	LKE	Due to E.ON affiliates	150	4.64%	Unsecured	2010
2010	LKE	Due to E.ON affiliates	100	Variable	Unsecured	2010
2009	LKE	Due to E.ON affiliates	50	3.98%	Unsecured	2009
2009	LKE	Due to E.ON affiliates	80	Variable	Unsecured	2009
2009	LKE	Due to E.ON affiliates	50	Variable	Unsecured	2009
2009	LKE	Due to E.ON affiliates	75	4.07%	Unsecured	2009

Issuances of long-term debt for 2010 and 2009 are summarized below:

<u>Year</u>	<u>Company</u>	<u>Description</u>	<u>Principal Amount</u>	<u>Rate</u>	<u>Secured/ Unsecured</u>	<u>Maturity</u>
<u>Successor</u>						
2010	LG&E	Due to PPL Investment Corp.	\$ 485	4.33%-6.48%	Unsecured	2012-2037
2010	KU	Due to PPL Investment Corp.	1,331	4.24%-7.035%	Unsecured	2010-2037
2010	KU	First mortgage bonds	250	1.625%	Secured	2015
2010	KU	First mortgage bonds	500	3.25%	Secured	2020
2010	KU	First mortgage bonds	750	5.125%	Secured	2040
2010	LG&E	First mortgage bonds	250	1.625%	Secured	2015
2010	LG&E	First mortgage bonds	285	5.125%	Secured	2040
2010	LKE	Senior Notes	400	2.125%	Unsecured	2015
2010	LKE	Senior Notes	475	3.75%	Unsecured	2020
<u>Predecessor</u>						
2010	LKE	Due to E.ON affiliates	50	Variable	Unsecured	2013
2009	LKE	Due to E.ON affiliates	50	7.784%	Unsecured	2011
2009	LKE	Due to E.ON affiliates	50	Variable	Unsecured	2012
2009	LKE	Due to E.ON affiliates	50	Variable	Unsecured	2012
2009	LKE	Due to E.ON affiliates	100	Variable	Unsecured	2012
2009	LKE	Due to E.ON affiliates	75	6.044%	Unsecured	2014
2009	LKE	Due to E.ON affiliates	50	Variable	Unsecured	2014
2009	LKE	Due to E.ON affiliates	50	Variable	Unsecured	2014
2009	LKE	Due to E.ON affiliates	80	Variable	Unsecured	2016
2009	KU	Due to E.ON affiliates	50	4.445%	Unsecured	2019
2009	KU	Due to E.ON affiliates	50	4.81%	Unsecured	2019
2009	KU	Due to E.ON affiliates	50	5.28%	Unsecured	2017

As of December 31, 2010, LG&E's and KU's first mortgage bonds are secured by first mortgage liens on substantially all of their respective real and tangible personal property located in Kentucky. The remaining long-term debt for the Company is unsecured. Long-term debt maturities for the Company are shown in the following table:

2011	\$ 2
2012	-
2013	-
2014	-
2015	900
Thereafter	2,935
	<u>\$ 3,837</u>

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

See Note 1, Summary of Significant Accounting Policies, for certain debt refinancing and associated transactions completed by LKE in connection with the PPL acquisition, Note 2, Acquisition by PPL, for the adjustment made to the pollution control bonds to reflect fair value and Note 15, Related Party Transactions, for long-term debt payable to affiliates.

Note 12 - Notes Payable and Other Short-Term Obligations

Intercompany Revolving Lines of Credit

The Company maintained revolving credit facilities totaling \$300 million at December 31, 2010 and \$313 million at December 31, 2009, to ensure funding availability for the money pool. At December 31, 2010, the Company maintained a facility with another subsidiary of PPL. The Company pays the subsidiary an annual commitment fee on the unused portion of the commitment based on the Utilities' current bond rating. At December 31, 2009, one facility, totaling \$150 million, was with E.ON North America, Inc., while the remaining line, totaling \$163 million, was with Fidelia, both affiliated companies of E.ON. The balances are as follows:

	Total Available	Amount Outstanding	Balance Available	Average Interest Rate
December 31, 2010, Successor	\$ 300	\$ -	\$ 300	N/A
December 31, 2009, Predecessor	313	276	37	1.25%

Notes Payable to Affiliated Company

In addition to the revolving line of credit, the Company entered into the following short-term loans in 2010 and 2009, which were eventually replaced by a portion of the senior notes that were issued in November 2010:

<u>Year</u>	<u>Company</u>	<u>Description</u>	<u>Principal Amount</u>	<u>Rate</u>	<u>Secured/ Unsecured</u>	<u>Maturity</u>
<u>Successor</u>						
2010	LKE	Due to PPL Investment Corp.	\$ 968	2.00%	Unsecured	2010
<u>Predecessor</u>						
2010	LKE	Due to E.ON affiliates	75	Variable	Unsecured	2010
2010	LKE	Due to E.ON affiliates	150	Variable	Unsecured	2010
2010	LKE	Due to E.ON affiliates	100	Variable	Unsecured	2010
2010	LKE	Due to E.ON affiliates	575	Variable	Unsecured	2010
2009	LKE	Due to E.ON affiliates	575	Variable	Unsecured	2010

Bank Revolving Lines of Credit

As of December 31, 2010, LG&E and KU each maintained a \$400 million revolving credit agreement 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 December 31, 2010, there was \$163 million borrowed under this facility for LG&E at an average interest rate of 2.27% and none for KU. However, letters of credit totaling \$198 million have been issued under KU's facility. 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.

As of December 31, 2009, KU maintained a \$35 million bilateral line of credit with an unaffiliated financial institution, maturing in June 2012. As of December 31, 2009, LG&E maintained bilateral lines of credit, with unaffiliated financial institutions, totaling \$125 million maturing in June 2012. LG&E and KU paid the banks an annual commitment fee on the unused portion of the commitment. At December 31, 2009, there was no balance outstanding under any of these facilities for LKE. These facilities were terminated on November 1, 2010, in conjunction with the PPL acquisition.

On December 1, 2010, KU replaced the letters of credit issued under prior letter of credit facilities with letters of credit of the same amount issued under the new revolving credit agreement. The four letter of credit facilities were subsequently terminated.

LKE and its subsidiaries, where applicable, were in compliance with all lines of credit covenants at December 31, 2010.

See Note 1, Summary of Significant Accounting Policies, for certain debt refinancing and associated transactions completed by LKE in connection with the PPL acquisition and Note 15, Related Party Transactions, for long-term debt payable to affiliates.

Note 13 - Commitments and Contingencies

Operating Leases

LKE leases office space, office equipment, plant equipment, real estate, railcars, telecommunications, vehicles and a helicopter and accounts for these leases as operating leases. Lease expense equaled \$17 million in 2010, \$16 million in 2009 and \$15 million in 2008. The future minimum annual lease payments for operating leases for years subsequent to December 31, 2010, are shown in the following table:

2011	\$	14
2012		12
2013		10
2014		8
2015		5
Thereafter		4
	\$	<u>53</u>

Owensboro Contract Litigation and Contract Termination

In May 2004, the City of Owensboro, Kentucky and OMU commenced a suit against KU concerning a long-term power supply contract (the “OMU Agreement”) with KU. In May 2009, KU and OMU executed a settlement agreement resolving the matter on a basis consistent with prior court rulings and KU has received the agreed settlement amounts. Pursuant to the settlement’s operation, the OMU Agreement terminated in May 2010.

Sale and Leaseback Transaction

LG&E and KU are participants in a sale and leaseback transaction involving their two jointly-owned CTs at E.W. Brown generating station (Units 6 and 7). Commencing in December 1999, LG&E and KU entered into a tax-efficient, 18-year lease of the CTs. The Utilities have provided funds to fully defease the lease and have executed an irrevocable notice to exercise an early purchase option contained in the lease after 15.5 years. The financial statement treatment of this transaction is the same as if the Utilities had retained their ownership interests. The leasing transaction was entered into following receipt of required state and federal regulatory approvals. At December 31, 2010, the Consolidated Balance Sheets included these assets at a value of \$104 million, which is reflected in “Regulated utility plant – electric and natural gas.”

In case of default under the lease, LKE is obligated to pay to the lessor its share of certain fees or amounts. Primary events of default include loss or destruction of the CTs, failure to insure or maintain the CTs and unwinding of the transaction due to governmental actions. No events of default currently exist with respect to the lease. Upon any termination of the lease, whether by default or expiration of its term, title to the CTs reverts jointly to LG&E and KU.

At December 31, 2010, the maximum aggregate amount of default fees or amounts was \$7 million. Of this amount, LG&E would be responsible for approximately \$3 million (38%) and KU would be responsible for approximately \$4 million (62%). LG&E and KU have made arrangements with LKE, via guarantee and regulatory commitment, for LKE to pay any default fees or amounts that LG&E or KU may incur.

Letters of Credit

LKE has issued letters of credit as of December 31, 2010 and December 31, 2009, for off-balance sheet obligations totaling \$4 million and \$12 million, respectively. LKE has issued letters of credit for on-balance sheet obligations as of December 31, 2010 and December 31, 2009, for \$198 million to support outstanding bonds of \$195 million.

Commodity Purchases

OVEC

The Utilities have a contract for power purchases with OVEC, terminating in 2026, for various Mw capacities. The Utilities hold an 8.13% investment interest in OVEC, with nine other electric utilities. LG&E and KU are not the primary beneficiary; therefore, the investment is not consolidated into LKE’s financial statements, but is recorded on the cost basis. OVEC is located in Piketon, Ohio, and owns and operates two coal-fired power plants, Kyger Creek Station in Ohio, and Clifty Creek Station in Indiana. LKE is contractually entitled to 8.13% of OVEC’s output, approximately 194 Mw of nameplate generation capacity. Pursuant to the OVEC power purchase contract, LKE 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. LKE’s contingent potential proportionate share of OVEC’s December 31, 2010 outstanding debt was \$113 million. Future obligations for power purchases from OVEC are demand payments, comprised of annual minimum debt

service payments, as well as contractually required reimbursement of plant operating, maintenance and other expenses and are as shown in the following table:

2011	\$	29
2012		32
2013		32
2014		33
2015		32
Thereafter		372
	\$	<u>530</u>

Coal and Natural Gas Purchase Obligations

LKE has contracts to purchase coal, natural gas and natural gas transportation. Future obligations are shown in the following table:

2011	\$	774
2012		309
2013		256
2014		191
2015		191
Thereafter		49
	\$	<u>1,770</u>

Construction Program

LKE had approximately \$244 million of commitments in connection with its construction programs at December 31, 2010.

In June 2006, LKE 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, LKE 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, LKE 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 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. LKE cannot currently estimate the ultimate outcome of these matters.

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 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.

Environmental Matters

The Company's operations are subject to a number of environmental laws and regulations in each of the jurisdictions in which they operate, 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.

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 NO_x emissions to 0.15 pounds weight per MMBtu on a company-wide basis. In 2005, the EPA issued the CAIR which required additional SO₂ emission reductions of 70% and NO_x emission reductions of 65% from 2003 levels. The CAIR provided for a two-phase cap and trade program, with initial reductions of NO_x 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 LG&E's and KU's 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 NO_x emissions.

In July 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 NO_x reductions in 2012, but the EPA advised that it is studying whether additional NO_x 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. The EPA has entered into a consent decree requiring it to promulgate a utility Maximum Achievable Control Technology rule to replace the CAMR with a proposed rule due by March 2011 and a final rule by November 2011. Depending on the final outcome of the rulemaking, the CAMR could be replaced by new rules with different or more stringent requirements for reduction of mercury and other hazardous air pollutants. Kentucky has also repealed its corresponding state mercury regulations.

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.

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.

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 their operations.

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 upon the Company's financial position or results of operations.

Ash Ponds and Coal-Combustion Byproducts

The EPA has undertaken various initiatives in response to the December 2008 impoundment failure at the TVA'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

The EPA has also announced plans to develop revised effluent limitations guidelines governing discharges from power plants and standards for cooling water intake structures. The EPA has further announced plans to develop revised standards governing the use of polychlorinated biphenyls ("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.

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 emissions reductions requirements, require more stringent emissions controls, or implement more stringent byproduct storage and disposal practices, such costs will likely be significant. With respect to NAAQS, CATR, CAMR replacement 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 byproduct 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 \$3.0 to \$3.5 billion range over the next ten years, although final costs may substantially vary. With respect to potential developments in water discharge, 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.

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.

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 TC1 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 station and claims regarding GHG emissions from LKE's generating stations. With respect to the former manufactured gas plant sites, LG&E has estimated that it could incur additional costs of less than \$1 million for remaining clean-up activities under existing approved plans or agreements. Based on analysis to date, the resolution of these matters is not expected to have a material impact on the Company's operations.

Argentina Matters

During November 2008, the Argentine Central Bank commenced an administrative proceeding alleging a violation of certain emergency currency exchange laws in place during the country's economic crisis in connection with a December 2002 refinancing by Centro of \$35 million of a previously-existing, maturing loan. 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. Centro and its then-seated directors, including two current officers of the company, have filed responsive pleadings in the matter and requested dismissal at the administrative phase. In April 2010, the Argentine Central Bank staff issued a ruling declining to dismiss the case at the conclusion of the administrative stage and therefore forwarded the matter to a specialized Buenos Aires-domiciled financial criminal court where further proceedings are on-going. A ruling in the matter may occur during 2011. The Company has standard indemnification arrangements with its officers. E.ON Spain has assumed relevant rights and obligations with respect to claims and liabilities relating to the Argentine businesses in connection with its purchase of the business in 2010.

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. The Company is not aware of claims made by any party at this time, although one matter is currently in arbitration, the outcome of which cannot be predicted at this time. See Note 19, Discontinued Operations, 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 \$11 million.

Other Contractual Obligations

As described in Note 19, Discontinued Operations, 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 14 - Jointly Owned Electric Utility Plant

Trimble County Unit 1

LKE owns a 75% undivided interest in TC1 which the Kentucky Commission has allowed to be reflected in customer rates. Of the remaining 25% of the unit, IMEA owns a 12.12% undivided interest and IMPA owns a 12.88% undivided interest. Each company is responsible for its proportionate ownership share of fuel cost, operation and maintenance expenses and incremental assets.

The following data represent shares of the jointly owned property (capacity based on nameplate rating):

	TC1			
	LKE	IMPA	IMEA	Total
Ownership interest	75%	12.88%	12.12%	100%
Mw capacity	425	73	68	566

LKE's 75% ownership:

Cost	\$ 288
Construction work in progress	17
Accumulated depreciation	(9)
Net book value	<u>\$ 296</u>

Trimble County Unit 2

TC2 is a jointly owned unit at the Trimble County site. LG&E and KU own undivided 14.25% and 60.75% interests, respectively. Of the remaining 25%, IMEA owns a 12.12% undivided interest and IMPA owns a 12.88% undivided interest. Each company is responsible for its proportionate share of capital cost during construction and fuel, operation and maintenance cost when TC2 is in-service. 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. In December 2009 and June 2008, LG&E sold assets to KU related to the construction of TC2 with a net book value of \$48 million and \$10 million, respectively.

	TC2				
	LG&E	KU	IMPA	IMEA	Total
Ownership interest	14.25%	60.75%	12.88%	12.12%	100%
Mw capacity	119	509	108	102	838

LKE's 75% ownership:

Plant held for future use	\$ 64
Construction work in progress	890
Accumulated depreciation	(1)
Net book value	<u>\$ 953</u>

Note 15 - Related Party Transactions

The Company's balances with affiliates as of December 31, 2010, were with PPL and its affiliates. The Company's balances with affiliates as of December 31, 2009, were with E.ON and its affiliates. See Note 10, Income Taxes, Note 11, Long-Term Debt, and Note 12, Notes Payable and Other Short-Term Obligations, for further information.

LKE relies on dividends from its subsidiaries to fund its dividends to its sole member. 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 the 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

LKE's interest expense to affiliated companies was as follows:

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008	
Interest on PPL loans	\$ 4	\$ -	\$ -	\$ -
Interest on E.ON loans	-	131	155	138

Intercompany Balances

The Company had the following balances with PPL and its affiliates as of December 31, 2010 and with E.ON and its affiliates as of December 31, 2009:

	Successor	Predecessor
	December 31, 2010	December 31, 2009
Accounts receivable	\$ 2	\$ -
Notes receivable	61	-
Accounts payable	3	43
Notes payable	-	851
Long-term debt	-	3,421

In 2010, prior to the PPL acquisition, the Company paid dividends of \$87 million to its sole member, E.ON US Investments Corp. The Company also paid dividends of \$43 million and \$68 million in 2009 and 2008, respectively, to E.ON US Investments Corp.

The Company made a \$100 million return of capital distribution in November 2010, to its sole member, PPL Corporation.

Note 16 - Selected Quarterly Data (Unaudited)

	For the 2010 Periods Ended (a)					Successor December 31
	Predecessor					
	March 31	June 30	September 30	October 31		
Operating revenues	\$ 713	\$ 603	\$ 719	\$ 179	\$ 494	
Operating income	147	106	175	10	96	
Income (loss) from continuing operations after income taxes	63	31	102	(5)	45	
Income (loss) from discontinued operations	(3)	1	-	1	2	
Net income (loss)	60	32	102	(4)	47	
Net income (loss) attributable to member	60	32	102	(4)	47	

(a) Periods ended March 31, June 30 and September 30 represent three months then ended. Period ended October 31 represents one month then ended and period ended December 31 represents two months then ended.

	For the 2009 Quarters Ended			
	Predecessor			
	March 31	June 30	September 30	December 31
Operating revenues	\$ 750	\$ 548	\$ 595	\$ 608
Operating income (loss)	27	78	211	(1,398)
Income (loss) from continuing operations after income taxes	-	35	101	(1,453)
Loss from discontinued operations	(35)	(93)	(71)	(21)
Net income (loss)	(35)	(58)	30	(1,474)
Net income (loss) attributable to member	(36)	(59)	28	(1,475)

Note 17 - Accumulated Other Comprehensive Income (Loss)

	Funded Status Of Pension And Postretirement Plans		Accumulated Derivative Gain or Loss		Foreign Currency Translation Adj.		Equity Investee's Accum Other Comp Income		Totals		
	Pretax	Tax	Pretax	Tax	Pretax	Tax	Pretax	Tax	Pretax	Tax	Net
Balance at December 31, 2007, Predecessor	\$ (32)	\$ 12	\$ (11)	\$ 4	\$ 22	\$ (4)	\$ -	\$ -	\$ (21)	\$ 12	\$ (9)
Change in funded status of defined- benefit pension and postretirement plans	(77)	31	-	-	-	-	-	-	(77)	31	(46)
Gains (losses) on derivative instruments- designated and qualifying as cash flow hedging instruments	-	-	(2)	-	-	-	-	-	(2)	-	(2)
Foreign currency translation adjustment	-	-	-	-	(5)	1	-	-	(5)	1	(4)
Balance at December 31, 2008, Predecessor	(109)	43	(13)	4	17	(3)	-	-	(105)	44	(61)
Change in funded status of defined- benefit pension and postretirement plans	29	(11)	-	-	-	-	-	-	29	(11)	18
Gains (losses) on derivative instruments- designated and qualifying as cash flow hedging instruments	-	-	5	(2)	-	-	-	-	5	(2)	3
Foreign currency translation adjustment	-	-	-	-	(4)	1	-	-	(4)	1	(3)
Balance at December 31, 2009, Predecessor	(80)	32	(8)	2	13	(2)	-	-	(75)	32	(43)
Change in funded status of defined- benefit pension and postretirement plans	(31)	13	-	-	-	-	-	-	(31)	13	(18)
Gains (losses) on derivative instruments- designated and qualifying as cash flow hedging instruments	-	-	17	(7)	-	-	-	-	17	(7)	10
Foreign currency translation adjustment	-	-	-	-	(13)	2	-	-	(13)	2	(11)
Equity investee's other comprehensive income (loss)	-	-	-	-	-	-	(3)	1	(3)	1	(2)
Balance at October 31, 2010, Predecessor	(111)	45	9	(5)	-	-	(3)	1	(105)	41	(64)
Effect of PPL acquisition Successor	111	(45)	(9)	5	-	-	3	(1)	105	(41)	64
Balance November 1, 2010, Successor											
Change in funded status of defined- benefit pension and postretirement plans	9	(3)	-	-	-	-	-	-	9	(3)	6
Balance at December 31, 2010, Successor	\$ 9	\$ (3)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 9	\$ (3)	\$ 6

Note 18 - Available for Sale Debt Securities

LKE's available for sale debt securities include the following pollution control bonds, which were repurchased from the remarketing agent in 2008:

	December 31,	
	<u>2010</u>	<u>2009</u>
Louisville Metro 2003 Series A, due October 1, 2033, variable %	\$ 128	\$ -
Louisville Metro 2007 Series B, due June 1, 2033, variable %	<u>35</u>	<u>-</u>
	<u>\$ 163 (a)</u>	<u>\$ - (b)</u>

- (a) No realized or unrealized gains (losses) were recorded on these securities as the difference between the carrying value and the fair value was insignificant.
- (b) Prior to the PPL acquisition, repurchased bonds were not accounted for as "Available for sale debt securities" and were presented on a net basis on the Consolidated Balance Sheets. See Note 1, Summary of Significant Accounting Policies, and Note 11, Long-Term Debt, for further discussion.

In January 2011, LKE remarketed these bonds to unaffiliated investors. See Note 21, Subsequent Events, for further discussion regarding the remarketing of these bonds.

Note 19 - Discontinued Operations

WKE

Through WKE and its subsidiaries, the Company had a 25-year lease on and operated the generating facilities of Big Rivers, a power-generating cooperative in western Kentucky, and a coal-fired generating facility owned by the City of Henderson, Kentucky.

In 2007, LKE entered into a termination agreement to terminate the lease, which closed in 2009, prior to PPL acquiring LKE. As part of the lease termination, LKE was obligated to pay a former customer, an aluminum smelter, an aluminum production payment in lieu of a lump-sum cash consent payment, as well as the difference between the electricity prices charged by WKE under the previous long-term sales contract and the electricity prices charged by the current electricity supplier. This obligation is partially mitigated by the opportunity to make off-system sales, when economic, for the contractual demand not used by the aluminum smelter. The total amount of the obligation to this smelter was limited to \$82 million, with any amount paid by LKE over the limit has been recorded as an interest-bearing receivable, which is required to be repaid only if certain conditions occur by 2028. Such exposure expired on December 31, 2010. During the years ended December 31, 2010 and December 31, 2009, the Company made payments totaling \$65 million and \$26 million, respectively, as part of the transaction. Since the former customer posted a letter of credit supporting payment to its current electricity supplier, LKE reversed a portion of the accrual associated with its guarantee of payment by the former customer. The estimated remaining payments were accrued at December 31, 2010 including an obligation to another aluminum smelter, also a former customer, to make an escrow payment of \$4 million in January 2011. The change in fair value of the derivative contract since acquisition along with the reversal of the accrual resulted in the income statement impact shown below. These amounts are reflected in "Gain (loss) on disposal of discontinued operations" on the Consolidated Statements of Income. See also Note

6, Fair Value Measurements, Note 10, Income Taxes, and Note 13, Commitments and Contingencies, for further discussion of these or of additional elements of the WKE lease termination transaction.

The table below provides selected income statement information for the WKE discontinued operations:

	Successor	Predecessor		
	November 1, 2010 through December 31, 2010	January 1, 2010 through October 31, 2010	Year Ended December 31, 2009 2008	
Revenues	\$ -	\$ -	\$ 128	\$ 300
Loss before taxes	-	(7)	(222)	(309)
Income tax benefit	<u>-</u>	<u>3</u>	<u>79</u>	<u>120</u>
Loss from discontinued operations	<u>-</u>	<u>(4)</u>	<u>(143)</u>	<u>(189)</u>
Gain (loss) on disposal of discontinued operations before tax	4	5	(114)	-
Income tax benefit (expense) from (disposal) of discontinued operations	<u>(2)</u>	<u>(2)</u>	<u>45</u>	<u>-</u>
Gain (loss) on disposal of discontinued operations	<u>\$ 2</u>	<u>\$ 3</u>	<u>\$ (69)</u>	<u>\$ -</u>

Argentine Natural Gas Distribution

At December 31, 2009, the Company owned interests in two natural gas distribution companies in Argentina: 45.9% of Centro and 14.4% of Cuyana. These two entities served a combined customer base of approximately one million customers. The Centro investment was consolidated due to the Company's majority ownership in the holding company of Centro. The Cuyana investment was accounted for using the equity method due to the ownership influence the Company exerted on the businesses.

In November 2009, subsidiaries of the Company entered into agreements to sell their direct and indirect interests in Centro and Cuyana to E.ON Spain and a subsidiary, both affiliates of E.ON. On January 1, 2010, the parties completed the transfer of the interests for a sale price of \$35 million. In December 2009, the Company recorded an impairment loss of \$12 million before income taxes. The impairment loss represented the difference between the carrying values of the Company's interests in Centro and Cuyana and the sales price. The Company classified the assets, liabilities and results of operations of the Argentine natural gas distribution companies, including the impairment loss, as discontinued operations for all periods presented effective December 31, 2009. In connection with the reorganization transaction, E.ON Spain assumed rights and obligations relating to claims and liabilities associated with the former Argentine businesses or indemnified the Company with respect to such matters.

The table below provides summarized income statement information for the Argentine natural gas distribution discontinued operations:

	Year Ended December 31, 2009	Year Ended December 31, 2008
Revenues	\$ 60	\$ 69
Income before taxes	\$ -	\$ 22
Income tax expense	(8)	(6)
Noncontrolling interest	(5)	(8)
Net income	\$ (13)	\$ 8

The table below provides summarized balance sheet information for the Argentine natural gas distribution discontinued operations as of December 31, 2009:

Assets:

Current assets	\$ 25
Property, plant and equipment	52
Investments in unconsolidated ventures	7
Deferred income taxes	6
Total assets	\$ 90

Liabilities:

Other liabilities	\$ 7
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Note 20 - Share Performance Plan

In 2006, the Company introduced a stock-based compensation system, the E.ON Share Performance Plan, and virtual shares were granted under the Plan to certain executives of the Company. The Plan was a stock-based compensation plan based on the value of E.ON's shares, and it entitled each participant to receive a payment at the end of a three-year and four-year vesting period equal to a target value per share times the number of virtual shares granted. The number of virtual shares did not change during the three-year and four-year vesting periods, but the target value per share could change based on E.ON's stock price and the performance of E.ON stock during the three-year and four-year periods compared to the change in the Dow Jones STOXX Utilities Index (Total Return EUR). The Company used the fair-value method to account for the Plan. See Note 6, Fair Value Measurements, for further information.

The 2007 grant under E.ON Share Performance Plan of 6,820 virtual shares with target prices of €6.52 each was paid out in January 2010. The total of the payouts was less than \$1 million. In the second quarter of 2010, the Company issued 27,643 virtual shares to Plan participants with a target price of €27.25.

All virtual shares vested on October 31, 2010, with the closing of the PPL acquisition. All shares were paid out in November 2010; the total of the payout was less than \$1 million.

The Company recorded expense of less than \$1 million related to the Plan in the year ended October 31, 2010 and less than \$1 million in 2009.

Starting November 1, 2010, certain compensation of selected employees is provided by PPL, the expense related to this compensation was less than \$1 million for 2010.

Note 21 - Subsequent Events

Subsequent events have been evaluated through February 25, 2011, the date of issuance of these statements. These statements contain all necessary adjustments and disclosures resulting from that evaluation.

On January 31, 2011, KU filed a notice of intent to file a rate case with the Virginia Commission for the test year ended December 31, 2010. The case is expected to be filed on or after April 1, 2011.

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.

On January 14, 2011, LKE contributed \$150 million to its pension plans.

On January 13, 2011, LG&E remarketed the Louisville/Jefferson County Metro Government 2003 Series A and 2007 Series B bonds, having \$128 million and \$35 million in outstanding principal amount, respectively, which bonds had been previously repurchased by LG&E and shown in "Available for sale debt securities" on the Consolidated Balance Sheets. In connection with the remarketing, each bond series was converted to a mode wherein the interest rate is fixed for an intermediate term but not the full term of the bond. The bonds will bear interest at the rate of 1.90% each, until April 2012 and June 2012, in the case of the 2003 Series A and 2007 Series B bonds, respectively. At the end of the intermediate term, the Company must remarket the bonds or buy them back. As of January 13, 2011, LG&E had no remaining repurchased bonds. LKE used the proceeds from the remarketed bonds to repay the balance of its credit facility.



Report of Independent Auditors

To the Member of LG&E and KU Energy LLC

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of income, retained earnings, comprehensive income, cash flows, and capitalization present fairly, in all material respects, the financial position of LG&E and KU Energy LLC and its subsidiaries (Successor Company) at December 31, 2010 and the results of their operations and their cash flows for the period from November 1, 2010 to December 31, 2010 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assertion of the effectiveness of internal control over financial reporting, included in "Management's Report of Internal Controls Over Financial Reporting" which appears on page 57. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audit. We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States) and in accordance with the auditing and attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

As discussed in Note 2 to the consolidated financial statements, on November 1, 2010, PPL Corporation completed its acquisition of LG&E and KU Energy LLC and its subsidiaries. The push-down basis of accounting was used at the acquisition date.

A company's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial



statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and those charged with governance and (iii) provide reasonable assurance regarding prevention or timely detection and correction of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

Louisville, Kentucky
February 25, 2011



Report of Independent Auditors

To the Member of LG&E and KU Energy LLC

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of income, retained earnings (deficit), comprehensive income (loss), cash flows, and capitalization present fairly, in all material respects, the financial position of LG&E and KU Energy LLC and its subsidiaries (formerly E.ON U.S. LLC, Predecessor Company) at December 31, 2009 and the results of their operations and their cash flows for the period from January 1, 2010 to October 31, 2010 and for each of the two years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, on November 1, 2010, PPL Corporation completed its acquisition of LG&E and KU Energy LLC and its subsidiaries. The push-down basis of accounting was used at the acquisition date.

PricewaterhouseCoopers LLP

Louisville, Kentucky
February 25, 2011