

**Kentucky Utilities Company**

Condensed Financial Statements and Additional Information  
(Unaudited)

As of September 30, 2010 and December 31, 2009  
and for the three and nine months ended  
September 30, 2010 and 2009

## INDEX OF ABBREVIATIONS

AG	Attorney General of Kentucky
ARO	Asset Retirement Obligation
ASC	Accounting Standards Codification
BART	Best Available Retrofit Technology
CAIR	Clean Air Interstate Rule
CAMR	Clean Air Mercury Rule
CATR	Clean Air Transport Rule
CCN	Certificate of Public Convenience and Necessity
Clean Air Act	The Clean Air Act, as amended in 1990
CMRG	Carbon Management Research Group
Companies	KU and LG&E
Company	KU
DSM	Demand Side Management
ECR	Environmental Cost Recovery
EEL	Edison Electric Institute
EKPC	East Kentucky Power Cooperative, Inc.
E.ON	E.ON AG
E.ON U.S.	E.ON U.S. LLC
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)
GHG	Greenhouse Gas
IRS	Internal Revenue Service
KCCS	Kentucky Consortium for Carbon Storage
KDAQ	Kentucky Division for Air Quality
Kentucky Commission	Kentucky Public Service Commission
KU	Kentucky Utilities Company
LG&E	Louisville Gas and Electric Company
MISO	Midwest Independent Transmission System Operator, Inc.
MMBtu	Million British thermal units
Moody's	Moody's Investors Service, Inc.
Mw	Megawatts
Mwh	Megawatt hours
NAAQS	National Ambient Air Quality Standards
NOV	Notice of Violation
NOx	Nitrogen Oxide
OMU	Owensboro Municipal Utilities
OVEC	Ohio Valley Electric Corporation
PPL	PPL Corporation
S&P	Standard & Poor's Ratings Services
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 <sub>2</sub>	Sulfur Dioxide
TC2	Trimble County Unit 2
Virginia Commission	Virginia State Corporation Commission

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**Report of Independent Accountants**

To Shareholder of Kentucky Utilities Company:

We have reviewed the accompanying condensed balance sheet of Kentucky Utilities Company as of September 30, 2010, and the related condensed statements of income and comprehensive income, and of retained earnings for the three-month and nine-month periods ended September 30, 2010 and 2009 and the condensed statement of cash flows for the nine-month periods ended September 30, 2010 and 2009. This condensed interim financial information is the responsibility of the Company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial information taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed interim financial information for it to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of Kentucky Utilities Company as of December 31, 2009, and the related statements of income, retained earnings, and of cash flows for the year then ended (not presented herein), and in our report dated March 19, 2010, we expressed an unqualified opinion on those financial statements. In our opinion, the information set forth in the accompanying condensed balance sheet information as of December 31, 2009, is fairly stated in all material respects in relation to the balance sheet from which it has been derived.

*PricewaterhouseCoopers LLP*

October 29, 2010

**Kentucky Utilities Company**  
Condensed Statements of Income  
(Unaudited)  
(Millions of \$)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Operating revenues (Note 10) .....	\$ 416	\$ 341	\$ 1,146	\$ 1,009
Operating expenses:				
Fuel for electric generation .....	146	114	391	329
Power purchased (Note 10) .....	41	47	135	154
Other operation and maintenance expenses .....	86	22	251	230
Depreciation, accretion and amortization.....	<u>38</u>	<u>33</u>	<u>106</u>	<u>99</u>
Total operating expenses.....	<u>311</u>	<u>216</u>	<u>883</u>	<u>812</u>
Operating income .....	105	125	263	197
Interest expense (Note 8).....	2	2	5	5
Interest expense to affiliated companies (Notes 8 and 10)	18	18	55	51
Other income (expense) – net .....	<u>1</u>	<u>-</u>	<u>2</u>	<u>7</u>
Income before income taxes .....	86	105	205	148
Income tax expense (Note 7) .....	<u>32</u>	<u>39</u>	<u>76</u>	<u>49</u>
Net income .....	<u>\$ 54</u>	<u>\$ 66</u>	<u>\$ 129</u>	<u>\$ 99</u>

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

**Kentucky Utilities Company**  
Condensed Statements of Comprehensive Income  
(Unaudited)  
(Millions of \$)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Net income .....	\$ 54	\$ 66	\$ 129	\$ 99
Comprehensive income (loss) attributable to unconsolidated venture – net of tax benefit of \$1, \$0, \$1 and \$0, respectively .....	<u>(2)</u>	<u>-</u>	<u>(2)</u>	<u>-</u>
Comprehensive income .....	<u>\$ 52</u>	<u>\$ 66</u>	<u>\$ 127</u>	<u>\$ 99</u>

Condensed Statements of Retained Earnings  
(Unaudited)  
(Millions of \$)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Balance at beginning of period.....	\$ 1,403	\$ 1,228	\$ 1,328	\$ 1,195
Net income .....	<u>54</u>	<u>66</u>	<u>129</u>	<u>99</u>
	1,457	1,294	1,457	1,294
Cash dividends declared (Note 10).....	<u>(50)</u>	<u>-</u>	<u>(50)</u>	<u>-</u>
Balance at end of period.....	<u>\$ 1,407</u>	<u>\$ 1,294</u>	<u>\$ 1,407</u>	<u>\$ 1,294</u>

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

**Kentucky Utilities Company**  
Condensed Balance Sheets  
(Unaudited)  
(Millions of \$)

	September 30, <u>2010</u>	December 31, <u>2009</u>
Assets		
Current assets:		
Cash and cash equivalents.....	\$ 2	\$ 2
Accounts receivable – net:		
Customer – less reserves of \$2 in 2010 and \$1 in 2009.....	172	155
Affiliated companies.....	-	9
Other – less reserves of \$2 in 2010 and 2009.....	28	18
Materials and supplies:		
Fuel (predominantly coal).....	98	98
Other materials and supplies.....	42	39
Regulatory assets (Note 2).....	14	32
Prepayments and other current assets.....	<u>11</u>	<u>13</u>
Total current assets.....	<u>367</u>	<u>366</u>
Investment in unconsolidated venture.....	<u>12</u>	<u>12</u>
Property, plant and equipment:		
Regulated utility plant – electric.....	5,426	4,892
Accumulated depreciation.....	<u>(1,902)</u>	<u>(1,838)</u>
Net regulated utility plant.....	3,524	3,054
Construction work in progress.....	<u>946</u>	<u>1,257</u>
Property, plant and equipment – net.....	<u>4,470</u>	<u>4,311</u>
Deferred debits and other assets:		
Regulatory assets (Note 2):		
Pension benefits.....	105	105
Other regulatory assets.....	110	117
Cash surrender value of key man life insurance.....	39	38
Other assets.....	<u>7</u>	<u>7</u>
Total deferred debits and other assets.....	<u>261</u>	<u>267</u>
Total assets.....	<u>\$ 5,110</u>	<u>\$ 4,956</u>

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

**Kentucky Utilities Company**  
Condensed Balance Sheets (continued)  
(Unaudited)  
(Millions of \$)

	September 30, <u>2010</u>	December 31, <u>2009</u>
<b>Liabilities and Equity</b>		
<b>Current liabilities:</b>		
Current portion of long-term debt (Notes 5 and 8) .....	\$ 228	\$ 228
Current portion of long-term debt to affiliated company (Note 5).....	33	33
Notes payable to affiliated companies (Notes 8 and 10).....	61	45
Accounts payable .....	105	107
Accounts payable to affiliated companies (Note 10) .....	71	88
Customer deposits .....	23	22
Regulatory liabilities (Note 2).....	12	4
Other current liabilities.....	<u>39</u>	<u>42</u>
Total current liabilities.....	<u>572</u>	<u>569</u>
<b>Long-term debt:</b>		
Long-term debt (Notes 5 and 8) .....	123	123
Long-term debt to affiliated company (Notes 5, 8 and 10).....	<u>1,298</u>	<u>1,298</u>
Total long-term debt .....	<u>1,421</u>	<u>1,421</u>
<b>Deferred credits and other liabilities:</b>		
Deferred income taxes.....	378	336
Accumulated provision for pensions and related benefits (Note 6) .....	160	160
Investment tax credits (Note 7) .....	104	104
Asset retirement obligations (Note 3) .....	59	34
Regulatory liabilities (Note 2):		
Accumulated cost of removal of utility plant.....	343	331
Other regulatory liabilities .....	24	29
Other liabilities.....	<u>20</u>	<u>20</u>
Total deferred credits and other liabilities .....	<u>1,088</u>	<u>1,014</u>
<b>Common equity:</b>		
Common stock, without par value –		
Authorized 80,000,000 shares, outstanding 37,817,878 shares .....	308	308
Additional paid-in capital.....	316	316
Accumulated other comprehensive loss .....	(2)	-
Retained earnings:		
Retained earnings.....	1,397	1,318
Undistributed earnings from unconsolidated venture .....	<u>10</u>	<u>10</u>
Total common equity.....	<u>2,029</u>	<u>1,952</u>
Total liabilities and equity .....	<u>\$ 5,110</u>	<u>\$ 4,956</u>

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

**Kentucky Utilities Company**  
Condensed Statements of Cash Flows  
(Unaudited)  
(Millions of \$)

	For the Nine Months Ended September 30,	
	<u>2010</u>	<u>2009</u>
Cash flows from operating activities:		
Net income .....	\$ 129	\$ 99
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, accretion and amortization .....	106	99
Deferred income taxes – net.....	42	48
Investment tax credits (Note 7).....	-	17
Provision for pension and postretirement benefits.....	11	13
Undistributed earnings of unconsolidated venture.....	(4)	10
Other .....	1	3
Changes in current assets and liabilities:		
Accounts receivable .....	(6)	30
Materials and supplies.....	(3)	(21)
Regulatory assets and liabilities.....	26	(1)
Accounts payable .....	(20)	(4)
Accounts payable to affiliated companies.....	31	(8)
Other current assets and liabilities .....	-	(10)
Pension and postretirement funding (Note 6).....	(17)	(17)
Other regulatory assets and liabilities .....	(3)	(64)
Other – net.....	<u>7</u>	<u>(4)</u>
Net cash provided by operating activities.....	<u>300</u>	<u>190</u>
Cash flows from investing activities:		
Construction expenditures.....	(218)	(378)
Purchases of assets from affiliate.....	(48)	-
Change in restricted cash.....	<u>-</u>	<u>9</u>
Net cash used in investing activities .....	<u>(266)</u>	<u>(369)</u>
Cash flows from financing activities:		
Borrowings from affiliated company (Note 8).....	104	106
Repayments on borrowings from affiliated company (Note 8).....	(88)	-
Payment of dividends (Note 10).....	(50)	-
Capital contribution (Note 10) .....	<u>-</u>	<u>75</u>
Net cash (used in) provided by financing activities.....	<u>(34)</u>	<u>181</u>
Change in cash and cash equivalents .....	-	2
Cash and cash equivalents at beginning of period.....	<u>2</u>	<u>2</u>
Cash and cash equivalents at end of period.....	<u>\$ 2</u>	<u>\$ 4</u>

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

**Kentucky Utilities Company**  
Notes to Condensed Financial Statements  
(Unaudited)

**Note 1 – General**

KU's common stock is wholly-owned by E.ON U.S., an indirect wholly-owned subsidiary of E.ON. In the opinion of management, the unaudited condensed financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for fair statements of income, comprehensive income, and retained earnings, balance sheets, and statements of cash flows for the periods indicated. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These unaudited condensed financial statements and notes should be read in conjunction with the Company's Financial Statements and Additional Information ("Annual Report") for the year ended December 31, 2009, including the audited financial statements and notes therein.

The December 31, 2009, condensed balance sheet included herein is derived from the December 31, 2009, audited balance sheet. Amounts reported in the condensed statements of income are not necessarily indicative of amounts expected for the respective annual periods due to the effects of seasonal temperature variations on energy consumption, regulatory rulings, the timing of maintenance on electric generating units, changes in mark-to-market valuations, changing commodity prices and other factors.

Certain reclassification entries have been made to the previous year's financial statements to conform to the 2010 presentation with no impact on total assets, liabilities and capitalization or previously reported net income and net cash flows.

PPL Acquisition

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, PPL and E.ON.

The Agreement provides for the sale of E.ON U.S. to PPL. Pursuant to the Agreement, at closing, PPL will acquire all of the outstanding limited liability company interests of E.ON U.S. for cash consideration of \$2.6 billion. In addition, pursuant to the Agreement, PPL agreed to assume \$764 million of pollution control bonds and medium term notes and to repay indebtedness owed by E.ON U.S. and its subsidiaries to E.ON US Investments and its affiliates. Such affiliate indebtedness is currently estimated to be \$4.2 billion. The aggregate consideration payable by PPL on closing is currently estimated to be \$7.6 billion (including the assumed indebtedness), subject to contractually agreed adjustments.

The transaction is 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. As of October 26, 2010, all of the required regulatory approvals were received, and the transaction is expected to close on November 1, 2010.

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, KU and LG&E commit that no base rate increases would take effect before January 1, 2013. The KU and LG&E rate increases that took effect on August 1, 2010, were not impacted by the settlement. Under the terms of the settlement, the Companies 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 Companies 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 Companies to earn up to a 10.75 percent return on equity. Any earnings above a 10.75 percent 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 KU and LG&E 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, KU and LG&E 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 has subsequently been 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 has agreed to not 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.

On September 30, 2010, October 19, 2010 and October 21, 2010, respectively, KU received Kentucky Commission, Virginia Commission and Tennessee Regulatory Authority approvals to complete certain refinancing transactions in connection with the anticipated PPL acquisition and other business factors. Based on credit and financial market conditions, KU anticipates issuing up to \$1.5 billion in first mortgage bonds, the proceeds of which will substantially be used to refund existing long-term intercompany debt. On October 29, 2010, as required by existing covenants, in connection with the anticipated issuance of any such secured debt, KU completed collateralization of certain outstanding pollution control bond debt series which were formerly unsecured. Pursuant to such collateralization, approximately \$351 million in existing pollution control debt became collateralized debt, supported by a first mortgage lien. KU also anticipates replacing its \$35 million bilateral line of credit with an unaffiliated institution by entering into a multi-year revolving credit facility with several financial institutions in an aggregate amount not to exceed \$400 million. KU may complete these transactions, in

whole or in part, during late 2010 and early 2011. See Note 8, Short-Term and Long-Term Debt, for further information regarding the refinancing, remarketing or conversion of existing pollution control debt.

## Recent Accounting Pronouncements

### *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 – Rates and Regulatory Matters**

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. Currently, none of the regulatory assets or regulatory liabilities are excluded from the return on capitalization utilized in the calculation of Kentucky base rates; therefore, a return is earned on all Kentucky regulatory assets.

KU's Virginia base rates are calculated based on a return on rate base (net utility plant less deferred taxes and miscellaneous deductions). All regulatory assets and liabilities are excluded from the return on rate base utilized in the calculation of Virginia base rates.

For a description of each line item of regulatory assets and liabilities and for descriptions of certain matters which may not have undergone material changes relating to the period covered by this quarterly report, reference is made to Note 2, Rates and Regulatory Matters, of KU's Annual Report for the year ended December 31, 2009.

### 2010 Kentucky Rate Case

In January 2010, KU filed an application with the Kentucky Commission requesting an increase in electric base rates of approximately 12%, or \$135 million annually, including an 11.5% return on equity. KU requested the increase, based on the twelve month test year ended October 31, 2009, to become effective on and after March 1, 2010. The requested rates were suspended until August 1, 2010. A number of intervenors entered the rate case, including the AG, certain representatives of industrial and low-income groups and other third parties, and submitted filings challenging the Company's requested rate increases, in whole or in part. A hearing was held on June 8, 2010. KU and all of the intervenors, except the AG, agreed to a stipulation providing for an increase in electric base rates of \$98 million annually and 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 stipulation. 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. A public hearing was held during January 2010. As permitted, pursuant to a Virginia Commission Order, KU elected to implement the proposed rates effective November 1, 2009, on an interim basis. 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. During August 2010, a report was filed detailing the costs of the refunds, the accounts charged and details validating that all refunds have been applied.

## 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 rate 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 adjustment to the formula rate. This updated rate became effective on July 1, 2010, subject to certain review procedures by the wholesale requirements customers and the FERC, including potential refunds in the case of disallowed costs or charges.

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. In August 2009, the FERC accepted the issue for briefing and the parties completed briefing submissions during 2009. 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.

## Regulatory Assets and Liabilities

The following regulatory assets and liabilities were included in KU's balance sheets as of:

(in millions)	September 30, <u>2010</u>	December 31, <u>2009</u>
Current regulatory assets:		
Storm restoration (a)	\$ 6	\$ -
FAC (b)	4	1
ECR (b)	-	28
MISO exit (a)	1	2
Other (c)	3	1
Total current regulatory assets	<u>\$ 14</u>	<u>\$ 32</u>

	September 30, <u>2010</u>	December 31, <u>2009</u>
Non-current regulatory assets:		
Pension benefits (d)	\$ 105	\$ 105
Other non-current regulatory assets:		
Storm restoration (a)	52	59
ARO (e)	34	30
Unamortized loss on bonds (a)	12	12
MISO exit (a)	4	9
Other (c)	8	7
Subtotal other non-current regulatory assets	<u>110</u>	<u>117</u>
Total non-current regulatory assets	<u>\$ 215</u>	<u>\$ 222</u>
Current regulatory liabilities:		
ECR	\$ 6	\$ -
DSM	4	3
Other (f)	2	1
Total current regulatory liabilities	<u>\$ 12</u>	<u>\$ 4</u>
Non-current regulatory liabilities:		
Accumulated cost of removal of utility plant	\$ 343	\$ 331
Other non-current regulatory liabilities:		
Deferred income taxes – net	8	9
Postretirement benefits	9	9
MISO exit	1	4
Other (f)	6	7
Subtotal other non-current regulatory liabilities	<u>24</u>	<u>29</u>
Total non-current regulatory liabilities	<u>\$ 367</u>	<u>\$ 360</u>

- (a) These regulatory assets are recovered through base rates.
- (b) The FAC and ECR regulatory assets have separate recovery mechanisms with recovery within twelve months.
- (c) Other regulatory assets:
- Other current and non-current regulatory assets, including the CMRG and KCCS contributions, an EKPC FERC transmission settlement agreement and rate case expenses, are recovered through base rates.
  - The current portion of the unamortized loss on bonds is recovered through base rates.
  - KU generally recovers the FERC jurisdictional portion of the EKPC FERC transmission settlement agreement included in current and non-current regulatory assets in the application of the annual Open Access Transmission Tariff formula rate updates.
  - Recovery of the FERC jurisdictional pension expense in non-current regulatory assets will be requested in a future FERC rate case.
- (d) KU generally recovers this asset through pension expense included in the calculation of base rates.

- (e) 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.
- (f) Other current and non-current regulatory liabilities includes the Virginia levelized fuel factor regulatory liability, ARO liabilities and a change in accounting method for FERC jurisdictional spare parts. ARO liabilities are established from the removal costs accrued through depreciation under regulatory accounting for assets associated with AROs.

### *Storm Restoration*

In January 2009, a significant ice storm passed through KU's service territory causing approximately 199,000 customer outages and was followed closely by a severe wind storm in February 2009, which caused approximately 44,000 customer outages. KU incurred \$57 million in incremental operation and maintenance expenses and \$33 million in capital expenditures related to the restoration following the two storms. The Company filed an application with the Kentucky Commission in April 2009, requesting approval to establish a regulatory asset and defer for future recovery approximately \$62 million in incremental operation and maintenance expenses related to the storm restoration. In September 2009, the Kentucky Commission issued an Order allowing the Company to establish a regulatory asset of up to \$62 million based on its actual costs for storm damages and service restoration due to the January and February 2009 storms. In September 2009, the Company established a regulatory asset of \$57 million for actual costs incurred. The Company received approval in its 2010 base rate case to recover this asset over a ten year period beginning August 1, 2010.

In September 2008, high winds from the remnants of Hurricane Ike passed through the service territory causing significant outages and system damage. In October 2008, KU filed an application with the Kentucky Commission requesting approval to establish a regulatory asset and defer for future recovery approximately \$3 million of expenses related to the storm restoration. In December 2008, the Kentucky Commission issued an Order allowing the Company to establish a regulatory asset of up to \$3 million based on its actual costs for storm damages and service restoration due to Hurricane Ike. In December 2008, the Company established a regulatory asset of \$2 million for actual costs incurred. The Company received approval in its 2010 base rate case to recover this asset over a ten year period beginning August 1, 2010.

### *FAC*

In August 2010, the Kentucky Commission initiated a six-month review of KU's FAC mechanism for the expense period ended April 2010. An order is expected by the end of the year.

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 January 2010, the Kentucky Commission initiated a six-month review of KU's FAC mechanism for the expense period ended August 2009. In May 2010, an Order was issued approving the charges and credits billed through the FAC during the review period.

## *ECR*

In July 2010, the Kentucky Commission initiated a six-month review of KU's environmental surcharge for the billing period ending April 2010. An order is expected in the fourth quarter of 2010.

In January 2010, the Kentucky Commission initiated a six-month review of KU's environmental surcharge for the billing period ending October 2009. In May 2010, an Order was issued approving the amounts billed through the ECR during the six-month period and the rate of return on capital and allowing recovery of the under-recovery position in subsequent monthly filings.

In June 2009, the Company filed an application for a new ECR plan with the Kentucky Commission seeking approval to recover investments in environmental upgrades and operations and maintenance costs at the Company's generating facilities. During 2009, KU reached a unanimous settlement with all parties to the case, and the Kentucky Commission issued an Order approving KU's application. Recovery on customer bills through the monthly ECR surcharge for these projects began with the February 2010 billing cycle. At December 31, 2009, the Company 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 September 30, 2010, the regulatory liability balance was \$6 million.

## *MISO*

In August 2010, the FERC issued three Orders accepting most facets of several MISO Revenue Sufficiency Guarantee ("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 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.

## Other Regulatory Matters

### *TC2 Depreciation*

In August 2009, the Companies jointly filed an application with the Kentucky Commission to approve new common 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 Companies 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 Transmission Matters*

KU's and LG&E's CCN for a transmission line associated with the TC2 construction has been challenged by certain property owners in Hardin County, Kentucky. In August 2006, the Companies obtained a successful dismissal of the challenge at the Franklin County Circuit Court, which was reversed by the Kentucky Court of Appeals in December 2007. In April 2009, the Kentucky Supreme Court granted KU's and LG&E's motion for discretionary review of the Court of Appeals' decision. In August 2010, the Kentucky Supreme Court issued an Order reversing the decision of the Kentucky Court of Appeals and reinstating the Franklin County Circuit Court's dismissal of the property owners' challenge to KU's and LG&E's CCN.

During 2008, KU obtained various successful rulings at the Hardin County Circuit Court confirming its condemnation rights. In August 2008, several landowners appealed such rulings to the Kentucky Court of Appeals. In May 2010, the Kentucky Court of Appeals issued an Order affirming the Hardin Circuit Court's finding that KU had the right to condemn easements on the properties. In May 2010, the landowners filed a petition for reconsideration with the Court of Appeals. In July 2010, the Court of Appeals denied that petition. In August, 2010, the landowners filed for discretionary review of that denial by the Kentucky Supreme Court.

In a separate proceeding, certain Hardin County landowners filed an action in federal district court in Louisville, Kentucky against the U.S. Army challenging the same transmission line claiming that certain Fort Knox-related sections of the line failed to comply with certain National Historic Preservation Act procedural requirements. In October 2009, the federal court granted the defendants' motion for summary judgment and dismissed the plaintiffs' claims. During November 2009, the petitioners filed submissions for review of the decision with the 6<sup>th</sup> Circuit Court of Appeals. In May 2010, the appellate court issued an order approving the plaintiffs' voluntary withdrawal of their appeals.

Consistent with the regulatory authorizations and relevant legal proceedings, the Companies have completed construction activities on temporary or permanent transmission line segments. During the second quarter of 2010, the Companies placed into operation an appropriate combination of permanent and temporary sections of the transmission line. While the Companies are not currently able to predict the ultimate outcome and possible financial effects of the remaining legal proceedings, the Companies do not believe the matter involves relevant or continuing risks to operations.

## *Mandatory Reliability Standards*

As a result of the EPCRA 2005, certain formerly voluntary reliability standards became mandatory in June 2007, and authority was delegated to various Regional Reliability Organizations ("RROs") by the North American Electric Reliability Corporation ("NERC"), which was authorized by the FERC to enforce compliance with such standards, including promulgating new standards. Failure to comply with mandatory reliability standards can subject a registered entity to sanctions, including potential fines of up to \$1 million per day, as well as non-monetary penalties, depending on the circumstances of the violation. The Companies are members of SERC, which acts as KU's and LG&E's RRO. During December 2009, SERC and the Companies agreed to settlements involving penalties totaling less than \$1 million for each utility related to their self-reports during June and October 2008, concerning possible violations of standards. During December 2009 and April, July and August 2010, the Companies submitted ten self-reports relating to various standards, which self-reports remain in the early stages of RRO review, and therefore, the Companies 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 FERC review before becoming final. While the Companies believe they are in compliance with the mandatory reliability standards, events of potential non-compliance may be identified from time-to-time. The Companies cannot predict such potential violations or the outcome of the self-reports described above.

### Note 3 – Asset Retirement Obligation

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

(in millions)	ARO Net <u>Assets</u>	ARO <u>Liabilities</u>	Regulatory <u>Assets</u>
As of December 31, 2009	\$ 4	\$ (34)	\$ 30
ARO accretion	-	(2)	2
ARO revaluation	<u>21</u>	<u>(23)</u>	<u>2</u>
As of September 30, 2010	<u>\$ 25</u>	<u>\$ (59)</u>	<u>\$ 34</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.

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 income statement of \$2 million for the nine months ended September 30, 2010 for the ARO accretion and depreciation expense. KU’s AROs are primarily related to the final retirement of assets associated with generating units.

KU transmission and distribution lines largely operate under perpetual property easement agreements which do not generally require restoration on 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 4 – Derivative Financial Instruments

KU 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 the interest rate risk to be managed through the use of fixed rate debt, floating rate debt and interest rate swaps. At September 30, 2010, a 100 basis point change in the benchmark rate on KU’s variable rate debt, not effectively hedged by an interest rate swap, would impact pre-tax interest expense by \$4 million annually. Although the Company’s policies allow for the use of interest rate swaps, as of September 30, 2010 and December 31, 2009, KU had no interest rate swaps outstanding.

The Company does not net collateral against derivative instruments.

## Energy Trading and Risk Management Activities

KU 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 topic 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.

KU's financial assets and liabilities as of September 30, 2010 and December 31, 2009, arising from energy trading and risk management contracts not designated as hedging instruments accounted for at fair value total less than \$1 million and are recorded in prepayments and other current assets and other current liabilities, respectively.

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, KU 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, KU 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 September 30, 2010, 100% of the trading and risk management commitments were with counterparties rated BBB-/Baa3 equivalent or better. The Company has reserves against counterparty credit risk based on the counterparty's credit rating and applying historical default rates within varying credit ratings over time provided by S&P or Moody's. At September 30, 2010 and December 31, 2009, counterparty credit reserves related to energy trading and risk management contracts were less than \$1 million.

The net volume of electricity based financial derivatives outstanding at September 30, 2010 and December 31, 2009, was zero and 43,400 Mwhts, respectively. No cash collateral related to the energy trading and risk management contracts was required at September 30, 2010. Cash collateral related to the energy trading and risk management contracts was less than \$1 million at December 31, 2009. Cash collateral related to the energy trading and risk management contracts is categorized as other accounts receivable in the accompanying balance sheets.

KU 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, and therefore realized and unrealized gains and losses are included in the statements of income.

The following tables present the effect of derivatives not designated as hedging instruments on income:

(in millions)		Three Months Ended September 30,	
<u>Loss Recognized in Income</u>	<u>Location</u>	<u>2010 (a)</u>	<u>2009</u>
Unrealized loss	Electric revenues	\$ -	\$ (3)

		Nine Months Ended September 30,	
<u>Loss Recognized in Income</u>	<u>Location</u>	<u>2010 (a)</u>	<u>2009</u>
Unrealized loss	Electric revenues	\$ -	\$ (1)

(a) Unrealized loss was less than \$1 million

Net realized gains were less than \$1 million in the three and nine months ended September 30, 2010 and 2009, respectively.

#### Credit Risk Related Contingent Features

Certain of the Company's derivative instruments contain provisions that require the Company to provide immediate and on-going collateralization on derivative instruments in net liability positions based on the Company's credit ratings from each of the major credit rating agencies. At September 30, 2010, there are no energy trading and risk management contracts with credit risk related contingent features that are in a liability position and no collateral posted in the normal course of business. At September 30, 2010, a one notch downgrade of the Company's credit rating would have no effect on the energy trading and risk management contracts or collateral required.

#### **Note 5 – Fair Value Measurements**

KU 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 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 KU's non-trading instruments:

(in millions)	<u>September 30, 2010</u>		<u>December 31, 2009</u>	
	<u>Carrying Value</u>	<u>Fair Value</u>	<u>Carrying Value</u>	<u>Fair Value</u>
Long-term bonds (including current portion of \$228 million)	\$ 351	\$ 352	\$ 351	\$ 351
Long-term debt to affiliated company (including current portion of \$33 million)	1,331	1,527	1,331	1,401

The long-term bond valuations reflect prices quoted by investment banks, which are active in the market for these debt instruments. The fair value of the long-term debt due to affiliated company 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 KU's credit ratings and default risk. 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.

KU 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 defined by the fair value measurements and disclosures topic of the FASB ASC, as follows:

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

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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 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.

KU's financial assets and liabilities as of September 30, 2010 and December 31, 2009, arising from energy trading and risk management contracts accounted for at fair value on a recurring basis total less than \$1 million. No cash collateral related to the energy trading and risk management contracts was required at September 30, 2010. Cash collateral related to the energy trading and risk management contracts was less than \$1 million at December 31, 2009.

There were no level 3 measurements for the periods ending September 30, 2010 and December 31, 2009.

## Note 6 – Pension and Other Postretirement Benefit Plans

### Net Periodic Benefit Costs

The following tables provide the components of net periodic benefit cost for pension and other postretirement benefit plans. The tables include the costs associated with both KU employees and Servco employees who are providing services to KU. The Servco costs are allocated to KU based on employees' labor charges and are approximately 53% and 51% of Servco costs for September 30, 2010 and 2009, respectively.

(in millions)

	Pension Benefits					
	2010			2009		
	<u>KU</u>	<u>Servco Allocation to KU</u>	<u>Total KU</u>	<u>KU</u>	<u>Servco Allocation to KU</u>	<u>Total KU</u>
Service cost	\$ 2	\$ 1	\$ 3	\$ 2	\$ 1	\$ 3
Interest cost	4	2	6	4	2	6
Expected return on plan assets	(5)	(2)	(7)	(3)	(1)	(4)
Amortization of prior service cost	-	1	1	-	-	-
Amortization of actuarial loss	2	1	3	2	1	3
Net periodic benefit cost	<u>\$ 3</u>	<u>\$ 3</u>	<u>\$ 6</u>	<u>\$ 5</u>	<u>\$ 3</u>	<u>\$ 8</u>

	Other Postretirement Benefits					
	2010			2009		
	<u>KU</u>	<u>Servco Allocation to KU(a)</u>	<u>Total KU</u>	<u>KU</u>	<u>Servco Allocation to KU(a)</u>	<u>Total KU</u>
Interest cost	\$ 2	\$ -	\$ 2	\$ 1	\$ -	\$ 1
Net periodic benefit cost	<u>\$ 2</u>	<u>\$ -</u>	<u>\$ 2</u>	<u>\$ 1</u>	<u>\$ -</u>	<u>\$ 1</u>

(a) amounts are less than \$1 million

	Pension Benefits					
	Nine Months Ended September 30,					
	2010			2009		
	Servco Allocation			Servco Allocation		
	<u>KU</u>	<u>to KU</u>	<u>Total KU</u>	<u>KU</u>	<u>to KU</u>	<u>Total KU</u>
Service cost	\$ 5	\$ 4	\$ 9	\$ 4	\$ 4	\$ 8
Interest cost	14	6	20	13	5	18
Expected return on plan assets	(13)	(5)	(18)	(10)	(4)	(14)
Amortization of prior service cost	-	1	1	1	1	2
Amortization of actuarial loss	5	2	7	6	2	8
Net periodic benefit cost	<u>\$ 11</u>	<u>\$ 8</u>	<u>\$ 19</u>	<u>\$ 14</u>	<u>\$ 8</u>	<u>\$ 22</u>

	Other Postretirement Benefits					
	Nine Months Ended September 30,					
	2010			2009		
	Servco Allocation			Servco Allocation		
	<u>KU</u>	<u>to KU</u>	<u>Total KU</u>	<u>KU</u>	<u>to KU</u>	<u>Total KU</u>
Service cost	\$ 1	\$ 1	\$ 2	\$ 1	\$ 1	\$ 2
Interest cost	4	-	4	3	-	3
Expected return on plan assets	(1)	-	(1)	-	-	-
Amortization of transitional obligation	1	-	1	1	-	1
Net periodic benefit cost	<u>\$ 5</u>	<u>\$ 1</u>	<u>\$ 6</u>	<u>\$ 5</u>	<u>\$ 1</u>	<u>\$ 6</u>

### Contributions

In January 2010, KU and Servco made discretionary pension plan contributions of \$13 million and \$9 million, respectively. The amount of future contributions to the pension plan will depend on the actual return on plan assets and other factors, but the Company's intent is to fund the pension plan in a manner consistent with the requirements of the Pension Protection Act of 2006.

Through September 2010, KU made contributions to other postretirement benefit plans totaling \$4 million. An additional contribution totaling \$1 million was made in October. The Company anticipates further funding to match the annual postretirement expense and funding the 401(h) plan up to the maximum amount allowed by law.

## 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 each of the three and nine months ended September 30, 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 KU 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.

KU continues to evaluate all implications of Health Care Reform on its benefit programs but at this time cannot predict the significance of those implications.

## **Note 7 – Income Taxes**

A United States consolidated income tax return is filed by E.ON U.S.'s direct parent, E.ON US Investments Corp., for each tax period. Each subsidiary of the consolidated tax group, including KU, 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 2006-2008 have been received from the IRS, effectively closing these years to additional audit adjustments. Tax years beginning with 2007 were examined under an IRS pilot program named "Compliance Assurance Process" ("CAP"). This program accelerates the IRS' review to begin during the year applicable to the return and ends 90 days after the return is filed. For 2008, the IRS allowed additional deductions in connection with the Company's application for a change in repair deductions and disallowed some of the bonus depreciation claimed on the original return. The net temporary tax impact for the Company was \$12 million and was recorded in the second quarter of 2010. Tax years 2009 and 2010 are also being examined under CAP. The 2009 federal return was filed in the third quarter, and the IRS issued a Partial Acceptance Letter with the 2009 return. The IRS is continuing to review bonus depreciation, storms and other repairs. No material impact is expected from the IRS review. For the tax year 2010, no material items have been raised by the IRS at this time.

Additions and reductions of uncertain tax positions during 2010 and 2009 were less than \$1 million. Possible amounts of uncertain tax positions for KU that may decrease within the next 12 months total less than \$1 million and are based on the expiration of the audit periods as defined in the statutes. If recognized, the less than \$1 million of unrecognized tax benefits would reduce the effective income tax rate.

The amount KU recognized as interest expense and interest accrued related to unrecognized tax benefits was less than \$1 million as of September 30, 2010 and December 31, 2009. 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. KU records the interest as interest expense and penalties as operating expenses in the income statement and accrued expenses in the balance sheet, on a pre-tax basis. No penalties were accrued by the Company through September 30, 2010.

In June 2006, the Companies 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 KU was selected to receive \$101 million in tax credits. A final IRS certification required to obtain the investment tax credits was received in August 2007. In September 2007, 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. Based on eligible construction expenditures incurred, KU recorded investment tax credits of \$6 and \$17 million during the three and nine months ended September 30, 2009, decreasing current federal income taxes. As of December 31, 2009 KU had recorded its maximum credit of \$101 million. The income tax expense impact from amortizing these credits over the life of the related property will begin when the facility is placed in service, which is expected to occur by year end.

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.

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:

(in millions)	Three Months Ended		Nine Months Ended	
	September 30, <u>2010</u>	September 30, <u>2009</u>	September 30, <u>2010</u>	September 30, <u>2009</u>
Statutory federal income tax expense	\$ 30	\$ 37	\$ 72	\$ 52
State income taxes – net of federal benefit	3	4	8	4
Dividends received deduction related to EEI investment	-	-	-	(3)
Other differences – net	<u>(1)</u>	<u>(2)</u>	<u>(4)</u>	<u>(4)</u>
Income tax expense	<u>\$ 32</u>	<u>\$ 39</u>	<u>\$ 76</u>	<u>\$ 49</u>
Effective income tax rate	37.2%	37.1%	37.1%	33.1%

The amounts shown in the table above are rounded to the nearest \$1 million; however, the effective income tax rates are based on actual underlying amounts. Other differences – net includes the qualified production activities deduction and excess deferred taxes on depreciation.

The effective tax rate for the nine months ended September 2010 was higher than the rate for the nine months ended 2009 due to state income taxes – net of federal benefit being lower due to a coal credit

recorded in 2009 and a lower dividends received deduction primarily due to the lack of EEI dividends in 2010.

### Note 8 – Short-Term and Long-Term Debt

KU’s long-term debt includes \$228 million of pollution control bonds that are classified as current portion of long-term debt 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:

(in millions)

Mercer Co. 2000 Series A, due May 1, 2023, variable %	\$	13
Carroll Co. 2002 Series A, due February 1, 2032, variable %		21
Carroll Co. 2002 Series B, due February 1, 2032, variable %		2
Carroll Co. 2008 Series A, due February 1, 2032, variable %		78
Mercer Co. 2002 Series A, due February 1, 2032, variable %		8
Muhlenberg Co. 2002 Series A, due February 1, 2032, variable %		2
Carroll Co. 2004 Series A, due October 1, 2034, variable %		50
Carroll Co. 2006 Series B, due October 1, 2034, variable %		54
	<u>\$</u>	<u>228</u>

The average annualized interest rates for these bonds follow:

	September 30,	
	<u>2010</u>	<u>2009</u>
Three months ended	0.37%	0.51%
Nine months ended	0.36%	0.65%

Pollution control bonds are obligations of KU issued in connection with tax-exempt pollution control bonds issued by counties in Kentucky. A loan agreement obligates the Company to make debt service payments to the counties that equate to the debt service due from the counties on the related pollution control bonds. The loan agreement is an unsecured obligation of the Company. Debt issuance expense is capitalized in either regulatory assets or current or long-term other assets and amortized over the lives of the related bond issues, consistent with regulatory practices.

In October 2010, KU’s pollution control bonds were converted from unsecured debt to debt which is collateralized by first mortgage bonds. 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 of the KU 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 September 30, 2010, KU had an aggregate \$351 million of outstanding pollution control indebtedness, of which \$96 million is in the form of insured auction rate securities wherein interest rates are reset 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, 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:

	September 30,	
	<u>2010</u>	<u>2009</u>
Three months ended	0.61%	0.34%
Nine months ended	0.50%	0.51%

The instruments governing these auction rate bonds permit KU 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. In June 2009, one national rating agency downgraded the credit rating of an insurer of the Company’s bonds. As a result, the national rating agency downgraded the rating on the Carroll County 2002 Series C bond. The national agency’s rating of this bond is now based on the rating of the Company rather than the rating of the insurer since the Company’s rating is higher.

The Company participates in an intercompany money pool agreement wherein E.ON U.S. and/or LG&E make funds available to KU at market-based rates (based on highly rated commercial paper issues) up to \$400 million. Details of the balances are as follows:

(in millions)	<u>Total Money Pool Available</u>	<u>Amount Outstanding</u>	<u>Balance Available</u>	<u>Average Interest Rate</u>
September 30, 2010	\$ 400	\$ 61	\$ 339	0.28%
December 31, 2009	\$ 400	\$ 45	\$ 355	0.20%

E.ON U.S. maintained revolving credit facilities totaling \$313 million at September 30, 2010 and December 31, 2009, to ensure funding availability for the money pool. At September 30, 2010, one facility, totaling \$150 million, was with E.ON North America, Inc. while the remaining line, totaling \$163 million, was with Fidelity; both are affiliated companies. The balances are as follows:

(in millions)	<u>Total Available</u>	<u>Amount Outstanding</u>	<u>Balance Available</u>	<u>Average Interest Rate</u>
September 30, 2010	\$ 313	\$ 181	\$ 132	1.44%
December 31, 2009	\$ 313	\$ 276	\$ 37	1.25%

As of September 30, 2010, the Company maintained a \$35 million bilateral line of credit, maturing in June 2012, with an unaffiliated financial institution. At September 30, 2010, there was no balance outstanding under this facility. The Company also maintains letter of credit facilities that support \$195 million of the \$228 million of bonds that can be put back to the Company. Should the holders elect to put the bonds back and they cannot be remarketed, the letter of credit would fund the investor’s payment.

There were no redemptions or issuances of long-term debt year-to-date through September 30, 2010. KU was in compliance with all debt covenants at September 30, 2010 and December 31, 2009. See Note 1,

General, for certain debt refinancing and associated transactions which are anticipated by KU in connection with the PPL acquisition and Note 10, Related Party Transactions, for long-term debt payable to affiliates.

## **Note 9 – Commitments and Contingencies**

Except as may be discussed in this quarterly report (including Note 2, Rates and Regulatory Matters), material changes have not occurred in the current status of various commitments or contingent liabilities from that discussed in the Company's Annual Report for the year ended December 31, 2009 (including, but not limited to Note 2, Rates and Regulatory Matters; Note 9, Commitments and Contingencies; and Note 12, Subsequent Events, contained therein). See the Company's Annual Report regarding such commitments or contingencies.

### Letters of Credit

KU has provided letters of credit as of September 30, 2010 and December 31, 2009, for on-balance sheet obligations totaling \$198 million to support bonds of \$195 million and a letter of credit for off-balance sheet obligations totaling less than \$1 million to support certain obligations related to workers' compensation.

### 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 the Company has received the agreed settlement amounts. Pursuant to the settlement's operation, the OMU agreement terminated in May 2010. In connection with such termination, KU has recorded a net receivable totaling \$4 million reflecting its estimate of remaining adjustments concerning prior accruals. The parties are engaged in discussions to resolve those remaining adjustments.

### Construction Program

KU had approximately \$167 million of commitments in connection with its construction program at September 30, 2010.

In June 2006, the Companies entered into a construction contract regarding the TC2 project. The contract is generally in the form of a lump-sum, 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 paid or payable to the contractor. During 2009 and 2010, the Companies 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, the Companies and construction contractor agreed to a settlement to resolve certain 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 damages calculations. During commissioning activities in the second and third quarters, separate delays

have occurred related to burner malfunctions and an excitation transformer failure. Certain temporary or permanent repairs for both matters have been completed, are underway or are planned for appropriate future outage periods. Commissioning steps resumed in October 2010, and a revised commercial operations date is currently expected by year end. The parties are analyzing the treatment of these additional delays under the liquidated damages provisions of the construction agreement. The Companies cannot currently estimate the ultimate outcome of these matters, including the extent, if any, that such outcome may result in materially increased costs for the construction of TC2, further changes in the TC2 construction completion or commercial operation dates or potential effects on levels of power purchases or wholesale sales due to such changed dates.

### 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 environmental groups 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.

### Thermostat Replacement

During January 2010, the Companies announced a voluntary plan to replace certain thermostats, which had been provided to customers as part of the Companies' demand reduction programs, due to concerns that the thermostats may present a safety hazard. Under the plan, the Companies have replaced approximately 90% of the estimated 14,000 thermostats that need to be replaced. Total estimated costs associated with the replacement program are \$2 million. However, the Companies cannot fully predict the ultimate outcome of the replacement program or other effects or developments which may be associated with the thermostat replacement matter at this time.

### OVEC

KU holds a 2.5% investment interest in OVEC with 10 other electric utilities. KU is not the primary beneficiary; therefore the investment is not consolidated into the Company'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. KU is contractually entitled to 2.5% of OVEC's output, approximately 55 Mw of generation capacity. Pursuant to the OVEC power purchase contract, the Company may be conditionally responsible for a 2.5% pro-rata

share 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 post-retirement benefits other than pension. KU's potential proportionate share of OVEC's September 30, 2010 outstanding debt was \$35 million.

### Environmental Matters

The Company's operations are subject to a number of environmental laws and regulations in each of the jurisdictions in which it operates governing, among other things, air emissions, wastewater discharges, the use, handling and disposal of hazardous substances and wastes, soil and groundwater contamination and employee health and safety. As indicated below and summarized at the conclusion of this section, evolving environmental regulations will likely increase the level of capital and operating and maintenance expenditures incurred by the Company during the next several years. Based on 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 SO<sub>2</sub> and NO<sub>x</sub> emissions from power plants. In 1998, the EPA issued its final "NO<sub>x</sub> SIP Call" rule requiring reductions in NO<sub>x</sub> 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<sub>x</sub> emissions to 0.15 pounds weight per MMBtu on a company-wide basis. In 2005, the EPA issued the CAIR which required additional SO<sub>2</sub> emission reductions of 70% and NO<sub>x</sub> emission reductions of 65% from 2003 levels. The CAIR provided for a two-phase cap and trade program, with initial reductions of NO<sub>x</sub> and SO<sub>2</sub> emissions due by 2009 and 2010, respectively, and final reductions due by 2015. In 2006, Kentucky proposed to amend its SIP to adopt state requirements similar to those under the federal CAIR.

In July 2008, a federal appeals court issued a ruling finding deficiencies in the CAIR and vacating it. In December 2008, the Court amended its previous Order, directing the EPA to promulgate a new regulation but leaving the CAIR in place in the interim. The remand of the CAIR results in some uncertainty with respect to certain other EPA or state programs and proceedings and the Companies' 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 nitrogen dioxide ("NO<sub>2</sub>") and SO<sub>2</sub> 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, KU's power plants are potentially subject to requirements for additional reductions in SO<sub>2</sub> and NO<sub>x</sub> emissions.

In July 2010, the EPA issued the proposed CATR, which serves to replace the CAIR. The CATR provides for a two-phase SO<sub>2</sub> reduction program with Phase I reductions due by 2012, and Phase II reductions due by 2014. The CATR provides for NO<sub>x</sub> reductions in 2012, but the EPA advised that it is studying whether additional NO<sub>x</sub> 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 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 due 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 SO<sub>2</sub> 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<sub>x</sub> 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. KU met its Phase I SO<sub>2</sub> requirements primarily through installation of FGD equipment on Ghent Unit 1. KU's strategy for its Phase II SO<sub>2</sub> 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. In order to achieve the NO<sub>x</sub> emission reductions mandated by the NO<sub>x</sub> SIP Call, KU installed additional NO<sub>x</sub> controls, including SCR technology, during the 2000 through 2009 time period at a cost of \$221 million. In 2001, the Kentucky Commission granted approval to recover the costs incurred by KU for these projects through the ECR mechanism. Such monthly recovery is subject to periodic review by the Kentucky Commission.

In order to achieve currently mandated emissions reductions, KU expects to incur additional capital expenditures totaling approximately \$285 million during the 2010 through 2012 time period for pollution controls including FGD and SCR equipment and additional operating and maintenance costs in operating such controls. In 2005, the Kentucky Commission granted approval to recover the costs incurred by the Company for these projects through the ECR mechanism. Such monthly recovery is subject to periodic review by the Kentucky Commission. KU believes its costs in reducing SO<sub>2</sub>, NO<sub>x</sub> and mercury emissions to be comparable to those of similarly situated utilities with like generation assets. 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. KU will continue to monitor these developments to ensure that its environmental obligations are met in the most efficient and cost-effective manner. See "Ambient Air Quality" above for a discussion of CAIR-related uncertainties.

**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 are scheduled to meet in Cancun, Mexico in late 2010 to continue negotiations toward a binding agreement.

**GHG Legislation.** KU 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 is a comprehensive energy bill containing the first-ever nation-wide GHG cap and trade program. The bill would provide 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 initially be allocated at no cost to the electric utility sector, with this allocation gradually declining to 7% in 2029 and zero thereafter. The bill would also establish a renewable electricity standard requiring utilities to meet 20% of their electricity demand through renewable energy and energy efficiency by 2020. The bill contains 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 is largely patterned on the House legislation, was introduced in the U.S. Senate. The Senate bill raises the emissions reduction target for 2020 to 20% below 2005 levels and does 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. In 2010, Senators Kerry and Lieberman and others have undertaken additional work to draft GHG legislation but have introduced no bill in the Senate to date. In July 2010, Senate Majority Leader Reid announced that he did not anticipate that GHG legislation would be brought to the Senate floor in the current session. The Company is closely monitoring the progress of pending energy legislation, but the prospect for passage of comprehensive GHG legislation in 2010 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 will be required to submit annual reports commencing with calendar year 2010. In May 2010, the EPA issued a final GHG "tailoring" rule 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.

**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 5<sup>th</sup> 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. The petitioners filed a petition for a writ of mandamus with the Supreme Court in August 2010. The *Comer* complaint alleges that GHG emissions from the defendants' facilities contributed to global warming which increased the intensity of Hurricane Katrina. E.ON, the

indirect parent of the Companies, was included as a defendant in the complaint but has not been subject to the proceedings due to the failure of the plaintiffs to pursue service under the applicable international procedures. The Companies are currently unable to predict further developments in the Comer case and continue 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 an 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 an 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, the Company received an EPA settlement proposal providing for imposition of additional permit limits and emission controls and anticipates continued settlement negotiations with the EPA. Depending on the provisions of a final settlement or the results of litigation, if any, resolution of this matter could involve significant increased operating and capital expenditures. The Company is currently unable to determine the final outcome of this matter or the impact of an unfavorable determination on the Company's financial position or results of operations.

**Ash Ponds and Coal-Combustion Byproducts.** The EPA has undertaken various initiatives in response to the December 2008 impoundment failure at the Tennessee Valley Authority's Kingston power plant, which resulted in a major release of coal combustion byproducts into the environment. The EPA issued information requests to utilities throughout the country, including 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 KU's impoundments, which the EPA found to be in satisfactory 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 limitation 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, KU will likely be substantially impacted by pending or future environmental rules or legislation requiring mandatory reductions in GHG emissions or other air emissions, imposing more stringent standards on discharges to waterways, or establishing additional requirements for handling or disposal of coal combustion byproducts. These evolving environmental regulations will likely require an increased level of capital expenditures and increased incremental operating and maintenance costs by the Company over the next several years. Due to the uncertain nature of the final regulations that will ultimately be adopted by the EPA, including the reduction targets and the deadlines that will be applicable, the Company cannot finalize estimates of the potential compliance costs, but should the final rules incorporate additional emission reduction requirements, require more stringent emissions controls or implement more stringent byproducts storage and disposal practices, such costs will likely be significant. With respect to NAAQS, CATR, 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. Capital expenditures for KU associated with such actions are preliminarily estimated to be in the \$1.7 billion range over the next 10 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 on 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. Until such time as the Secretary issues a final order of the agency and all appeals are exhausted, the Company is unable to predict the outcome or precise impact of this matter.

**General Environmental Proceedings.** From time to time, KU 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 issues at KU's Ghent unit 2; completed settlement with state regulators regarding compliance with particulate limits in the air permit for KU's Tyrone generating station; remediation activities for 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 claims regarding the GHG emissions from the Company's generating stations. Based on analysis to date, the resolution of these matters is not expected to have a material impact on the Company's operations.

## Note 10 – Related Party Transactions

KU, subsidiaries of E.ON U.S. and subsidiaries of E.ON engage in related party transactions. Transactions between KU and E.ON U.S. subsidiaries are eliminated on consolidation of E.ON U.S. Transactions between KU and E.ON subsidiaries are eliminated on consolidation of E.ON. These transactions are generally performed at cost and are in accordance with FERC regulations under the Public Utility Holding Company Act of 2005 and the applicable Kentucky Commission and Virginia Commission regulations. The significant related party transactions are disclosed below.

### Intercompany Wholesale Sales and Purchases

KU and LG&E 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 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 two Companies. The volume of energy each company has to sell to the other is dependent on its native load needs and its available generation.

These sales and purchases are included in the statements of income as operating revenues, power purchased expenses and other operation and maintenance expenses. KU's intercompany electric revenues and power purchased expense were as follows:

(in millions)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Electric operating revenues from LG&E	\$ 3	\$ 2	\$ 13	\$ 18
Power purchased and related operations and maintenance expenses from LG&E	22	22	71	82

### Interest Charges

See Note 8, Short-Term and Long-Term Debt, for details of intercompany borrowing arrangements. Intercompany agreements do not require interest payments for receivables related to services provided when settled within 30 days.

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

(in millions)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Interest on Fidelia loans	\$ 18	\$ 18	\$ 55	\$ 51

Interest expense paid to E.ON U.S. on the money pool arrangement was less than \$1 million for the three and nine months ended September 30, 2010 and 2009.

### Dividends

In September 2010, the Company paid dividends of \$50 million to its common shareholder, E.ON U.S.

### Capital Contributions

In March and June 2009, the Company received capital contributions of \$50 million and \$25 million, respectively, from its common shareholder, E.ON U.S.

### Other Intercompany Billings

Servco provides the Company with a variety of centralized administrative, management and support services. These services include payroll taxes paid by Servco on behalf of KU, labor and burdens of Servco employees performing services for KU, coal purchases and other vouchers paid by Servco on behalf of KU. The cost of these services is directly charged to the Company, or for general costs which cannot be directly attributed, charged based on predetermined allocation factors, including the following ratios: number of customers, total assets, revenues, number of employees and other statistical information. These costs are charged on an actual cost basis.

In addition, the Companies provide services to each other and to Servco. Billings between the Companies relate to labor and overheads associated with union and hourly employees performing work for the other utility, charges related to jointly-owned generating units and other miscellaneous charges. Billings from KU to Servco include cash received by Servco on behalf of KU, primarily tax settlements, and other payments made by the Company on behalf of other non-regulated businesses which are reimbursed through Servco.

Intercompany billings to and from KU were as follows:

(in millions)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Servco billings to KU	\$ 64	\$ 43	\$ 181	\$ 121
KU billings to LG&E	-	16	1	63
LG&E billings to KU	28	-	47	-
KU billings to Servco	11	3	11	5

## Intercompany Balances

The Company had the following balances with its affiliates:

(in millions)	September 30, <u>2010</u>	December 31, <u>2009</u>
Accounts receivable from E.ON U.S.	\$ -	\$ 9
Accounts payable to LG&E	17	53
Accounts payable to Servco	18	20
Accounts payable to E.ON U.S.	18	-
Accounts payable to Fidelia	18	15
Notes payable to E.ON U.S.	61	45
Long-term debt to Fidelia (including current portion of \$33 million)	1,331	1,331

### **Note 11 – Subsequent Events**

Subsequent events have been evaluated through October 29, 2010, the date of issuance of these statements, and these statements contain all necessary adjustments and disclosures resulting from that evaluation.

On October 29, 2010, KU's pollution control bonds were converted from unsecured debt to debt which is collateralized by first mortgage bonds. See Note 1, General, and Note 8, Short-Term and Long-Term Debt.

On October 26, 2010, the FERC issued an Order approving the acquisition of E.ON U.S. by PPL. See Note 1, General.

On October 19, 2010 and October 21, 2010, respectively, the Virginia Commission and Tennessee Regulatory Authority issued Orders approving the acquisition of E.ON U.S. by PPL. On the same dates, KU received Virginia Commission and Tennessee Regulatory Authority approvals to complete certain refinancing transactions in connection with the anticipated PPL acquisition and other business factors. See Note 1, General, and Note 8, Short-Term and Long-Term Debt.

## Management's Discussion and Analysis

### Overview

KU, incorporated in Kentucky in 1912 and in Virginia in 1991, is a regulated public utility engaged in the generation, transmission, distribution and sale of electric energy in Kentucky, Virginia and Tennessee. KU provides electric service to approximately 515,000 customers in 77 counties in central, southeastern and western Kentucky, to approximately 29,000 customers in 5 counties in southwestern Virginia and 5 customers in Tennessee. KU's service area covers approximately 6,600 noncontiguous square miles. Approximately 99% of the electricity generated by KU is produced by its coal-fired electric generating stations. The remainder is generated by a hydroelectric power plant and natural gas and oil fueled combustion turbines. In Virginia, KU operates under the name Old Dominion Power Company. KU also sells wholesale electric energy to 12 municipalities.

KU is a wholly-owned subsidiary of E.ON U.S., an indirect wholly-owned subsidiary of E.ON, a German corporation. KU's affiliate, LG&E, is a regulated public utility engaged in the generation, transmission, distribution and sale of electric energy and the storage, distribution and sale of natural gas in Kentucky.

The following discussion and analysis by management focuses on those factors that had a material effect on KU's financial results of operations and financial condition during the three and nine months ended September 30, 2010, and should be read in connection with the condensed financial statements and notes thereto and the Annual Report for the year ending December 31, 2009. Dollars are in millions unless otherwise noted.

Some of the following discussion may contain forward-looking statements that are subject to certain risks, uncertainties and assumptions. Such forward-looking statements are intended to be identified in this document by the words "anticipate," "expect," "estimate," "objective," "possible," "potential" and similar expressions. Actual results may vary materially. Factors that could cause actual results to differ materially include: general economic conditions; business and competitive conditions in the energy industry; changes in federal or state legislation; unusual weather; actions by state or federal regulatory agencies; and other factors described from time to time in the Company's reports, including the Annual Report for the year ended December 31, 2009.

#### PPL Acquisition

See Note 1, General, for information regarding the acquisition of E.ON U.S. by PPL, settlement agreements in change of control proceedings, closing conditions and anticipated financing transactions.

#### Regulatory Matters

See Note 2, Rates and Regulatory Matters, for information regarding rate cases, regulatory assets and liabilities and other regulatory matters.

## Environmental Matters

### *General*

Protection of the environment is a major priority for KU and a significant element of its business activities. KU'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, KU 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 or proposed various regulatory initiatives relating to GHG matters, including an endangerment finding relating to mobile sources of GHGs, a GHG reporting requirement and a rule relating to permitting requirements for new or modified GHG emission sources. 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, KU, as a primarily coal-fired utility, could be highly affected by such proceedings.

### *Other Environmental Regulatory Initiatives*

Additionally, 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 SO<sub>2</sub>, NO<sub>2</sub>, ozone, and particulate matter 2.5 microns in size or less, rules aimed at mitigating the interstate transport of SO<sub>2</sub> and NO<sub>x</sub>, 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 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 KU and the effect on KU's business of complying with potential GHG restrictions and other environmental regulatory initiatives will depend on the details of the programs ultimately enacted. Some of the design elements which may have the greatest effect on KU 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. Base on prior regulatory precedent, KU 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. Capital expenditures for KU associated with such actions are preliminarily estimated to be in the \$1.7 billion range over the next 10 years, although final costs may substantially vary. See Management's Discussion and Analysis and Note 9, Commitments and Contingencies, for additional information.

## Results of Operations

The electric utility business is affected by seasonal temperatures. As a result, operating revenues (and associated operating expenses) are not generated evenly throughout the year.

### Three Months Ended September 30, 2010, Compared to Three Months Ended September 30, 2009

#### Net Income

Net income was \$54 million for the three months ended September 30, 2010, compared to \$66 million for the same period in 2009. The decrease was primarily the result of the following:

	Three Months Ended September 30,		Increase (Decrease)
	2010	2009	
Total operating revenues	\$ 416	\$ 341	\$ 75
Total operating expenses	311	216	95
Operating income	105	125	(20)
Interest expense to affiliated companies	18	18	-
Other income (expense) – net	(1)	(2)	1
Income before income taxes	86	105	(19)
Income tax expense	32	39	(7)
Net income	\$ 54	\$ 66	\$ (12)

#### Operating Revenues

The \$75 million increase in operating revenues in the three months ended September 30, 2010, was primarily due to:

	Increase (Decrease)
Retail sales volumes (a)	\$ 40
Retail base rates (b)	14
ECR surcharge due to increased recoverable capital spending	10
Retail FAC costs billed to customers due to higher fuel prices	6
Other	5
	\$ 75

- (a) Primarily due to increased consumption by residential customers as a result of increased cooling degree days and higher energy usage by industrial customers as a result of improved economic conditions and increased cooling degree days.

(b) Primarily due to higher rates effective August 1, 2010. See Note 2, Rates and Regulatory Matters, for further discussion of the 2010 Kentucky rate case.

### Operating Expenses

Fuel for electric generation comprises a large component of total operating expenses. Increases or decreases in the cost of fuel are reflected in retail rates through the FAC, subject to the approval of the Kentucky Commission, the Virginia Commission and the FERC. Operating expenses follow:

	Three Months Ended September 30,		Increase (Decrease)
	<u>2010</u>	<u>2009</u>	
Fuel for electric generation	\$ 146	\$ 114	\$ 32
Power purchased	41	47	(6)
Other operation and maintenance expenses	86	22	64
Depreciation, accretion and amortization	<u>38</u>	<u>33</u>	<u>5</u>
Total operating expenses	<u>\$ 311</u>	<u>\$ 216</u>	<u>\$ 95</u>

#### Fuel for Electric Generation

The \$32 million increase in fuel for electric generation in the three months ended September 30, 2010, was primarily due to increased volumes of fuel usage due to increased retail sales volumes.

#### Power Purchased

The \$6 million decrease in power purchased expense in the three months ended September 30, 2010, was primarily due to:

	Increase (Decrease)
Third-party purchased volumes for native load	\$ (8)
Demand payments for third-party purchase	(4)
Prices for purchases used to serve retail customers	<u>6</u>
	<u>\$ (6)</u>

#### Other Operation and Maintenance Expenses

Other operation and maintenance expenses increased \$64 million in the three months ended September 30, 2010, due to \$55 million of increased maintenance expenses, and \$9 million of increased other operation expenses. These increases were primarily due to distribution expenses (\$53 million related to maintenance and \$4 million related to other operations) incurred in the first quarter of 2009 for wind and ice storm restoration that were reclassified to a regulatory asset in the third quarter of 2009.

### Income Tax Expense

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

Nine Months Ended September 30, 2010, Compared to  
Nine Months Ended September 30, 2009

**Net Income**

Net income was \$129 million for the nine months ended September 30, 2010, compared to \$99 million for the same period in 2009. The increase was primarily the result of the following:

	Nine Months Ended September 30,		Increase (Decrease)
	<u>2010</u>	<u>2009</u>	
Total operating revenues	\$ 1,146	\$ 1,009	\$ 137
Total operating expenses	<u>883</u>	<u>812</u>	<u>71</u>
Operating income	263	197	66
Interest expense to affiliated companies	55	51	4
Other income (expense) – net	<u>(3)</u>	<u>2</u>	<u>(5)</u>
Income before income taxes	205	148	57
Income tax expense	<u>76</u>	<u>49</u>	<u>27</u>
Net income	<u>\$ 129</u>	<u>\$ 99</u>	<u>\$ 30</u>

**Operating Revenues**

The \$137 million increase in operating revenues in the nine months ended September 30, 2010, was primarily due to:

	Increase (Decrease)
Retail sales volumes (a)	\$ 98
Retail base rates (b)	14
ECR surcharge due to increased recoverable capital spending	10
Miscellaneous operating revenue (c)	8
DSM revenue due to increased recoverable program spending	6
Other	<u>1</u>
	<u>\$ 137</u>

- (a) Primarily due to increased consumption by residential customers as a result of increased cooling and heating degree days and higher energy usage by industrial customers as a result of improved economic conditions and increased cooling and heating degree days.
- (b) Primarily due to higher rates effective August 1, 2010. See Note 2, Rates and Regulatory Matters, for further discussion of the 2010 Kentucky rate case.
- (c) Primarily related to increased late payment charges and transmission service revenues.

## Operating Expenses

Fuel for electric generation comprises a large component of total operating expenses. Increases or decreases in the cost of fuel are reflected in retail rates through the FAC, subject to the approval of the Kentucky Commission, the Virginia Commission and the FERC. Operating expenses follow:

	Nine Months Ended September 30,		Increase (Decrease)
	<u>2010</u>	<u>2009</u>	
Fuel for electric generation	\$ 391	\$ 329	\$ 62
Power purchased	135	154	(19)
Other operation and maintenance expenses	251	230	21
Depreciation, accretion and amortization	<u>106</u>	<u>99</u>	<u>7</u>
Total operating expenses	<u>\$ 883</u>	<u>\$ 812</u>	<u>\$ 71</u>

### Fuel for Electric Generation

The \$62 million increase in fuel for electric generation in the nine months ended September 30, 2010, was primarily due to:

	Increase (Decrease)
Fuel usage volumes due to increased native load and wholesale sales	\$ 73
Commodity and transportation costs for coal	<u>(11)</u>
	<u>\$ 62</u>

### Power Purchased

The \$19 million decrease in power purchased expense in the nine months ended September 30, 2010, was primarily due to:

	Increase (Decrease)
Third-party purchased volumes for native load	\$ (16)
Purchases from LG&E due to volume (a)	(13)
Demand payments for third-party purchases	(5)
Prices for purchases used to serve retail customers	7
OMU settlement received in 2009 (b)	6
Purchases from LG&E due to fuel costs	<u>2</u>
	<u>\$ (19)</u>

- (a) Primarily due to increased consumption by residential customers at LG&E as a result of increased cooling and heating degree days and increased coal-fired generation outages in the first six months of 2010 and higher energy usage by industrial customers as a result of

improved economic conditions and increased cooling and heating degree days. See Note 10, Related Party Transactions, for further discussion of the mutual agreement for wholesale sales and purchases between the Companies.

- (b) See Note 9, Commitments and Contingencies, for further discussion of the OMU settlement.

### Other Operation and Maintenance Expenses

Other operation and maintenance expenses increased \$21 million in the nine months ended September 30, 2010, due to \$19 million of increased other operation expenses and \$2 million of increased maintenance expenses.

#### *Other Operation Expenses*

The \$19 million increase in other operation expenses in the nine months ended September 30, 2010, was primarily due to:

	<u>Increase (Decrease)</u>
Transmission expense (a)	\$ 7
Administrative and general (b)	6
Steam expense due to increased generation in 2010	5
Other	<u>1</u>
	<u>\$ 19</u>

- (a) Primarily due to transmission expense for a third party pursuant to a settlement agreement, the establishment of a regulatory asset approved by the Kentucky Commission for the EKPC settlement in 2009, net of nine months of amortization expense recorded in 2010, and increased transmission expense due to transmission charges for FERC jurisdictional municipal customers now unbundled from energy.
- (b) Primarily due to increased bad debt expense due to higher billed revenues, implementation of a late payment charge and a higher net charge-off percentage, increased labor costs, and increased insurance cost.

### **Interest Expense to Affiliated Companies**

The \$4 million increase in interest expense to affiliated companies in the nine months ended September 30, 2010, was primarily due to increased intercompany notes outstanding.

### **Income Tax Expense**

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

## Financial Condition

### Liquidity and Capital Resources

	September 30, <u>2010</u>	December 31, <u>2009</u>
Cash and cash equivalents	\$ 2	\$ 2
Current portion of long-term debt	228	228
Current portion of long-term debt to affiliated company	33	33
Notes payable to affiliated company	61	45

Activity in KU's cash and cash equivalents in the nine months ended September 30, 2010, included the following:

	Increase <u>(Decrease)</u>
Cash provided by operating activities	\$ 300
Construction expenditures	(218)
A net increase in short-term borrowings from affiliated company	16
Expenditures to purchase assets from affiliate	(48)
Payment of dividends	<u>(50)</u>
	<u>\$ -</u>

### Working Capital Deficiency

As of September 30, 2010, KU had a working capital deficiency of \$205 million, primarily due to the terms of certain tax-exempt bonds totaling \$228 million, which allow the investors to put the bonds back to the Company causing them to be classified as current portion of long-term bonds. The Company has adequate liquidity facilities to repurchase any bonds put back to the Company. Working capital deficiencies can be funded through an intercompany money pool agreement through bilateral lines of credit or drawings under letters of credit. See Note 8, Short-Term and Long-Term Debt. KU believes that its sources of funds will be sufficient to meet the needs of its business in the foreseeable future.

### Auction Rate Securities

Auctions for auction rate securities issued by KU continued to fail during the quarter. KU did not hold any of its own auction rate securities at September 30, 2010 and December 31, 2009. See Note 8, Short-Term and Long-Term Debt, for further discussion of auction rate securities.

### Debt

Regulatory approvals are required for 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, KU 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. These short-term funds are made available

via the Company's participation in an intercompany money pool agreement wherein E.ON U.S. and/or LG&E make funds available to KU at market-based rates (based on highly rated commercial paper issues) up to \$400 million.

See Note 1, General, for information on PPL related financing and Note 8, Short-Term and Long-Term Debt, for information on redemptions, maturities and issuances of long-term debt.

### **Common Stock Dividends**

In September 2010, the Company paid dividends of \$50 million to its common shareholder, E.ON U.S. KU uses net cash generated from its operations and external financing (including financing from affiliates) to fund the payment of dividends. Future dividends, declared at the discretion of the Board of Directors, will be dependent on future earnings, financial requirements and other factors.

### **Credit Ratings**

KU's credit ratings reflect the views of two 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 Company's issuer rating as a result of the pending acquisition by PPL. See Note 8, Short-Term and Long-Term Debt, for a discussion of downgrade actions related to the pollution control bonds caused by a change in the rating of the entity insuring those bonds.

KU has various derivative and non-derivative contracts, including contracts for the sale and purchase of electricity and fuel, which contain provisions requiring KU to post additional collateral or permit the counterparty to terminate the contract if KU's credit rating were to fall below investment grade. At September 30, 2010, KU had no open positions under these contracts that would require the Company to post collateral to counterparties if KU's credit rating had been downgraded below investment grade for both derivative and non-derivative commodity and commodity-related contracts used in its generation, marketing and trading operations.

## Future Capital Requirements

KU'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. KU expects its capital expenditures for the three year period ending December 31, 2012, to total approximately \$1.1 billion, consisting primarily of the following:

Construction of generation assets	\$	305
Construction of distribution assets		245
Ash pond and landfill projects		210
Brown SCR		155
Installation of FGDs on Ghent and Brown units		125
Information technology projects		35
Other projects		25
Construction of TC2 (includes \$5 million for environmental controls)		<u>25</u>
	\$	<u>1,125</u>

In addition to the amounts in the table shown above, evolving environmental regulations will likely increase the level of capital expenditures above the amounts currently expected over 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. Capital expenditures for KU associated with such actions are preliminarily estimated to be in the \$1.7 billion range over the next 10 years, although final costs may substantially vary. See Note 9, Commitments and Contingencies, for further discussion of environmental matters. Future capital requirements may 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, changes in environmental regulations and other regulatory requirements. Credit market conditions can affect aspects of the availability, terms or methods in KU and LG&E fund their capital requirements. KU and LG&E anticipate funding future capital requirements through operating cash flow, debt and/or infusions of capital from their parent.

## Controls and Procedures

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process 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 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 generally accepted accounting principles and 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 condensed 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.

As of December 31, 2009, KU is 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 the Company's internal control over financial reporting pursuant to Section 404 of the Act. However, management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2009, 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, 2009, the Company's internal control over financial reporting was effective based on those criteria. There have been no changes in the Company's internal control over financial reporting that occurred during the nine months ended September 30, 2010, that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2009, was audited by PricewaterhouseCoopers LLP, an independent accounting firm, as stated in its report which is included in the 2009 KU Annual Report.

## **Legal Proceedings**

For a description of the significant legal proceedings, including, but not limited to, certain rates and regulatory, environmental, climate change and litigation matters, involving KU, reference is made to the information under the following captions of the Company's Annual Report for the year ended December 31, 2009: Business, Risk Factors, Legal Proceedings, Management's Discussion and Analysis, Financial Statements and Notes to Financial Statements. Reference is also made to the matters described in Note 2, Rates and Regulatory Matters; Note 9, Commitments and Contingencies; and Note 11, Subsequent Events, of this quarterly report. Except as described in this quarterly report, to date, the proceedings reported in the Company's Annual Report for the year ended December 31, 2009, have not materially changed.

### Other

In the normal course of business, other lawsuits, claims, environmental actions and other governmental proceedings arise against KU. 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 other currently pending or threatened lawsuits and claims will have a material adverse effect on the Company's financial position or results of operations.