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JUN 30 2005
PUBLIC SERVICE COMMISSION

June 30, 2005

Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40601

RE: AN ADJUSTMENT OF THE GAS AND ELECTRIC RATES, TERMS AND CONDITIONS OF LOUISVILLE GAS AND ELECTRIC COMPANY
CASE NO. 2003-00433

AN ADJUSTMENT OF THE ELECTRIC RATES, TERMS AND CONDITIONS OF KENTUCKY UTILITIES COMPANY
CASE NO. 2003-00434

Dear Ms. O'Donnell:

Pursuant to Ordering Paragraph No. 6 of the Commission's Orders dated June 30, 2004, in the aforementioned proceedings, Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU"), collectively ("the Companies"), hereby submit an original and ten (10) copies of its plan to address the Commission's request regarding the underfunding of pension and post-retirement plans. The report provides information regarding the funding strategy and status of the plans.

As mentioned in the aforementioned proceedings, the Companies will subsequently file progress reports beginning March 31, 2007 in conjunction with the filing of the Companies annual financial reports.

Should you have any questions about this report, please contact me at 502-627-4110 or Don Harris at 502-627-2021.

Very truly yours,

John Wolfram
Manager, Regulatory Affairs

Response of Louisville Gas and Electric Company and Kentucky Utilities Company to the Commission's Inquiry Concerning the Status of the Companies' Pension and Post-Retirement Plans June 30, 2005

In its Final Orders dated June 30, 2004 in Case Nos. 2003-00433 and 2003-00434, the Kentucky Public Service Commission ("the Commission") expressed some concern over the underfunded status of pension and post-retirement plans of the Louisville Gas and Electric Company ("LG&E) and Kentucky Utilities Company ("KU"). Specifically, the Commission stated in the LG&E Order:

The Commission does have some concerns about the underfunded status of LG&E's pension and post-retirement plans. LG&E should develop and implement a plan that eliminates the underfunding within a reasonable period of time. This plan should be filed with the Commission within one year from the date of this Order. In addition, LG&E should file progress reports describing the progress made in eliminating the underfunding of its pension and post-retirement plans. The progress reports should be filed every two years, and will be due with the filing of LG&E's annual financial report. The first progress report should be filed by March 31, 2007. The Commission ordered the same requirement for KU in Case No. 2003-00434.

LG&E and KU provide this response pursuant to the aforementioned requirements. The report provides information regarding the funding strategy and status with respect to their pension and post-retirement plans.

TABLE OF CONTENTS

	PAGE
I. LG&E Energy LLC Pension Plan	
A. Funding Strategy	3
B. ERISA Methodologies and FASB Standards	4
C. Additional Actions Taken by Company	5
D. Conclusion	6
II. LG&E Energy LLC Post-Retirement Plan	
A. OPEB versus Pension	7
B. Funding Strategy	7
C. Funding Vehicles	7
D. Actions Taken by Company	8
E. Conclusion	8

PENSION PLAN

The LG&E Energy LLC Retirement Plan (the "Non-Union Plan") is a non-contributory defined benefit plan that covers regular part-time and full-time employees of LG&E Energy LLC and certain subsidiaries ("LEL" or the "Company"), who have completed one year of credited service. The Plan covers employees of LG&E Energy Services, Inc., non-union employees of LG&E and employees of KU in accordance with specified plan provisions. Full-time Bargaining Unit employees of LG&E that have completed one year of service are covered by the LG&E Union Retirement Plan (the "Union Plan", and collectively with the Non-Union Plan, the "Plans"). The Plans are subject to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended. The Pension Benefit Guaranty Corporation ("PBGC") is a wholly owned government corporation established by ERISA charged with overseeing and insuring certain benefits accrued under qualified plans in the U.S. As such LG&E Energy's qualified defined benefit plans and all other qualified defined benefit plans subject to ERISA pay insurance premiums to the PBGC and are subject to its regulatory oversight. Prudent plan sponsors generally attempt to fund plans to minimize insurance premiums paid to the PBGC.

Pension issues are very complex, and the Company has utilized the independent expertise of Mercer Human Resources Consulting ("Mercer") to assist in designing and administering the pension plans for over 20 years. The Company's long-standing funding strategy for the pension plans is to fund up to certain limits described in more detail below based on guidelines established by Congress under ERISA and further defined through regulations from the IRS. This funding strategy was established several years ago with input from Mercer, and the paper will display that the Company has consistently followed this strategy. The Final Orders reference the underfunded status of the pensions based on the Financial Accounting Standards Board ("FASB") methodologies. However, the Company believes that the ERISA guidelines are more appropriate for determining funding strategies than FASB accounting methodology for the following reasons:

- The range of allowable annual funding amounts for a defined benefit pension plan is by law determined under ERISA and related IRS regulations. The FASB methodology defines generally accepted accounting requirements but was never intended to define an appropriate funding policy for a pension plan; and

- The ERISA methodology takes a long-term investment view of the issues. The guidelines are based on assumptions that link the long-term return on asset assumptions to the discount rate used in calculating the liability. This methodology eliminates much of the volatility in the measurement of the liability found in the FASB approaches.

Funding Strategy

The funding strategy for the Plans is to fund at a level actuarially necessary to provide the benefits due under the Plans while also meeting the "full funding limitation" established under ERISA. The "full funding limitation" is the greater of (a) the plan's accrued liability projected to the end of the year minus the lesser of (i) the market value of the assets or (ii) the calculated value of the assets (based on the five-year smoothing method) projected to the end of the year or (b) 90% of the plan's current liability projected to the end of the year minus the calculated value of the assets projected to the end of the year. Companies that meet the ERISA full funding standard are required to pay a PBGC annual premium of $19 per participant. Plans more poorly funded could pay a premium as high as $100 or more per participant depending on the unfunded status. The funding strategy being used thus minimizes company costs by avoiding more costly PBGC variable rate premiums while adequately funding plan liabilities consistent with the ERISA methodology.

The following table, based on information provided by LEL's actuary, Mercer, indicates the application of this strategy over the past five years, concluding with the Company's most recent 2004 year-end funding status of approximately 109%.

Non-Union Retirement Plan [Covers employees of LG&E Energy Services, Inc., non-union employees of LG&E and employees of KU in accordance with specified plan provisions]	Plan Year {In Millions}				
	2004	2003	2002	2001	2000
1. Expected liability at end of plan year	$ 415.2	$ 401.9	$ 400.2	$ 373.4	$ 343.7
2. Expected assets at end of plan year	$ 455.4	$ 346.3	$ 334.2	$ 371.8	$ 424.0
3. Full Funding Limit (1) - (2), not less than zero	$ -	$ 55.6	$ 66.0	$ 1.6	$ -
4. Funded Percentage Prior to Contribution	109.7%	86.2%	83.5%	99.6%	123.4%
5. Contribution Made	$ -	$ 55.6	$ 81.1	$ 20.0	$ -
6. Funded Percentage After Contribution	109.7%	100.0%	103.8%	104.9%	123.4%

Union Retirement Plan [Covers full-time employees of the LG&E who are members of Local 2100 of IBEW]	Plan Year {In Millions}				
1. Expected liability at end of plan year	$ 178.6	$ 180.2	$ 184.2	$ 180.4	$ 168.9
2. Expected assets at end of plan year	$ 194.0	$ 147.8	$ 150.3	$ 230.7	$ 225.6
3. Full Funding Limit (1) - (2), not less than zero	$ -	$ 32.4	$ 33.9	$ -	$ -
4. Funded Percentage Prior to Contribution	108.6%	82.0%	81.6%	127.9%	133.6%
5. Contribution Made	$ -	$ 32.4	$ 33.9	$ -	$ -
6. Funded Percentage After Contribution	108.6%	100.0%	100.0%	127.9%	133.6%

The balance of this report to the Commission will discuss in greater detail the pension related calculations and disclosures required by FASB and compare FASB and ERISA standards.

ERISA Methodologies and FASB Standards

The ERISA calculations that form the basis for the Company's funding decisions are based on established ERISA and IRS standards. They promote a long-term view of the pension liabilities. This is exhibited by the discount rate used to value the present worth of the plans' long term obligations. Specifically, the ERISA calculations require discounting of the projected obligation at the actuarial assumed long-term rate of return on plan assets (8.50% as of 12/31/04). This assumed rate of return is based on the actual asset allocation of the plans.

Alternatively, there are other methods for determining the funded status based on FASB accounting requirements as outlined in Statement of Financial Accounting Standards No. 87 (FAS 87). (Note that the Companies' financial statements and related footnote disclosures are based on FASB standards not ERISA standards. Thus the funded status reflected in the Companies' footnote disclosures will likely indicate a different level of funding than the ERISA standard at any point in time.)

The alternative calculations under FAS 87 include the comparison of Asset Value to the Accumulated Benefit Obligation ("ABO") and the Projected Benefit Obligation ("PBO"). The ABO calculates the pension liability at any point in time based upon employees' earnings up to the date of the calculation. It does not project any future employee service or any increase in employee compensation. The PBO contemplates salary increases throughout the projected future service lives of the employees. Thus the PBO results in a greater obligation than the ABO. Similar to the ERISA method, the calculations are impacted by a series of actuarial assumptions (i.e., expected rate of return on plan assets, discount rate, mortality tables, retirement assumptions and salary escalation rates, in some cases). The following chart illustrates the factors included in the various funding methods:

Factors	Funding/Financial Measures ERISA Full Funding Limit	FAS 87 ABO	FAS 87 PBO
Liabilities			
A. Discount Rate	Long-term Rate of Return on Plan Assets (8.50% as of 12/31/04)	Long-term Corporate Bond Rate (5.75% as of 12/31/04)	Long-term Corporate Bond Rate (5.75% as of 12/31/04)
B. Future Wage Escalation	Yes	No	Yes
C. Mortality Table	Yes	Yes	Yes
D. Retirement Rates	Yes	Yes	Yes
E. Turnover Rates	Yes	Yes	Yes
F. Disability Rates	Yes	Yes	Yes
Assets			
A. Actual Year-End Market Value	No	Yes	Yes
B. Expected Year-End Market Value	Yes	No	No

As shown above, the primary differences in the ERISA methodology and the FASB PBO method are the discount rate used to value the present value of the pension liabilities and the market valuation for pension assets. The ERISA method takes a long-term view of funding (using the Rate of Return on Plan Assets actuarial assumption) while the FASB calculation uses the more volatile current Moody's Bond Index Corporate Aa rating. Regarding asset valuation, the ERISA method estimates the year-end market value using the expected rate of return, the market value at the beginning of the year and estimated benefits and disbursements projected to the end of the year, while the FASB PBO uses the actual year-end market value. In addition to the differences noted above between PBO and ERISA, ABO excludes projected salary increases.

The funded status will be different in each calculation based on the input assumptions inherent in the respective calculations. The table below compares the funded status as of 12/31/2004 based on the three methodologies:

	Plan Assets	Discount Rate for Liabilities	Future Wage Escalation	PV of Liabilities	Assets in Excess of (less than) Liabilities
ERISA	$ 649.4	8.50%	5.00%	$ 593.8	$ 55.6
ABO	$ 669.0	5.75%	N/A	$ 748.0	$ (79.0)
PBO	$ 669.0	5.75%	4.50%	$ 827.3	$ (158.3)

In summary, the Company's funding status under the ERISA standards is approximately 9% overfunded, while under the FASB ABO standard it is approximately 10% underfunded.

Additional Actions Taken by Company

In addition to maintaining "full funding" under the ERISA standard, the Company monitors its funded status versus ABO and PBO. The Company's pension investment advisor, LCG Associates ("LCG") performed an Asset/Liability Study ("ALS") to determine the likelihood of meeting the ABO. The process in connection with the ALS was as follows:

- LCG used actuarial projections provided by Mercer to estimate ABO liability using a variety of discount rate assumptions;
- LCG modeled asset growth using various return assumptions; and
- LCG compared the liability estimates to estimated assets.

The ALS concluded the following:

- With a stable discount rate and modest contributions for the next ten years, projections indicate the Company has more than a 50% probability of achieving a fully funded status of ABO within five years and approximately an 80% probability of achieving a fully funded status of ABO within ten years. Given the average remaining service life of participants in the Plans of approximately 14 years, the results give comfort that the funding methodology currently adopted is sufficient to meet the liabilities under the Plans.

<u>Conclusion</u>

The primary objectives of the funding strategy for LEL and its subsidiaries are to avoid higher cost variable rate PBGC premiums by funding at the full funding limitation and to achieve a fully funded status of ABO within a reasonable period of time. As shown in the aforementioned table, for the past five years, the non-union and union plans, which include LG&E and KU, have achieved the fully funded requirement from an ERISA perspective. The Company continues to monitor the components that impact pension cost and funded status and respond accordingly, as evidenced by the Company's funding in the amount of $115 million and $88 million in 2003 and 2004, respectively and the asset/liability study.

POST-RETIREMENT PLANS

LEL offers a Retiree Medical Continuation Plan (the "Plan") to eligible employees. The Plan allows retirees to continue medical coverage for themselves and their families under company-sponsored group medical plan options. The options are available to retirees of Louisville Gas and Electric Company and Kentucky Utilities Company. The Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended. The Company also uses Mercer to provide plan design and actuarial assistance with respect to the Plan.

OPEB versus Pension

The method used to estimate the Other Post-Employment Benefit ("OPEB") liability is similar to the one used for pensions. A company and its actuaries make assumptions regarding discount rate, employee turnover, retirement age and mortality. Unlike pensions, however, assumptions about per capita claims cost by age, health care cost trend rates, and participation rates, also significantly impact OPEB liability computations. Differences between pension and OPEB plans are:

Issue	Defined Benefit Pension Plans	LG&E OPEB Plans
Statutory funding requirement	Yes	No
Pre-Funding is deductible for tax purposes	Yes	Limited
Linked to employee's salary at retirement	Yes	No
Ability to make modifications to or cancel plans to control costs	Very Limited	Allowed
Insured by the PBGC	Yes	No

Employers are required by law to prefund their defined benefit pension plans and are given substantial tax incentives to do so. However, most employers have funded their OPEB liability on a pay-as-you-go basis due to the lack of a statutory funding requirement, the limitations on tax-deductible funding and the fact that employers generally reserve the right to modify or terminate retiree medical benefits.[1]

Funding Strategy

The funding strategy for the LEL Plan is to fund post-retirement benefits for current active and retired participants to the extent allowable under the 401(h) account in the LG&E Energy LLC Retirement Plan with the remainder funded on a pay-as-you-go basis through the following VEBA trusts:

- The LG&E Energy LLC Voluntary Employees Beneficiary Association (Union VEBA), a VEBA under Section 501(c)(9) of the IRC;
- The LG&E Energy LLC Voluntary Employees Beneficiary Association (Non-Union VEBA), a VEBA under Section 501(c)(9) of the IRC;

Contributions are made to the VEBA trusts which in turn pay claims and fees by active employees and retirees for medical and dental benefits. The employee and retiree contributions are immediately directed to the VEBA trusts, with employer contributions occurring as needed.

[1] Source: Mercer Human Resource Consulting

Funding Vehicles

VEBA trusts are separate trusts established to pay for life, sickness, accident and similar benefits for both active and retired participants. Contributions are generally tax-deductible when made, subject to certain limits. Benefits are not taxable when received by participants. Investment earnings within the VEBA for the union plan accrue tax-free; however, investment earnings within the VEBA for the non-union plans are subject to the tax on unrelated business income. Consequently, non-union VEBA accounts are not efficient tax vehicles for prefunding OPEB liability and are not frequently utilized. According to the 2004 Mercer National Survey of Employer-Sponsored Health Plans, 92% of all large employers (defined as employers with 500 or more employees) and 85% of employers in the transportation/communication/utilities industry do not utilize VEBA trusts to prefund retiree medical benefits.

The 401(h) accounts are the medical-benefit components in the defined benefit pension plan used to pay retiree medical benefits for retirement plan participants. Contributions are tax-deductible when made, subject to certain limits. Benefits are not taxable when received by participants. Unlike contributions to VEBAs, investments accumulate tax-free within 401(h) accounts. Thus 401(h) accounts are more tax-efficient than non-union VEBA accounts. Assets must be used to pay retiree medical benefits, otherwise a 50% excise tax applies if assets revert to the employer.

Actions Taken by the Company

LEL funded the 401(h) account in the amount of $7.4 million in June 2005, which represents the maximum employer contribution under IRC Section 401(h) requirements for all plan years through 2004. Subsequent 401(h) contributions will be made in accordance with the maximum funding limitation governed by tax laws, currently $1.5 – $2.0 million per year. The Company continues to monitor the components that impact post-retirement cost, market trends and funded status.

Conclusion

Generally, OPEB's are largely unfunded and pay-as-you-go funding is still the norm for most companies. The vehicles for funding OPEB obligations have significant limitations on the company's ability to prefund the OPEB on a tax efficient basis. Similar to market trends, LG&E and KU are currently funding post-retirement obligations through such funding vehicles as the 401(h) account under the Retirement Plan, VEBA trusts and the pay-as-you-go method. LEL will continue to monitor the components that impact post-retirement cost, market trends and funded status with the assistance of Mercer and execute its funding strategy as described in the report.