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April 21, 2005

RECEIVED
APR 21 2005
PUBLIC SERVICE COMMISSION

Ms. Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602-0615

RE: ***The Application of Kentucky Utilities Company for a Certificate of Public Convenience and Necessity to Construct Flue Gas Desulfurization Systems and Approval of its 2004 Compliance Plan for Recovery by Environmental Surcharge***
Case No. 2004-00426

Dear Ms. O'Donnell:

Enclosed please find an original and eight (8) copies of Kentucky Utilities Company's ("KU") supplemental response to Question No. 1 Request for Information Posed by the Attorney General ("AG") dated January 26, 2005 and revised response to Question No. 1 Second Data Request of the KIUC dated February 22, 2005, in the above-referenced docket. The FERC Form 1 for KU in response to the AG request is available and is attached. KU's response to the KIUC incorrectly stated the target debt ratio of 48.5% in the first paragraph. The correct target is 46% based on the range of 42-50% assigned by S&P.

Should you have any questions concerning the enclosed, please do not hesitate to contact me at (502) 627-3324.

Sincerely,

Robert M. Conroy
Manager, Rates

cc: Hon. Elizabeth E. Blackford
Hon. Michael L. Kurtz

KENTUCKY UTILITIES COMPANY

CASE NO. 2004-00426

April 21, 2005 Supplemental Response to Request for Information Posed by the Attorney General
Dated January 26, 2005

Question No. 1

Responding Witness: Valerie L. Scott

Q-1. Provide a copy of the 2004 FERC Form 1 for KU as soon as it becomes available.

A-1. The FERC Form 1 is attached.

KENTUCKY UTILITIES COMPANY

CASE NO. 2004-00426

April 21, 2005 Revised Response to Second Data Requests of the KIUC Dated February 22, 2005

Question No. 1

Responding Witnesses: Daniel K. Arbough / Kent W. Blake

Q-1. Please provide the projected financing mix (dollars and percentages) during the period from June 2005 through the in-service date of the last project. Such projected financing should be consistent with the growth in the investment in CWIP/Plant-In Service reflected in the Company's projection of the annual revenue requirements provided in response to Staff 1-3 and KIUC 1-3.

A-1. KU does not assign a specific financing mix to any of its construction projects, including projects for which ECR treatment is requested. KU funds its capital projects through a mix of funds consistent with the Company's current capital structure and consistent with a capital structure needed to maintain its strong investment-grade credit rating. As cited in past proceedings, the Company is targeting its debt ratios at the mid-point of the ranges published by Standard and Poor's for a utility with an "A" rating. This target (based on the range of 42-50% assigned by S&P as shown in Table 5 of the attached document) is 46% including imputed debt associated with purchased power agreements.

The information requested in the question does not exist.

Additionally, the Commission has repeatedly stated its position on this issue. In its December 21, 1990 Order in Case No. 90-158, In the Matter of: *Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company,* the Commission states: "...the Commission has ruled in prior cases that the investment in utility plant cannot be traced to specific capital sources. [....] Trimble County's construction has been financed by all components of capital, not solely by common equity. It is reasonable to allocate the [25%] disallowance on a pro rata basis, in order to reflect this fact." Order at 14.

Further, as cited in response to the 1st Set of Data Requests from the KIUC dated January 26, 2005, Question No. 9, the Commission has previously determined that a "reasonable return on capital expenditures included in the surcharge constitutes part of the total actual costs incurred by the utility." The Commission further states that "[c]oncerning the financing of utility plant, it has long been recognized in the utility industry that capital expenditures are financed by numerous sources of capital, and that it is generally not possible to match a capital expenditure with a specific source of capital." Source: Order of the Commission, Case No. 2000-439, page 22, April 18, 2001.

Return to Regular Format

Research:

Corporate Ratings Criteria--Ratings and Ratios: Ratio Medians; Ratio Guidelines

Publication date: 28-Oct-2004

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Ratings and Ratios: Ratio Medians

The key ratio medians for U.S. corporates by rating category and their definitions are displayed below. The ratio medians are purely statistical, and are not intended as a guide to achieving a given rating level. The ratio guidelines that follow more faithfully represent the role of ratios in the ratings process.

In any event, ratios are helpful in broadly defining a company's position relative to rating categories. They are not intended to be hurdles or prerequisites that should be achieved to attain a specific debt rating.

Caution should be exercised when using the ratio medians for comparisons with specific company or industry data because of differences in method of ratio computation, importance of industry or business risk, and the impact of mergers and acquisitions. Because ratings are designed to be valid over the entire business cycle, ratios of a particular company at any point in the cycle may not appear to be in line with its assigned debt ratings. Particular caution should be used when making cross-border comparisons, because of differences in accounting principles, financial practices, and business environments.

Company data are adjusted for the following:

- Nonrecurring gains or losses are eliminated from earnings. This includes gains on asset sales, significant transitory income items, unusual losses, losses on asset sales, and charges because of asset writedowns, plant shutdowns, and retirement programs. These adjustments chiefly affect interest coverage, return, and operating margin ratios.
- Unusual cash-flow items similar in origin to the nonrecurring gains or losses also are reversed.
- The operating lease adjustment is performed for all companies. Companies that buy all plant and equipment are put on a more comparable basis with those that lease part or all of their operating assets. The lease adjustment affects all ratios.
- The net debt adjustment affects median ratios largely for the 'AAA' rating category, composed almost entirely of cash-rich pharmaceutical companies.
- The captive-finance adjustment has a great effect, mainly on automobile, department store, and some capital goods companies.

The adjusted ratio median universe for industrials includes about 1,000 companies. The data exclude transportation companies that exhibit different financial-ratio profiles.

The medians themselves are affected by economic and environmental factors, as well as mergers and acquisitions. The universe of rated companies constantly is changing, and in certain rating categories, adding or deleting a few companies also can affect the financial-ratio medians.

Strengths and weaknesses in different areas have to be balanced and qualitative factors evaluated. There are many nonnumeric distinguishing characteristics that determine a company's creditworthiness (see Tables 1, 2, and 3).

Table 1 Key Industrial Financial Ratios, Long-Term Debt

Three-Year (2001 to 2003) Medians

	AAA	AA	A	BBB	BB	B	CCC
EBIT interest coverage (x)	23.8	13.6	6.9	4.2	2.3	0.9	0.4
EBITDA interest coverage (x)	25.3	17.1	9.4	5.9	3.1	1.6	0.9
FFO/total debt (%)	167.8	77.5	43.2	34.6	20.0	10.1	2.9
Free operating cash flow/total debt (%)	104.1	41.1	25.4	16.9	7.9	2.6	(0.9)
Total debt/EBITDA (x)	0.2	1.1	1.7	2.4	3.8	5.6	7.4
Return on capital (%)	35.1	26.9	16.8	13.4	10.3	6.7	2.3
Total debt/capital (x)	6.2	34.8	39.8	45.6	57.2	74.2	101.2

Table 2 Key Utility Financial Rates, Long-Term Debt

2003 Medians

	AA	A	BBB	BB	B
EBIT interest coverage (x)	5.0	3.2	2.3	1.9	0.8
FFO interest coverage (x)	8.8	4.7	3.9	2.7	1.4
FFO/Average total debt (%)	35.7	21.5	17.0	13.5	5.0
Net cash flow/Capital expenditures (%)	137.9	101.2	119.9	105.5	92.4
Total debt/Capital (%)	55.7	54.9	59.1	75.2	74.6
Return on common equity (%)	12.0	9.5	7.3	6.1	(26.1)

Table 3 Key Ratios

Formulas

Ratio	Formula
1. EBIT interest coverage	Earnings from continuing operations* before interest and taxes/Gross interest incurred before subtracting capitalized interest and interest income
2. EBITDA interest coverage	Adjusted earnings from continuing operations** before interest, taxes, depreciation, and amortization/Gross interest incurred before subtracting capitalized interest and interest income
3. Funds from operations (FFO)/total debt	Net income from continuing operations, depreciation and amortization, deferred income taxes, and other non-cash items/Long-term debt§ + current maturities + commercial paper, and other short-term borrowings
4. Free operating cash flow/total debt	FFO - capital expenditures - (+) increase (decrease) in working capital (excluding changes in cash, marketable securities, and short-term debt)/Long-term debt§ + current maturities, commercial paper, and other short-term borrowings
5. Return on capital	EBIT/Average of beginning of year and end of year capital, including short-term debt, current maturities, long-term debt§, non-current deferred taxes, minority interest, and equity (common and preferred stock)
6. Operating income/sales	Sales - cost of goods manufactured (before D&A), SG&A costs, and R&D costs/Sales
7. Long-term debt/capital	Long-term debt§/Long-term debt§ + shareholders' equity (including preferred stock) + minority interest
8. Total debt/capital	Long-term debt§ + current maturities, commercial paper, and other short-term borrowings/Long-term debt§ + current maturities, commercial paper, and other short-term borrowings + shareholders' equity (including preferred stock) + minority interest
9. Total debt/EBITDA	Long-term debt§ + current maturities, commercial paper, and other short-term borrowings/Adjusted earnings from continuing operations before interest, taxes, and D&A
10. Discretionary cash flow/total debt	FFO - capital expenditures - (+) increase (decrease) in working capital (excluding changes in cash, marketable securities, and short-term debt) - common and preferred dividends/Long-term debt§ + current maturities, commercial paper, and other short-term borrowings

*Including interest income and equity earnings; excluding nonrecurring items. **Excludes interest income, equity earnings, and nonrecurring items; also excludes rental expense that exceeds the interest component of capitalized operating leases. §Including amounts for operating lease debt equivalent, and debt associated with accounts receivable sales/securitization programs.

Ratio Guidelines

Risk-adjusted ratio guidelines depict the role financial ratios play in Standard & Poor's rating process, because financial ratios are viewed in the context of a company's business risk. A company with a stronger competitive position, more favorable business prospects, and more predictable cash flows can afford to undertake added financial risk while maintaining the same credit rating.

The guidelines displayed in the matrices make explicit the linkage between financial ratios and levels of business risk. For example, consider a U.S. industrial--which includes manufacturing, service, and transportation sectors--with an average business-risk profile. Cash-flow coverage of 60% would indicate an 'A' rating. If a company were below average, it would need about 85% cash flow coverage (which could be achieved through extremely conservative financial policies) to qualify for the same rating.

Similarly, for the 'A' category, a company with an above-average business risk profile could tolerate about 40% leverage, and an average company, only 30%. The matrices also show that a company with only an average business position could not aspire to an 'AAA' rating, even if its financial ratios were extremely conservative.

The ratio medians Standard & Poor's has been publishing for more than two decades are merely statistical composites. They are not rating benchmarks, precisely because they gloss over the critical link between a company's financial risk and its business risk. Medians are based on historical performance, while Standard & Poor's risk-adjusted guidelines refer to expected future performance.

Guidelines are not meant to be precise. Rather, they are intended to convey ranges that characterize levels of credit quality as represented by the rating categories. Obviously, strengths evidenced in one financial measure can offset, or balance, relative weakness in another (see Tables 4 and 5).

Table 4 U.S. Industrials--Manufacturing, Service and Transportation Companies

Funds from Operations/Total Debt Guidelines (%)

	—Rating category—				
Company business risk profile	**AAA**	**AA**	**A**	**BBB**	**BB**
Well above average business position	80	60	40	25	10
Above average	150	80	50	30	15
Average	—	105	60	35	20
Below average	—	—	85	40	25
Well below average	—	—	—	65	45

Total Debt/Capitalization Guidelines (%)

	—Rating category—				
Company business risk profile	**AAA**	**AA**	**A**	**BBB**	**BB**
Well above average business position	30	40	50	60	70
Above average	20	25	40	50	60
Average	—	15	30	40	55
Below average	—	—	25	35	45
Well below average	—	—	—	25	35

Table 5 U.S. Utilities

Funds From Operations/Interest (x)

	—Rating Category—			
Company business profile	**AA**	**A**	**BBB**	**BB**
1	2.5-3	1.5-2.5	1-1.5	—
2	3-4	2-3	1-2	—
3	3.5-4.5	2.5-3.5	1.5-2.5	1-1.5

4	4.2-5	3.5-4.2	2.5-3.5	1.5-2.5
5	4.5-5.5	3.8-4.5	2.8-3.8	1.8-2.8
6	5.2-6	4.2-5.2	3-4.2	2-3
7	6.5-8	4.5-6.5	3.2-4.5	2.2-3.2
8	7.5-10	5.5-7.5	3.5-5.5	2.5-3.5
9	—	7-10	4-7	2.8-4
10	—	8-11	5-8	3-5
Funds From Operations/Total Debt (%)				
1	15-20	10-15	5-10	—
2	20-25	12-20	8-12	—
3	25-30	15-25	10-15	5-10
4	28-35	20-28	12-20	8-12
5	30-40	22-30	15-22	10-15
6	35-45	28-35	18-28	12-18
7	45-55	30-45	20-30	15-20
8	55-70	40-55	25-40	15-25
9	—	45-65	30-45	20-30
10	—	55-70	40-55	25-40
Total Debt/Total Capital (%)				
1	48-55	55-60	60-70	—
2	45-52	52-58	58-68	—
3	42-50	50-55	55-65	65-70
4	38-45	45-52	52-62	62-68
5	35-42	42-50	50-60	60-65
6	32-40	40-48	48-58	58-62
7	30-38	38-45	45-55	55-60
8	25-35	35-42	42-52	52-58
9	—	32-40	40-50	50-55
10	—	25-35	35-48	48-52

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