



RECEIVED
APR 03 2007
PUBLIC SERVICE
COMMISSION

139 East Fourth Street, R. 25 At II
P.O. Box 960
Cincinnati, Ohio 45201-0960
Tel. 513-287-3601
Fax. 513-287-3810
John.Finnigan@duke-energy.com

John J. Finnigan, Jr.
Associate General Counsel

VIA OVERNIGHT MAIL

April 2, 2007

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

Re: Application of Duke Energy Kentucky, Inc. for an Order Authorizing the Issuance of Unsecured Dept and Long-Term Notes, Execution and Delivery of Long-Term Loan Agreement, and Use of Interest Rate Management Instruments
Case No. 2006-00563

Dear Ms. O'Donnell:

Enclosed are an original and eight copies of Duke Energy Kentucky, Inc.'s amended response to the Staff's second data request (KyPSC-DR-02-001-Amended) in the above-referenced case.

Please date-stamp and return the two extra copies of the filing in the enclosed envelope.

Thank you.

Sincerely,

John J. Finnigan, Jr.
Associate General Counsel

**KyPSC Staff First Set Data Requests
Duke Energy Kentucky Case No. 2006-00563
Date Received: March 19, 2007
Response Due Date: March 29, 2007**

KyPSC-DR-02-001-AMENDED

REQUEST:

1. Refer to Item 1(a) of Duke Kentucky's response to the Commission Staff's first data request. Duke Kentucky has explained that it is unlikely that it will issue secured debt in the near term due to the restrictions that would be placed on its assets if it uses secured debt.
 - a. Identify the type of restrictions that issuing secured debt would place on Duke Kentucky's assets.
 - b. Does issuing unsecured debt rather than secured debt provide any cost savings for Duke Kentucky?
 - c. If the answer to (b) is yes, provide an estimate of the amount of savings Duke Kentucky could experience.

RESPONSE:

- a. Secured debt is marginally more restrictive than unsecured debt because of the lien that such debt imposes on the Company's assets. The effect is a limitation on the Company's ability to sell or otherwise transfer assets, as well as a higher on-going compliance obligation to demonstrate that the secured debt is adequately collateralized at all times.
- b. Yes. Refer to item 1(b) of Duke Kentucky's response to the Commission Staff's first data request. The interest rate coupon on secured debt is approximately five to ten basis points lower than that of secured debt. However, the Company does not believe that the current margin (margins can vary over time) justifies the higher level of restrictions and compliance obligations that secured debt requires.

The increased compliance obligations would include an obligation to prepare audited financial statements and to file periodic reports with the U.S. Securities and Exchange Commission. Due to the Sarbanes-Oxley Act's low threshold of "materiality" for purposes of preparing audited financial statements, the Company estimates that its compliance costs would exceed \$100,000 annually if it issued secured debt. Additionally, this could trigger a requirement to implement push-down accounting

arising from the merger between Duke Energy Corporation and Cinergy Corp. Attachment KyPSC-DR-02-001(b)-Amended is a letter dated March 8, 2006 filed in Case No. 2005-00228 that discusses the impacts of push-down accounting.

- c. See response to KyPSC-DR-02-001(b)-Amended.

WITNESS RESPONSIBLE: Stephen G. De May

VIA OVERNIGHT MAIL

March 8, 2006

Ms. Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, Kentucky 40602-0615

Re: Joint Application of Duke Energy Corporation, Duke Energy Holding Corp.,
Deer Acquisition Corp., Cougar Acquisition Corp., Cinergy Corp., The
Cincinnati Gas & Electric Company and The Union Light, Heat and Power
Company for Approval of a Transfer and Acquisition of Control,
Case No. 2005-00228

Dear Ms. O'Donnell:

We write this letter to update the Commission and the parties on the applicability of push-down accounting to ULH&P; to discuss the impacts of push-down accounting; and to seek the Commission's further input. Push-down accounting would impact ULH&P's merger commitments, as explained more fully below. Our analysis has indicated that push-down accounting will be required for ULH&P unless we take certain actions. Specifically, push-down accounting can be avoided so long as ULH&P ceases to file periodic reports with the Securities and Exchange Commission ("SEC"). ULH&P would be filing such reports voluntarily and is currently permitted, under SEC rules and regulations, to stop filing at any time. ULH&P is inclined to stop filing such reports for the reasons stated below, but seeks Commission input with respect to this matter. ULH&P requests that the Commission schedule an informal conference to discuss these issues.

The remainder of this letter will discuss the process that ULH&P went through to determine the appropriate accounting, the ramifications of that accounting, and our recommended course of action.

1. Background of Push-Down Accounting Issue

Under generally accepted accounting principles ("GAAP"), business combinations must be accounted for by using purchase accounting. Purchase accounting treats a business combination, such as the Duke/Cinergy merger, as an acquisition of one

company by another. Consequently, the purchase price paid for the acquired company is allocated to the acquired assets and liabilities based on their fair values.¹

If the acquiring company's purchase price exceeds the fair value of the acquired company's net assets, then this excess is recorded as goodwill on the acquiring company's balance sheet. The goodwill, and any other corresponding adjustments to the values of assets or liabilities of the acquired entity (as discussed further below), on the acquiring company's balance sheet must be reviewed to determine whether it must then be assigned or "pushed-down" to the balance sheets of any acquired subsidiaries to the extent those subsidiaries file periodic reports with the SEC.

If applied to ULH&P, push-down accounting would result in a one-time adjustment to certain of ULH&P's assets and liabilities as of the merger closing. This is expected to have the following impacts:

(a.) Pension and Other Post-Retirement Benefits ("OPEB")

GAAP accounting for pension and OPEB expenses requires ULH&P to estimate the cost of providing those benefits and accrue that cost over time, which requires estimating various items including discount rates, health care cost trend rates, and future returns on investments. GAAP allows revisions to those estimates, along with credit granted for prior service, to be expensed over an extended period rather than immediately. These differences are in effect deferred, and the deferrals are amortized over time, which smooths pension and OPEB expenses over time. The amortization of these amounts has historically been recognized in customer rates.

When purchase accounting is applied to the pension and OPEB plans, the unrecognized costs and deferrals are eliminated and the amounts for pension and OPEB obligations reflected on ULH&P's books will be increased to current fair value without a corresponding adjustment to pension expense. ULH&P's current rates are based on ULH&P's historical cost for these expenses. The one-time increase in the pension and OPEB liability will cause an anomalous accounting adjustment that will not be reflective of the historical costs of the pension and OPEB plans consistent with established ratemaking concepts. If push down accounting is required, ULH&P requests that the Commission allow ULH&P to establish a regulatory asset equal to the increase in the pension and OPEB obligations resulting from purchase accounting. This regulatory asset would be amortized in a manner consistent with how the previously unrecognized costs would have been amortized resulting in consistent expense recognition had push-down accounting not been applied.

It would be fair and reasonable for the Commission to allow ULH&P to create this regulatory asset if push-down accounting is required. This would be consistent with ULH&P's merger commitment that the impacts of push-down accounting should not be

¹ The accounting treatment for the Duke/Cinergy merger is primarily governed by FASB Statement No. 141 – Business Combinations; SEC Staff Accounting Bulletin (SAB) No. 54 – Push-Down Basis of Accounting in Financial Statements of Subsidiaries; and SAB No. 73 – Push-Down Basis of Accounting Required in Certain Limited Circumstances.

reflected in ULH&P's retail rates. If a regulatory asset is not created, this would result in unfair, asymmetrical treatment of the push-down accounting adjustments.

(b.) Retained Earnings and Future Dividend Payments

Under push-down accounting, ULH&P's retained earnings would be re-set to zero as of the merger closing. In Merger Commitment #22, ULH&P committed that it would only pay dividends out of retained earnings. The intent of this merger commitment was to tie ULH&P's ability to pay dividends to its historical retained earnings existing prior to the merger, not to retained earnings of zero, which would result from a push-down accounting adjustment. ULH&P therefore will interpret this merger commitment to tie its ability to pay dividends to the level of historical retained earnings existing prior to the merger if push-down accounting is required, as well as additional future retained earnings. If the Commission or the parties have any concerns, this topic can be discussed at the informal conference.

(c.) Other Potential Impacts

Fully regulated utilities have historically applied push-down accounting in a manner whereby only adjustments to paid-in capital, retained earnings, pension and OPEB, and goodwill resulted from purchase accounting. ULH&P is aware of a discussion occurring within the SEC and certain public accounting firms that could challenge this historical practice. The alternate view is that all assets and liabilities should be adjusted to fair values, as judged from a competitive market perspective. For example, a generating plant owned by a utility might be worth \$100 if sold to an independent power producer. Further, assume the utility shows a net book value of \$60. Following this alternate view, purchase accounting would result in the plant being adjusted up in value to \$100 notwithstanding the fact that the utility can only recover historical cost. An offsetting regulatory liability would be established for the differential of \$40 to reflect the fact that the increased value is effectively being conveyed back to the ratepayer through rates. These adjustments would largely result in balance sheet gross-ups but could occur for each asset and liability on ULH&P's balance sheet and for certain intangible assets or liabilities that may only arise due to the application of purchase accounting. ULH&P does not support this point of view and is concerned that if this view were to be required that our financial statements would be significantly less meaningful to certain stakeholders, including the Kentucky Public Service Commission. This view, if required, would only be applicable to ULH&P's financial statements if push-down accounting is required.

2. Commission Order on Push-Down Accounting

When the Joint Applicants filed this case, the Joint Applicants notified the Commission that the SEC does not require companies to apply push-down accounting to the acquired company or a subsidiary if the acquired company or subsidiary have significant levels of publicly held debt and preferred stock that can preclude the acquiring company from controlling the form of ownership of the acquired subsidiary. The assessment involves both quantitative as well as qualitative factors. The rationale for not

requiring push-down accounting in these situations is that the public investors could interfere with the acquiring company's ability to control the acquired company or subsidiary.² Joint Applicants explained, however, that ULH&P does not have significant levels of publicly held debt and preferred stock that can provide investors the right to control the form of ownership; therefore, push-down accounting probably would be required.³ Accordingly, the Joint Applicants agreed to the following merger commitments relating to push-down accounting:

3. The payment for Cinergy's stock shall be recorded on New Duke Energy's books, and shall be excluded from the books of ULH&P for retail ratemaking purposes and for accounting purposes, unless inconsistent with Securities and Exchange Commission ("SEC") principles.

4. Any acquisition premium paid by Duke Energy for the Cinergy stock shall not be 'pushed down' to ULH&P for retail ratemaking purposes, and for accounting purposes, unless inconsistent with SEC principles.⁴

The Commission made the following order relating to push-down accounting:

.....[T]he Commission urges ULH&P and the Joint Applicants to seek accounting interpretations that do not require 'push down' accounting. If the conclusion is reached that, in order to be consistent with SEC principles, ULH&P must record these expenses on its books for accounting purposes, ULH&P should notify the Commission in writing within 30 days of reaching that conclusion.⁵

² *In the Matter of Joint Application of Duke Energy Corporation, Duke Energy Holding Corp., Deer Acquisition Corp., Cougar Acquisition Corp., Cinergy Corp., The Cincinnati Gas & Electric Company and the Union Light, Heat and Power Company for Approval of a Transfer and Acquisition of Control*, Case No. 2005-00228 (Direct Testimony of Lynn J. Good on Behalf of Joint Applicants at 8) (August 1, 2005). The rationale for pushing down the acquisition costs to subsidiaries is that, post-merger, the new entity's financial statements should reflect the results of the merger in the same manner, regardless of whether the acquired company is merged into the acquiring company or continues to exist as a separate legal entity. The exception to push-down accounting occurs when the acquired company or subsidiary has significant levels of publicly held debt and preferred stock that preclude the acquiring company from controlling that decision. In such cases, the acquiring company is deemed not to control the form of ownership for the acquired company or subsidiary.

³ *Id.*

⁴ *Id.* (Agreed Stipulation, Attachment 2, at 15) (October 18, 2005).

⁵ *Id.* (Order at 7) (November 29, 2005).

3. Joint Applicants' Preliminary Conclusion on Push-Down Accounting

As of December 31, 2005, ULH&P had the following long-term debt (all publicly held) and total capitalization:

Table 1 – ULH&P's Percentage of Publicly Held Long-Term Debt and Preferred Stock to Total Capitalization as of 12/31/05 (in thousands)

Long-Term Debt	Amount
6.50% Debentures due 4/30/08	\$20,000
7.65% Debentures due 7/15/25	15,000
7.875% Debentures due 9/15/09	20,000
5.00% Debentures due 12/15/14	40,000
Unamortized Discount	(591)
Total Long-Term Debt	94,409
Preferred Stock	0
Equity	196,459
Total Capitalization	\$290,868
% Public Debt to Total Capitalization	32%

ULH&P has a *quantitatively* significant amount of publicly held debt relative to total capitalization. The SEC, however, also requires the company to evaluate the debt *qualitatively* – that is, the extent to which the public investors could actually interfere with the acquiring company's ability to control the form of ownership for the acquired company or subsidiary.

ULH&P's publicly held debt was all issued pursuant to indentures which contained the following covenant (or a close variation):

Nothing contained in this Indenture or in any of the Securities shall prevent any consolidation or merger of the Company with or into any other corporation....


ULH&P discussed this information with its independent auditors, Deloitte & Touche, LLP ("Deloitte"). Based on their recent experience with the SEC on this matter, Deloitte advised ULH&P that the nature of its publicly held debt would not be viewed as qualitatively significant because it does not prevent the public investors from interfering with Duke's form of ownership of ULH&P. ULH&P further discussed with Deloitte that, although the public debt holders may not have the ability to affect Duke's control of ULH&P, the Kentucky Public Service Commission would certainly have qualitatively significant influence over the form of ownership of ULH&P. Deloitte had informal discussions with SEC Staff as to whether regulatory restrictions on the form of ownership could be viewed as analogous to a debt holder's ability to control the form of ownership. The SEC Staff informally indicated that their guidance addresses only the impact of publicly held securities and that other stakeholders that have the ability to impact control should not be considered in evaluating whether push-down accounting is required. Based on the foregoing, ULH&P has determined that it will be required to apply push-down accounting for financial accounting purposes, unless ULH&P stops filing periodic reports with the SEC.

4. **Ending ULH&P's Reporting with the SEC**

Push-down accounting is an SEC rule, not a rule promulgated by the Financial Accounting Standards Board or its predecessors. As a result, it applies only to companies that file periodic reports with the SEC. Under the SEC's rules, although permitted to do so on a voluntary basis, ULH&P currently is not required to file periodic reports with the SEC because ULH&P's registered securities are held by fewer than 300 persons. So long as ULH&P does not file a periodic report with the SEC after the merger closes, then ULH&P would not be required to use push-down accounting. ULH&P also sees other benefits to ending its SEC reporting. The increased compliance costs associated with being a public reporting company have led many companies, particularly smaller companies such as ULH&P, to re-evaluate the cost-benefit analysis of maintaining their public company status. ULH&P further believes that these costs will increase as a result of push-down accounting since we will be required to keep "two sets of books," one for financial reporting and one for ratemaking. ULH&P has considered the pros and cons and has concluded that it would be in its best interest not to continue as a public reporting company. If ULH&P stops filing periodic reports with the SEC, ULH&P does not expect that this would materially impact its debt cost and believes any potential additional cost would be outweighed by avoided costs associated with the overly burdensome reporting requirements. ULH&P's stakeholders will still have access to information about ULH&P's financial condition because ULH&P will continue to file audited financial statements annually with this Commission, as part of ULH&P's FERC Form 1 and 2 filings. ULH&P will also continue to file quarterly financial statements with the Commission. Finally, ULH&P will also prepare audited financial statements for bondholders, and ULH&P will file copies of these financial statements with the Commission. ULH&P therefore is inclined to stop filing periodic reports with the SEC, but ULH&P seeks the Commission's input with respect to this issue.

Thank you for your consideration of the matters raised in this letter. We look forward to discussing all of these matters at the upcoming informal conference.

Sincerely,


John J. Finnigan, Jr.
Senior Counsel

JJF/sew

cc: Hon. Richard G. Raff
Hon. Dennis G. Howard, II
Hon. Elizabeth E. Blackford
Hon. David Edward Spenard
Hon. Michael L. Kurtz