

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF KENTUCKY)	
UTILITIES COMPANY FOR AN ORDER)	
AUTHORIZING THE ISSUANCE OF)	CASE NO. 2006-00390
SECURITIES AND THE ASSUMPTION)	
OF OBLIGATIONS)	

O R D E R

On August 23, 2006, Kentucky Utilities Company ("KU") filed an application for authority to refinance its only two outstanding issuances of secured debt for the purpose of converting them to unsecured debt. The Commission held two informal conferences and issued two information requests. KU has fully responded to both information requests, and, on December 22, 2006, KU filed an amended application. This case now stands submitted for a decision.

KU has two series of First Mortgage Bonds outstanding: (1) \$53 million in taxable First Mortgage Bonds that will mature on May 15, 2007, and (2) \$54 million in tax exempt First Mortgage Bonds that secure a loan from Carroll County, Kentucky through its Solid Waste Disposal Facilities Revenue Bonds that will mature on November 1, 2024. KU proposes two separate transactions, as discussed below, in order to convert these bonds from secured debt to unsecured debt. Although KU will incur higher interest expense and insurance premiums by refinancing with unsecured debt, it will reduce its accounting and legal expenses by being relieved of the filing requirements under the Securities Exchange Act of 1934 and provisions of the Sarbanes-Oxley Act of

2002. KU estimates that the expense savings will be \$267,500 annually, and will more than offset the additional costs associated with the unsecured debt.

KU's \$53 million in taxable bonds that mature in May 2007 are not redeemable and, therefore, they cannot be retired before they mature. KU proposes to defease these bonds by depositing with a trustee the amount of cash or U.S. Treasury securities that will cover the principal and accrued interest of the bonds. The trustee will then make the payments on the bonds at maturity. KU proposes to fund the defeasance by borrowing \$53 million from its affiliate, Fidelia Corporation ("Fidelia"), a finance company subsidiary of E.ON U.S. Holding GmbH ("E.ON").

The KU tax exempt mortgage bonds securing the loan from Carroll County will be refinanced through tax exempt refunding bonds that KU will then use to pay off the existing bonds. Carroll County would once again loan the proceeds to KU with the same type of agreement as currently exists except that none of KU's assets will be pledged as security for the loan. KU believes that the refunding bonds will be able to be issued for 4 years longer than the existing bonds, i.e., through 2028 rather than 2024. This will allow KU to extend the tax exempt status of this loan, resulting in reduced interest expense in the future.

Except for these two series of secured debt, all of KU's outstanding debt is unsecured. As part of its request to refinance the two series of secured debt, KU initially proposed that all future debt be priced at unsecured debt rates, rather than the current pricing method which is the lower of KU's secured debt rates or E.ON's unsecured debt rates.

KU plans to borrow the money it needs for the refinancing from Fidelia, issuing unsecured notes with final maturity not to exceed 30 years. KU states that it will not borrow from Fidelia unless the interest rate on the loan will be equal to or lower than the cost of borrowing that KU could obtain in the capital markets on its own. All borrowings will be at the lower of (1) E.ON's effective cost of capital or (2) KU's effective cost of capital as determined by the effective cost of KU borrowing directly from an independent third party. KU initially proposed that the actual interest rate would be the lower of (a) the average of three quotes obtained by Fidelia from international investment banks for an unsecured bond issued by E.ON for the applicable term of the loan and (b) the lowest of three quotes obtained by KU from international investment banks for an unsecured bond issued by KU for the applicable term of the loan. KU refers to this as the Best Rate Method, which it states will assure that it will not pay more for a loan from an affiliate than it would pay in the capital markets for a similar loan. In connection with this debt, KU may enter into one or more interest rate hedging agreements either with an E.ON affiliate or with a bank or financial institution. KU's issuance expenses will not exceed \$50,000.

The Commission raised two issues with KU through discovery and at the informal conferences. One was that, while the reduced accounting and legal expenses exceeded the anticipated additional interest and insurance on KU's current debt, no consideration was given to the cost for future debt. KU indicated that it will be borrowing approximately \$1 billion over the next 5 years in connection with several construction projects.¹ Although KU would incur a higher interest rate by employing

¹ Response to Item 6 of the Commission's Order dated October 19, 2006.

unsecured debt, it would avoid approximately \$200,000 in future legal expenses for each series of debt issued to its affiliate, rather than to the public.² However, depending on the future spread between secured and unsecured interest rates, using unsecured debt might be more costly in the future. To address this issue, KU amended its application to continue its existing practice of using the lower of E.ON's unsecured interest rate or KU's secured interest rate.³ The Commission finds that this amendment will preserve KU's ability to obtain the lowest possible interest rate without the additional filing requirements and costs inherent in issuing secured debt.

The second issue raised by the Commission was that KU's proposal to be exempt from existing SEC reporting requirements might deprive the Commission of necessary and timely information. To address this concern, KU has committed to continue to file with the Commission all of the information that it would have been included in its SEC filings. In particular, KU has committed to file the information that it would have filed with SEC Form 8-K, which requires the timely disclosure of any material changes involving the company.⁴

The Commission, having considered the evidence of record and being otherwise sufficiently advised, finds that the proposed issuance of securities and the assumption of obligations in connection therewith as set out in KU's amended application should be approved. The Commission also finds that the proposed financing is for lawful objects within the corporate purposes of KU's utility operations, is necessary and appropriate for

² Id.

³ Amendment filed December 22, 2006.

⁴ Response to Item 5 of the Staff's Initial Data Request dated October 3, 2006.

and consistent with the proper performance of its service to the public, will not impair its ability to perform that service, is reasonably necessary and appropriate for such purposes, and should therefore be approved.

IT IS THEREFORE ORDERED that:

1. KU is authorized to obtain long-term debt in an aggregate amount not to exceed \$53 million as set forth in its application to defease its First Mortgage Bonds of the same amount maturing in May 2007.

2. KU is authorized to assume certain obligations in an aggregate principal amount not to exceed \$54 million in connection with the issuance of new County of Carroll, Kentucky Environmental Facilities Revenue Bonds as set forth in its application.

3. KU shall obtain an interest rate that is the lower of the average of the interest rates available to Fidelia for unsecured bonds or the lowest rate available to KU for secured bonds.

4. KU is authorized to execute, deliver and perform its obligations under the agreements and documents as set out in the application, including but not limited to the inter-company loan agreement with Fidelia and the unsecured notes, and to perform the transactions contemplated by such agreements.

5. The proceeds from the transactions authorized herein shall be used only for the lawful purposes set out in the application.

6. KU shall agree to only such terms and prices that are consistent with this Order.

7. KU shall, within 30 days from the date of issuance, file with this Commission a statement setting forth the date or dates of issuance of the securities

authorized herein, the price paid, the interest rate, and all fees and expenses, including underwriting discounts or commissions or other compensation, involved in the issuance and distribution. KU shall also file documentation showing the quotes that it relied upon to determine the lowest interest rate. In addition, KU shall supply the market indicators KU used to compare the bids it used in developing Fidelia's rate as well as other utility debt offering close in time, the utilities' bond rating and the interest rates.

8. Within 10 days of the date of this Order, KU shall designate an executive officer who shall be responsible for timely filing with the Commission a report of material changes at KU. The material changes that KU must report are those that it would have had to disclose to the SEC on Form 8-K if KU continued to have publicly held secured debt.

Nothing contained herein shall be construed as a finding of value for any purpose or as a warranty on the part of the Commonwealth of Kentucky or any agency thereof as to the securities authorized herein.

Done at Frankfort, Kentucky, this 22nd day of January, 2007.

By the Commission

ATTEST:


Executive Director