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

November 9, 2006

RE: **In the Matter of: The Application of Louisville Gas and Electric Company for an Order Authorizing the Issuance of Securities and the Assumption of Obligations, Case No. 2006-00445**

Dear Ms. O'Donnell:

Enclosed please find an original and eight (8) copies of the Response of Louisville Gas and Electric Company ("LG&E") to the Commission Staff's Initial Data Requests issued on November 1, 2006 in the above-referenced docket.

The redemption of LG&E's preferred stock is a prerequisite for the conversion of all of LG&E's secured financing to unsecured financing, which redemption can only occur on fixed dividend dates for certain series. In order to redeem LG&E's preferred stock on the next available date of January 15, 2007, which date helps support maximizing LG&E's discussed savings for the current period, LG&E must provide advance notice to applicable stockholders by no later than December 15, 2006. Accordingly, LG&E respectfully requests the Commission to enter its Order in the above-referenced proceeding by December 12, 2006.

Should you have any questions concerning the enclosed, please do not hesitate to contact me.

Sincerely,

Allyson K Sturgeon

Allyson K. Sturgeon

AKS/kmw

Enclosures

C: Parties of Record

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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PUBLIC SERVICE
COMMISSION

In the Matter of:

THE APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR AN ORDER AUTHORIZING THE ISSUANCE OF SECURITIES AND THE ASSUMPTION OF OBLIGATIONS	)	CASE NO. 2006-00445

RESPONSE OF
LOUISVILLE GAS AND ELECTRIC COMPANY
TO
COMMISSION STAFF'S
DATA REQUEST
DATED NOVEMBER 1, 2006

FILED: NOVEMBER 9, 2006

LOUISVILLE GAS AND ELECTRIC COMPANY

Response to Commission Staff's Data Request
Dated November 1, 2006

Case No. 2006-00445

Question No. 1

Witness: Kent W. Blake, Director, State Regulation and Rates/ Counsel

Q-1. Will LG&E be in compliance with KRS 278.2213(11) if it discloses to Fidelia the lowest interest rate quoted by another financial institution and then allows Fidelia to match that lowest-quoted interest rate? Explain in detail your response.

A-1. Yes, LG&E is in compliance with KRS 278.2213(11) in disclosing to Fidelia the lowest interest rate quoted by a financial institution and then allowing Fidelia to match that rate. The purpose of the loan methodology at issue is, and has been, to use the cash available to E.ON to provide the best possible terms to the utilities without any closing costs. That methodology comports with the statutory purposes of KRS 278.300 and has, in fact, been approved by the Commission repeatedly.[1]

Subsection (11) of KRS 278.2213 prohibits only "undue" preferential treatment to a nonregulated affiliate. The circumstances here do not fit any dictionary definition of "undue."[2] It is not "undue" for a utility to provide information that

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[1] *See, e.g., The Application of Kentucky Utilities Company for an Order Authorizing the Issuance of Securities and the Assumption of Obligations,* PSC Case No. 2003-00059 (April 30, 2003); *The Application of Louisville Gas and Electric Company for an Order Authorizing the Issuance of Securities and the Assumption of Obligations,* PSC Case No. 2003-00058 (April 30, 2003) ("April 2003 LG&E Order"); *The Application of Kentucky Utilities Company for an Order Authorizing the Issuance of Securities and the Assumption of Obligations,* PSC Case No. 2006-00155 (May 22, 2006); *The Application of Kentucky Utilities Company for an Order Authorizing the Issuance of Securities and the Assumption of Obligations,* PSC Case No 2005-00117 (May 10, 2005); *The Application of Kentucky Utilities Company for an Order Authorizing the Issuance of Securities and the Assumption of Obligations,* PSC Case No. 2003-00301 (September 22, 2003); *The Application of Louisville Gas and Electric Company for an Order Authorizing the Issuance of Securities and the Assumption of Obligations,* PSC Case No. 2003-00300 (September 22, 2003).

[2] The word "undue" is defined as "1. unwarranted; excessive; " "2. inappropriate; unjustifiable; improper;" or "3. not owed or currently payable." *Dictionary.com Unabridged (v 1.0.1); Based on Random House Unabridged Dictionary* (Random

will result in low-cost financing on reasonable terms and conditions – particularly as the Commission itself has directly addressed, and approved, the very method of determining the interest rate for loans obtained by LG&E from Fidelia Corporation that is at issue here:

> The Commission's intent is that LG&E should obtain an interest rate that is no higher than it would otherwise pay if there were no financing available through Fidelia. … If E.ON, through Fidelia, is able to offer a rate lower than that available to LG&E from an external sources, the fact that the rate is an average of rates available to E.ON is acceptable to the Commission. … [W]e will approve LG&E borrowing at the lower of (a) the average of the interest rates available to E.ON or (b) the lowest interest rate available to LG&E.

April 2003 LG&E Order, at 2.

It is not "undue" – or "unwarranted," "excessive," "inappropriate," "unjustifiable," or "improper" - for LG&E to disclose information in a manner and for a purpose that have been expressly approved by the Commission. Thus, its disclosure of the subject information to Fidelia cannot, either legally or logically, be considered "undue" preferential treatment.

Next, KRS 278.2213(11) prohibits only that "undue" preferential treatment that is to the "detriment" of a "competitor." Disclosure of the rates quoted by investment banking houses cannot properly be considered "detrimental" to a "competitor" for a number of reasons. First, it is not "detrimental" to an investment bank to disclose the interest rates it quotes. Transparency in such matters is to be expected, and quoted rates are not given to LG&E in confidence.

Moreover, Fidelia simply is not a "competitor" of the investment banks in the sense contemplated by KRS 278.2213. It does not market services to the public in competition with investment banks in the manner contemplated by the statute. Subsection after subsection of KRS 278.2213 makes it clear that the protection for utility "competitors" that it provides pertains only to situations in which a utility could leverage its strong market presence to injure competitors who market services *to third parties*. For example, subsection (12) requires a utility, when asked by a customer to recommend a nonregulated service provider (e.g., a plumber) to respond not only by recommending itself or an affiliate, but also by informing the customer that competing suppliers for that service exist. Subsection (13) similarly seeks to limit the utility's market power by requiring it to use a disclaimer when its own well-known trademarks are used by itself or by an affiliate to advertise nonregulated services.

House, Inc. 2006). Definition 3 clearly does not apply in this instance; and 1 and 2 are equally inapplicable under the circumstances here.

In short, the clear and express language of the statute demonstrates no objective whatsoever to use the machinery of state government to protect investment banking firms from utility affiliates that engage solely in intra-system loans – particularly as KRS 278.300, which enables the Commission to ensure that utilities obtain financing on reasonable terms and conditions, is part and parcel of KRS Chapter 278's statutory scheme pursuant to which the Commission is to ensure that utility rates are reasonable.

LOUISVILLE GAS AND ELECTRIC COMPANY

Response to Commission Staff's Data Request
Dated November 1, 2006

Case No. 2006-00445

Question No. 2

Witness: Daniel K. Arbough, Director, Corporate Finance and Treasurer

Q-2. Assuming that Fidelia purchases LG&E's debt at an interest rate that is equal to the lowest rate available to LG&E from a non-affiliate, explain in detail any advantages to LG&E from issuing debt to Fidelia rather than to a non-affiliate.

A-2. The methodology at issue here leads to competitively priced debt with no closing costs to LG&E and its customers. Thus, there are both practical and economic benefits in issuing debt to Fidelia rather than to a non-affiliated banking institution. Specifically, unlike financings through non-affiliated investment banks, LG&E does not have to pay for costs relating to legal and trustee fees, or for printing and other services. In addition, the transaction is completed more expeditiously, allowing LG&E to take advantage of favorable market conditions more readily.

LOUISVILLE GAS AND ELECTRIC COMPANY

Response to Commission Staff's Data Request
Dated November 1, 2006

Case No. 2006-00445

Question No. 3

Witness: Daniel K. Arbough, Director, Corporate Finance and Treasurer

Q-3. For each note listed in LG&E's application, Exhibit 7, page 4 of 10, paragraph 6, explain why the interest rate would not have been lower if either: (a) the note had been secured by a first mortgage lien on LG&E's property; or (b) LG&E had issued a bond secured by a first mortgage lien in lieu of the note.

A-3.

For each note listed in Exhibit 7, the rate was determined using the Best Rate Method wherein the rate was set using <u>the lower of</u>:

a) the average of three quotes obtained by E.ON AG from international investment banks for an unsecured bond issued by E.ON for the applicable term of the loan, or

b) the lowest of three quotes obtained by the Company from international investment banks for a secured bond issued by the Company with the applicable term of the loan.

There would be no difference in the interest rate on a note verses bond if each is secured by a first mortgage lien. Thus, utilizing the Best Rate Method has ensured that the Company has paid no more for the loans than it would have if it had issued either a) a note secured by a first mortgage lien on LG&E's property, or b) a bond secured by a first mortgage lien.

In addition, the use of intercompany loans from Fidelia has allowed the company to avoid significant legal costs associated with bond documentation required by capital market participants. Based on an average cost of $200,000 in legal expenses per issuance, the savings total $600,000.

For these reasons, the interest rate for each note listed in LG&E's application, Exhibit 7, page 4 of 10, paragraph 6, would not have been lower if either: the note had been secured by a first mortgage lien on LG&E's property; or LG&E had issued a bond secured by a first mortgage lien in lieu of the note.

LOUISVILLE GAS AND ELECTRIC COMPANY

Response to Commission Staff's Data Request
Dated November 1, 2006

Case No. 2006-00445

Question No. 4

Witness: Daniel K. Arbough, Director, Corporate Finance and Treasurer

Q-4. Refer to LG&E's application, Exhibit 5.

a. For each line, beginning January 1, 2007 through September 1, 2028, explain the derivation of the figure shown in the column labeled "net periodic (cost) or savings."

b. Explain why the Administrative Savings are only $38,893 in the row for September 1, 2017.

c. LG&E uses a discount rate of 7 percent. Explain what the discount rate is based on.

A-4. a.

Net Periodic (Cost) or Savings

The calculation of the "Net Periodic (Cost) or Savings" column is the sum of the numbers in the columns labeled "Increase in Interest Charges and Ins Premium", "Interest on New Debt Replacing Preferred Stk", "Administrative Savings", "Underwriting, Call Premium and Issue Expenses", "Taxes", After-Tax Return on Additional Equity, and After-Tax Elimination of Pfd Stk Dividend".

Increase in Interest Charges and Ins Premium

The amount shown in the "Increase in Interest Charges and Ins Premium" column is stated in semi-annual periods. The calculation of the amount is shown on page 2 of Exhibit 5 as shown below:

Increased Interest Rate on Uninsured Bonds Times the Amount of Uninsured Bonds

0.100%	x	$	246,200,000	=	$	246,200	/ 2 =	$\boxed{\$\ 123{,}100}$

Plus

Insurance Premium Increase Times the Amount of Insurance with Variable Premium

0.115%	x	$	83,335,000	=	$	95,835		
0.100%	x	$	10,104,000	=	$	10,104		
0.170%	x	$	41,665,000	=	$	70,831		
0.100%	x	$	128,000,000	=	$	128,000		
0.125%	x	$	25,000,000	=	$	31,250		
Total		$	288,104,000			336,020	/ 2 =	$\boxed{\$\ 168{,}010}$

The final entry in this column was pro-rated for 62 days and was calculated as $582,220 x 62/365 = $98,898.

Interest on New Debt Replacing Preferred Stk

LG&E anticipates replacing approximately 90% of the costs of redeeming the three outstanding series of LG&E's preferred stock with debt. The amount shown in the column entitled "Interest on New Debt Replacing Preferred Stk" is calculated by taking 90% of the outstanding preferred stock times the estimated interest rate based on current market conditions reflected semi-annually.

[$91,507,175 x .90 x .0602] / 2 = $2,478,929

Additional Debt Expense Amortization

The amounts listed in the column entitled "Additional Debt Expense Amortization" are used in determining the tax liability/(savings), but are non-cash items. Consequently, they are not included in the summation of cash flows under the heading "Net Periodic (Cost) or Savings". The semi-annual amount of debt expense amortization is calculated by taking the sum of the underwriting fees of $441,700 plus the issuance cost of $296,000 and dividing that sum by the number of months the bonds will be outstanding (128). This results in a monthly number which is multiplied by 6 reflecting semi-annual periods.

[$441,700 + $296,000] / 128 x 6 = $34,580

Once again, in the final period the amount is prorated for 62 days.

Administrative Savings

The estimates of administrative savings were developed internally based on actual charges incurred in recent years. The breakdown of the estimated savings follows:

Outside Legal Counsel (SEC Filings)	$	53,106
Indenture Legal Work (State Filings)	$	4,000
First Mortgage Bond Trustee Fee	$	51,300
Financial Printer Costs	$	51,569
Accounting Work	$	25,000
Internal Accounting Costs	$	100,000
Sarbanes-Oxley Compliance	$	50,000
Total	**$**	**334,975**

An inflation rate of 1.50% per six months was applied to this total each year. The final year was pro-rated for 62 days.

Underwriting, Call Premium and Issue Expenses
The Underwriting, Defeasance and Issue Expenses are detailed on page 2 of Exhibit 5.

The Underwriting Cost is expected to be 0.35% x $126,200,000 = $441,700.

In the case of the 5% cumulative preferred series with an initial $25 par value, LG&E must redeem the series at $28. The Call Premium Cost is calculated by taking the $3 premium times the outstanding shares (860,287).

[860,287 x $3.00 = $2,580,861]

The Issuance Expenses totaling $296,000 are detailed on page 2 of Exhibit 5. They include costs for legal counsel, rating agency fees, printing, external auditor fees and trustee fees.

Taxes
Taxes are calculated at a rate of 38.90% of the total of the first four columns of the exhibit. For example, the 2007 number is calculated as illustrated below:

[($291,110) + ($2,478,929) + ($34,580) + $167,488] x (0.3890) = $1,025,844

After-Tax Return on Additional Equity
LG&E anticipates replacing the remaining 10% of the costs of redeeming the three outstanding series of LG&E's preferred stock with an increase in common equity for the Company. The amount shown in the column entitled "After Tax Return on Additional Equity" is calculated by taking the increased common equity amount times the allowed equity return of 10.5% reflected semi-annually.

[$91,507,175 x .10 x .105] / 2 = $480,413

After-Tax Elimination of Pfd Stk Dividend

The amount shown in the column entitled "After-Tax Elimination of Pfd Stk Dividend" shows the after-tax savings derived from the elimination of the preferred stock dividend. Only the dividends on the 5% preferred series are tax deductible. The amount is calculated by taking the preferred stock expenses for the last twelve months ("LTM") related to the three LG&E preferred stock series minus the tax benefit of the dividend related to the 5% series reflected semi-annually.

LG&E Preferred Series	LTM Expense
Auction Rate	$ 2,895,000
$5.875 Series	$ 1,075,359
5% Series	$ 1,231,844
	$ 5,202,203
Less Tax (5% Series) (Rate=38.9%)	$ (418,311)
	$ 4,783,892
Semi-Annual (Divided by 2)	$ 2,391,946

b. The final period for the "Administrative Savings" column was pro-rated for 62 days.

c. The discount rate of 7 percent is the weighted after-tax cost of capital for LG&E as of August 31, 2006 rounded to the nearest .25% as shown below:

	Capital Structure	After-Tax Rate	Weighted After-tax COC
Debt	41.17%	2.63%	1.08%
Preferred	4.71%	5.23%	0.25%
Common	54.12%	10.50%	5.68%
			7.01%

For purposes of the above calculation, the 5.875% preferred stock series is included in preferred stock rather than in debt as shown in the accounting records.

LOUISVILLE GAS AND ELECTRIC COMPANY

Response to Commission Staff's Data Request
Dated November 1, 2006

Case No. 2006-00445

Question No. 5

Witness: Daniel K. Arbough, Director, Corporate Finance and Treasurer

Q-5. Does LG&E anticipate issuing any new long-term debt within the next 5 years? If yes, provide an estimate of the total amount of new debt and the difference in the cost over the life of that debt if it is unsecured rather than secured by a first mortgage lien.

A-5. LG&E does anticipate issuing long-term debt in the next five years with respect to pension funding and the construction of Trimble County 2. These projects are in addition to the ongoing maintenance capital expenditures required. Based on current estimates, the Company expects to borrow approximately $300 million in the next five years.

The comparison of the cost of secured vs. unsecured debt is impacted by the tenor of the loan selected. As a result, the Company has provided indications for 10 and 30 year loans as representative samples of the impact.

Based on current market conditions for ten year bonds, and assuming the use of the Best Rate Method as described in the application for this case, the Best Rate Method produces a 0.04% lower interest rate compared to issuing debt secured by a first mortgage lien. The lower interest rate results in savings of $120,000 annually on a pre-tax basis or $1.2 million over the 10 year life of the debt. This is supported by the attached pricing indications received by E.ON and the Company.

Based on current market conditions for thirty year bonds, and assuming the use of the Best Rate Method as described in the application for this case, the Best Rate Method produces a 0.05% higher interest rate compared to issuing debt secured by a first mortgage lien. The higher interest rate results in additional costs of $150,000 annually on a pre-tax basis or $4.5 million over the 30 year life of the debt. This is supported by the attached pricing indications received by E.ON and the Company.

The amounts above are for interest expense only. There will be continued savings using the Best Rate Method from avoiding legal expenses associated with the issuance of First Mortgage Bonds. As noted above, an estimated average cost of $200,000 per issuance is avoided. Assuming one transaction per year over the next five years, these savings would total approximately $1 million. All of these estimates are independent of cost savings identified in the original Application which totaled approximately $4 million as shown on Exhibit 5 to the Application.

LG&E Intercompany Loan with Fidelia
Spread Comparison
$150,000,000

	10 Year		30 Year	
	LG&E FMB	E.ON AG	LG&E FMB	E.ON AG
Lehman Brothers	0.88%		1.08%	
Wachovia	0.89%		1.06%	
Merrill Lynch	0.94%		1.16%	
UBS		0.90%		1.30%
Morgan Stanley		0.86%		1.02%
ABNAmro		0.76%		1.00%
Lowest Rate - LG&E, Avg. Rate - E.ON AG	**0.88%**	**0.84%**	**1.06%**	**1.11%**

Louisville Gas and Electric Company

November 6, 2006

Market	Institutional
Tenor	10 year
Amount	$150.0
Structure / Security	First Mortgage
Ratings	A1 / A-
Pay Frequency	Semi-Annual
Reference Benchmark	10 YR UST
Benchmark Yield	4.70%
Reoffer Spread	**80 bps area**
Reoffer Yield	**5.50% area**
Underwriting Fee	0.650%
All-In Yield	**5.59%**
All-In Spread	**89 bps**
Mid Swap Rate	5.24%
Reoffer Floating Rate Spread	**26 bps**
All-In Floating Rate Spread	**35 bps**

"Area" defined as +/- 2 to 3 bps.

Louisville Gas and Electric Company

November 6, 2006

Market	Institutional
Tenor	30 year
Amount	$150.0
Structure / Security	First Mortgage
Ratings	A1 / A-
Pay Frequency	Semi-Annual
Reference Benchmark	30 YR UST
Benchmark Yield	4.79%
Reoffer Spread	**100 bps area**
Reoffer Yield	**5.79% area**
Underwriting Fee	0.875%
All-In Yield	**5.85%**
All-In Spread	**106 bps**
Mid Swap Rate	5.35%
Reoffer Floating Rate Spread	**44 bps**
All-In Floating Rate Spread	**50 bps**

"Area" defined as +/- 2 to 3 bps.

LG&E ENERGY

New Issue Pricing Indications

Louisville Gas & Electric

Indicative Pricing: First Mortgage Bonds (Senior Secured Ratings: A1/A-)

Maturity	**10 Year**
Issue Size ($mm)	$150
Coupon Type	Fixed
Reset/Payment	NA/Semi
Call Provision	Make-Whole
Benchmark	UST 4.875% due 8/16
Benchmark Yield	4.725%
Reoffering Spread	**T + 85 bps Area**
Reoffer Yield	**5.575%**
Underwriting Commissions	0.650%
All-in Yield	5.661%
All-in Spread	**T + 94 bps Area**

Pricing indications as of November 6, 2006. Assumes a new issue settlement date of November 9, 2006, with interest accruing from November 9, 2006. All yields are quoted on a semiannual basis. Based upon FMB ratings of A1/A-.

LG&E ENERGY

Disclaimers

Merrill Lynch prohibits (a) employees from, directly or indirectly, offering a favorable research rating or specific price target, or offering to change such rating or price target, as consideration or inducement for the receipt of business or for compensation, and (b) Research Analysts from being compensated for involvement in investment banking transactions except to the extent that such participation is intended to benefit investor clients.

This proposal is confidential, for your private use only, and may not be shared with others (other than your advisors) without Merrill Lynch's written permission, except that you (and each of your employees, representatives or other agents) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the proposal and all materials of any kind (including opinions or other tax analyses) that are provided to you relating to such tax treatment and tax structure. For purposes of the preceding sentence, tax refers to U.S. federal and state tax. This proposal is for discussion purposes only. Merrill Lynch is not an expert on, and does not render opinions regarding, legal, accounting, regulatory or tax matters. You should consult with your advisors concerning these matters before undertaking the proposed transaction.

LG&E ENERGY

New Issue Pricing Indications

Louisville Gas & Electric

Indicative Pricing: First Mortgage Bonds (Senior Secured Ratings: A1/A-)

Maturity	**30 Year**
Issue Size ($mm)	$150
Coupon Type	Fixed
Reset/Payment	NA/Semi
Call Provision	Make-Whole
Benchmark	UST 4.500% due 2/36
Benchmark Yield	4.814%
Reoffering Spread	**T + 110 bps Area**
Reoffer Yield	**5.914%**
Underwriting Commissions	0.875%
All-in Yield	5.977%
All-in Spread	**T + 116 bps Area**

Pricing indications as of November 6, 2006. Assumes a new issue settlement date of November 9, 2006, with interest accruing from November 9, 2006. All yields are quoted on a semiannual basis. Based upon FMB ratings of A1/A-.

LG&E ENERGY

Disclaimers

Merrill Lynch prohibits (a) employees from, directly or indirectly, offering a favorable research rating or specific price target, or offering to change such rating or price target, as consideration or inducement for the receipt of business or for compensation, and (b) Research Analysts from being compensated for involvement in investment banking transactions except to the extent that such participation is intended to benefit investor clients.

This proposal is confidential, for your private use only, and may not be shared with others (other than your advisors) without Merrill Lynch's written permission, except that you (and each of your employees, representatives or other agents) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the proposal and all materials of any kind (including opinions or other tax analyses) that are provided to you relating to such tax treatment and tax structure. For purposes of the preceding sentence, tax refers to U.S. federal and state tax. This proposal is for discussion purposes only. Merrill Lynch is not an expert on, and does not render opinions regarding, legal, accounting, regulatory or tax matters. You should consult with your advisors concerning these matters before undertaking the proposed transaction.

Confidential Presentation to:

Louisville Gas & Electric

Indicative New Issue Pricing

November 6, 2006

LEHMAN BROTHERS

Summary Terms for Louisville Gas & Electric – 10-year

Louisville Gas & Electric
Assumes Secured Debt Ratings of A1 / A-

Security	First Mortgage Bonds
Maturity	10 yrs
Size	$150,000,000
Ratings	A1 / A
Optionality	Non-call
Treasury Benchmark	10-yr Treasury
Treasury Yield	4.70%
Re-offer Spread	+ 80 - 82 bps
Re-offer Yield	5.50% - 5.52%
Gross Spread:	0.65%
Amortization of Gross Spread:	0.08%
Semiannual All-in Cost:	5.59% - 5.61%

US Treasury Rate as of November 6, 2006

Summary Terms for Louisville Gas & Electric – 30-year

Louisville Gas & Electric
Assumes Secured Debt Ratings of A1 / A-

Security	First Mortgage Bonds
Maturity	30 yrs
Size	$150,000,000
Ratings	A1 / A
Optionality	Non-call
Treasury Benchmark	30-yr Treasury
Treasury Yield	4.79%
Re-offer Spread	+ 102 - 104 bps
Re-offer Yield	5.81% - 5.83%
Gross Spread:	0.875%
Amortization of Gross Spread:	0.06%
Semiannual All-in Cost:	5.87% - 5.89%

US Treasury Rate as of November 6, 2006