DUKE ENERGY®

Mailing Address
139 East Fourth Street
1303 Main / P O. Box 960
Cincinnati, Ohio 45202

513-287-4320
513-287-4385

VIA OVERNIGHT DELIVERY

RECEIVED

SEP 16 2014

PUBLIC SERVICE
COMMISSION

September 15, 2014

Mr. Jeff Cline
Public Service Commission
Commonwealth of Kentucky
211 Sower Boulevard
Frankfort, Kentucky 40602-0615

Re: In the Matter of an Adjustment of Gas Rates of The Union Light, Heat and Power Company, Case No. 2001-00092; and

In the Matter of the 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 Mr. Cline:

Enclosed please find Duke Energy Kentucky's revised financial statements for the end of Second Quarter 2014 per order by the Commission in the above-referenced cases.

Please file-stamp the extra copy of this letter and return to me in the enclosed return-addressed envelope.

If you have any questions regarding the financial statements, please contact me at 513-287-4320.

Sincerely,

Rocco D'Ascenzo
Associate General Counsel

Enclosures

cc: Jay Baucom
Charmain Barnes

575129

Duke Energy Kentucky, Inc.
Financial Statements
(Unaudited)

June 30, 2014

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DUKE ENERGY KENTUCKY, INC.
June 30, 2014

DUKE ENERGY KENTUCKY, INC.
Condensed Statements of Operations
(Unaudited)

	Six Months Ended June 30,	
(in thousands)	2014	2013
Operating Revenues		
Electric	$ 183,343	$ 170,402
Gas	77,766	61,311
Total operating revenues	261,109	231,713
Operating Expenses		
Fuel used in electric generation and purchased power	92,319	69,291
Cost of natural gas	39,767	27,834
Operation, maintenance and other	66,813	62,525
Depreciation and amortization	21,977	22,466
Property and other taxes	6,354	6,961
Total operating expenses	227,230	189,077
Gains on Sales of Other Assets and Other, net	—	4,814
Operating Income	33,879	47,450
Other Income and Expenses, net	1,357	745
Interest Expense	8,190	8,447
Income Before Income Taxes	27,046	39,748
Income Tax Expense	9,537	14,064
Net Income	$ 17,509	$ 25,684

See Notes to Condensed Financial Statements

DUKE ENERGY KENTUCKY, INC.
Condensed Balance Sheets
(Unaudited)

(in thousands, except share amounts)	June 30, 2014	December 31, 2013
ASSETS		
Current Assets		
Cash and cash equivalents	$ 12,145	$ 13,038
Receivables (net of allowance for doubtful accounts of $216 at June 30, 2014 and $229 at December 31, 2013)	12,877	4,246
Receivables from affiliated companies	17,538	25,999
Notes receivable from affiliated companies	—	1,267
Inventory	50,929	41,667
Regulatory assets	15,671	4,038
Other	12,644	10,906
Total current assets	121,804	101,161
Investments and Other Assets		
Intangibles, net	56	115
Other	7,630	7,983
Total investments and other assets	7,686	8,098
Property, Plant and Equipment		
Cost	1,761,175	1,741,308
Accumulated depreciation and amortization	(739,237)	(728,396)
Net property, plant and equipment	1,021,938	1,012,912
Regulatory Assets and Deferred Debits		
Regulatory Assets	43,122	41,437
Other	2,067	2,138
Total regulatory assets and deferred debits	45,189	43,575
Total Assets	1,196,617	1,165,746
LIABILITIES AND COMMON STOCKHOLDER'S EQUITY		
Current Liabilities		
Accounts payable	16,200	25,536
Accounts payable to affiliated companies	6,461	18,204
Notes payable to affiliated companies	30,084	—
Taxes accrued	11,576	10,306
Interest accrued	3,561	3,442
Current maturities of long-term debt	41,623	41,688
Regulatory liabilities	3,269	2,390
Other	21,584	18,462
Total current liabilities	134,358	120,028
Long-term Debt	296,798	297,365
Deferred Credits and Other Liabilities		
Deferred income taxes	261,228	257,220
Investment tax credits	1,200	1,304
Accrued pension and other post-retirement benefit costs	10,138	10,776
Asset retirement obligations	6,389	6,253
Regulatory liabilities	65,894	69,495
Other	25,149	25,351
Total deferred credits and other liabilities	369,998	370,399
Commitments and Contingencies		
Common Stockholder's Equity		
Common Stock, $15.00 par value, 1,000,000 shares authorized and 585,333 shares outstanding at June 30, 2014 and December 31, 2013	8,780	8,780
Additional paid-in-capital	167,494	167,494
Retained earnings	219,189	201,680
Total common stockholder's equity	395,463	377,954
Total Liabilities and Common Stockholder's Equity	$ 1,196,617	$ 1,165,746

See Notes to Condensed Financial Statements

DUKE ENERGY KENTUCKY, INC.
Condensed Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30,	
(in thousands)	**2014**	**2013**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	**$ 17,509**	$ 25,684
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**22,283**	22,805
Gains on sales of other assets and other, net	**—**	(4,814)
Deferred income taxes	**8,746**	2,831
Accrued pension and other post-retirement benefit costs	**1,061**	1,525
(Increase) decrease in		
Net realized and unrealized mark-to-market and hedging transactions	**7**	(68)
Receivables	**(8,453)**	1,352
Receivables from affiliated companies	**8,461**	(1,961)
Inventory	**(9,263)**	3,357
Other current assets	**(13,055)**	3,122
Increase (decrease) in		
Accounts payable	**(6,955)**	(10,453)
Accounts payable to affiliated companies	**(11,743)**	(12,607)
Taxes accrued	**589**	5,541
Other current liabilities	**472**	(524)
Other assets	**(3,568)**	1,909
Other liabilities	**(3,414)**	(4,893)
Net cash provided by operating activities	**2,677**	32,806
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	**(34,158)**	(20,246)
Net proceeds from the sales of other assets	**—**	10,397
Notes receivable from affiliated companies	**1,267**	(27,224)
Other	**(5)**	(21)
Net cash used in investing activities	**(32,896)**	(37,094)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments for the redemption of long-term debt	**(677)**	(754)
Notes payable to affiliated companies	**30,084**	—
Other	**(81)**	—
Net cash provided by (used in) financing activities	**29,326**	(754)
Net increase in cash and cash equivalents	**(893)**	(5,042)
Cash and cash equivalents at beginning of period	**13,038**	10,693
Cash and cash equivalents at end of period	**$ 12,145**	$ 5,651
Supplemental Disclosures:		
Significant non-cash transactions:		
Accrued capital expenditures	**$ 2,429**	$ 2,851

See Notes to Condensed Financial Statements

DUKE ENERGY KENTUCKY, INC.
Condensed Statements of Changes in Common Stockholder's Equity
(Unaudited)

(in thousands)	Common Stock	Additional Paid-in Capital	Retained Earnings	Total
Balance at December 31, 2012	$ 8,780	$ 167,494	$ 196,611	$ 372,885
Net income	—	—	25,684	25,684
Balance at June 30, 2013	$ 8,780	$ 167,494	$ 222,295	$ 398,569
Balance at December 31, 2013	**$ 8,780**	**$ 167,494**	**$ 201,680**	**$ 377,954**
Net income	**—**	**—**	**17,509**	**17,509**
Balance at June 30, 2014	**$ 8,780**	**$ 167,494**	**$ 219,189**	**$ 395,463**

See Notes to Condensed Financial Statements

1. ORGANIZATION AND BASIS OF PRESENTATION

NATURE OF OPERATIONS

Duke Energy Kentucky, Inc. (Duke Energy Kentucky) is a combination electric and gas public utility company that provides service in northern Kentucky. Duke Energy Kentucky's principal lines of business include generation, transmission and distribution of electricity, as well as the sale of and transportation of natural gas. Duke Energy Kentucky is subject to the regulatory provisions of the Kentucky Public Service Commission (KPSC) and the Federal Energy Regulatory Commission (FERC). Duke Energy Kentucky's common stock is wholly owned by Duke Energy Ohio, Inc. (Duke Energy Ohio), an indirect wholly owned subsidiary of Duke Energy Corporation (Duke Energy).

BASIS OF PRESENTATION

These interim Condensed Financial Statements and Notes do not include all of the information and notes required by generally accepted accounting principles (GAAP) in the United States (U.S.) for annual financial statements. Accordingly, the Condensed Financial Statements and Notes should be read in conjunction with Duke Energy Kentucky's Financial Statements and Notes for the year ended December 31, 2013. These Condensed Financial Statements reflect all normal recurring adjustments that are, in the opinion of management, necessary to fairly present Duke Energy Kentucky's financial position and results of operations. Amounts reported in the interim Condensed Statements of Operations are not necessarily indicative of amounts expected for the respective annual periods due to the effects of seasonal temperature variations on energy consumption, regulatory rulings, the timing of maintenance on electric generating units and other factors.

In preparing financial statements that conform to GAAP, management must make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses, and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

These financial statements reflect Duke Energy Kentucky's proportionate share of East Bend Station, which is jointly owned with The Dayton Power and Light Company. See Note 2 for further discussion.

REVENUE RECOGNITION AND UNBILLED REVENUE

Revenues on sales of electricity are recognized when service is provided. Unbilled revenues are recognized by applying customer billing rates to the estimated volumes of energy delivered but not yet billed. Unbilled revenues can vary significantly from period to period as a result of seasonality, weather, customer usage patterns and meter reading schedules.

Duke Energy Kentucky sells, on a revolving basis, nearly all of its retail accounts receivable, including receivables for unbilled revenues, to an affiliate, Cinergy Receivables Company, LLC (CRC), a bankruptcy remote, special-purpose entity. As discussed further in Note 8, Duke Energy Kentucky accounts for the transfers of receivables to CRC as sales. Accordingly, the receivables sold are not reflected on the Condensed Balance Sheets. Receivables for unbilled revenues related to retail accounts receivable included in the sales of accounts receivable to CRC at June 30, 2014 and December 31, 2013 were $15 million and $21 million, respectively.

Unbilled revenues, which are recorded as Receivables on the Condensed Balance Sheets and exclude receivables sold to CRC, primarily relate to wholesale sales and were not significant at June 30, 2014 or December 31, 2013.

NEW ACCOUNTING STANDARDS

The new accounting standards that were adopted for 2014 and 2013 had no significant impact on the presentation or results of operations, cash flows or financial position of Duke Energy Kentucky. Disclosures have been enhanced to provide a discussion and tables on derivative contracts subject to enforceable master netting agreements and a table of quantitative disclosures about unobservable inputs. See Notes 6 and 7 for further information.

The following new Accounting Standard Update (ASU) was issued, but has not yet been adopted by Duke Energy Kentucky, as of June 30, 2014.

ASC 606 - Revenue from Contracts with Customers. In May 2014, the FASB issued revised accounting guidance for revenue recognition from contracts with customers. The core principle of this guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

For Duke Energy Kentucky, this guidance is effective for interim and annual periods beginning January 1, 2017. Duke Energy Kentucky is currently evaluating the potential impact of the adoption of this revised accounting guidance on its revenue recognition and is unable to estimate at this time the impact of adoption on its consolidated results of operations, cash flows, financial position or disclosures.

2. REGULATORY MATTERS

RATE RELATED INFORMATION

The KPSC approves rates for retail electric and gas service within the Commonwealth of Kentucky. The FERC approves rates for electric sales to wholesale customers served under cost-based rates, as well as sales of transmission service.

Regional Transmission Organization Realignment

Duke Energy Ohio and Duke Energy Kentucky transferred control of their transmission assets to effect a Regional Transmission Organization (RTO) realignment from Midcontinent Independent System Operator, Inc. (MISO) to PJM Interconnection, LLC (PJM), effective December 31, 2011.

On December 22, 2010, the KPSC approved Duke Energy Kentucky's request to effect the RTO realignment, subject to a commitment not to seek double-recovery in a future rate case of the transmission expansion fees that may be charged by MISO and PJM in the same period or overlapping periods.

Upon its exit from MISO on December 31, 2011, Duke Energy Kentucky recorded a liability for its exit obligation and share of MISO Transmission Expansion Planning (MTEP) costs, excluding Multi Value Projects (MVP). This liability was recorded within Other in Current liabilities and Other in Deferred credits and other liabilities on the Condensed Balance Sheets.

The following table provides a reconciliation of the beginning and ending balance of recorded obligations related to the withdrawal from MISO.

(in thousands)	December 31, 2013	Provision / Adjustments	Cash Reductions	June 30, 2014
MISO withdrawal liability	$ 20,514	$ 359	$ (480)	$ 20,393

MVP

MISO approved 17 MVP proposals prior to Duke Energy Ohio and Duke Energy Kentucky's exit from MISO on December 31, 2011. Construction of these projects is expected to continue through 2020. Costs of these projects, including operating and maintenance costs, property and income taxes, depreciation and an allowed return, are allocated and billed to MISO transmission owners.

On December 29, 2011, MISO filed a tariff with the FERC providing for the allocation of MVP costs to a withdrawing owner based on monthly energy usage. The FERC set for hearing (i) whether MISO's proposed cost allocation methodology to transmission owners who withdrew from MISO prior to January 1, 2012 is consistent with the tariff at the time of their withdrawal from MISO, and, (ii) if not, what should be the amount of and methodology for calculating any MVP cost responsibility. On July 16, 2013, a FERC Administrative Law Judge (ALJ) issued an initial decision. Under this initial decision, Duke Energy Ohio and Duke Energy Kentucky would be liable for MVP costs. Duke Energy Ohio and Duke Energy Kentucky filed exceptions to the initial decision, requesting the FERC overturn the ALJ's decision. After reviewing the initial decision, along with all exceptions and responses filed by the parties, the FERC will issue a final decision. Duke Energy Ohio and Duke Energy Kentucky fully intend to appeal to the federal court of appeals if the FERC affirms the ALJ's decision. Duke Energy Kentucky cannot predict the outcome of these proceedings.

In 2012, MISO estimated Duke Energy Kentucky's MVP obligation over the period from 2012 to 2071 at $450 million, on an undiscounted basis. The estimated obligation is subject to great uncertainty including the ultimate cost of the projects, the annual costs of operation and maintenance, taxes and return over the project lives and the allocation to Duke Energy Kentucky.

OTHER REGULATORY MATTERS

Potential Plant Retirements

Duke Energy Kentucky periodically files Integrated Resource Plans (IRP) with the KPSC. The IRPs provide a view of forecasted energy needs over a 10-20 year period, and options being considered to meet those needs. The IRPs filed by Duke Energy Kentucky in 2011 included planning assumptions to potentially retire by 2015, Miami Fort Unit 6, which does not have the requisite emission control equipment, primarily to meet the Environmental Protection Agency (EPA) Mercury and Air Toxics Standard (MATS) regulation. The net book value of the 163 MW Miami Fort Unit 6, as of June 30, 2014, is $9 million. As of June 30, 2014, no decision has been made regarding the retirement.

East Bend Station

On May 15, 2014, Duke Energy Kentucky entered into an agreement to acquire the Dayton Power and Light Company's 31 percent interest in East Bend Station for approximately $12.4 million. The transaction is subject to various state and federal regulatory approvals. Duke Energy Kentucky expects the transaction to close in late 2014.

3. COMMITMENTS AND CONTINGENCIES

ENVIRONMENTAL

Duke Energy Kentucky is subject to federal, state and local regulations regarding air and water quality, hazardous and solid waste disposal and other environmental matters. These regulations can be changed from time to time, imposing new obligations on Duke Energy Kentucky.

Remediation Activities

Duke Energy Kentucky is responsible for environmental remediation at various contaminated sites. These include some properties that are part of ongoing operations and sites formerly owned or used by Duke Energy Kentucky. These sites are in various stages of investigation, remediation and monitoring. Managed in conjunction with relevant federal, state and local agencies, activities vary with site conditions and locations, remediation requirements, complexity and sharing of responsibility. If remediation activities involve joint and several liability provisions, strict liability, or cost recovery or contribution actions, Duke Energy Kentucky could potentially be held responsible for contamination caused by other parties. In some instances, Duke Energy Kentucky may share liability associated with contamination with other potentially responsible parties, and may also benefit from insurance policies or contractual indemnities that cover some or all cleanup costs. Liabilities are recorded when losses become probable and are reasonably estimable. The total costs that may be incurred cannot be estimated because the extent of environmental impact, allocation among potentially responsible parties, remediation alternatives, and/or regulatory decisions have not yet been determined. Additional costs associated with remediation activities are likely to be incurred in the future and could be significant. Costs are typically expensed as Operation, maintenance and other unless regulatory recovery of the costs is deemed probable.

Duke Energy Kentucky has accrued approximately $340 thousand for probable and estimable costs related to its various environmental sites. These amounts are recorded in Other within Deferred credits and other liabilities on the Condensed Balance Sheets. Duke Energy Kentucky could incur additional losses in excess of its recorded reserves of up to approximately $70 thousand for the stages of investigation, remediation and monitoring for its environmental sites that have been evaluated. The maximum amount of the range for all stages of Duke Energy Kentucky's environmental sites cannot be determined at this time. Actual experience may differ from current estimates, and it is probable that estimates will continue to change in the future.

LITIGATION

Duke Energy Kentucky is involved in other legal, tax and regulatory proceedings arising in the ordinary course of business, some of which involve substantial amounts. Duke Energy Kentucky believes that the final disposition of these proceedings will not have a material adverse effect on its results of operations, cash flows or financial position. Duke Energy Kentucky expenses legal costs related to the defense of loss contingencies as incurred.

OTHER COMMITMENTS AND CONTINGENCIES

General

Duke Energy Kentucky enters into various fixed-price, non-cancelable commitments to purchase or sell power, take-or-pay arrangements, transportation, or throughput agreements and other contracts that may or may not be recognized on the Condensed Balance Sheets. Some of these arrangements may be recognized at fair value on the Condensed Balance Sheets if such contracts meet the definition of a derivative and the normal purchase/normal sale (NPNS) exception does not apply. In most cases, Duke Energy Kentucky's purchase obligation contracts contain provisions for price adjustments, minimum purchase levels and other financial commitments.

4. DEBT AND CREDIT FACILITIES

Duke Energy has a master credit facility with a capacity of $6 billion through December 2018. Duke Energy Kentucky has borrowing capacity under the master credit facility up to a specified sublimit. Duke Energy has the unilateral ability at any time to increase or decrease Duke Energy Kentucky's borrowing sublimit, subject to a maximum sublimit. At June 30, 2014, Duke Energy Kentucky had a borrowing sublimit of $100 million and available capacity of $89 million under Duke Energy's master credit facility. The amount available to Duke Energy Kentucky under the master credit facility may be reduced to backstop issuances of letters of credit, certain tax-exempt bonds and certain moneypool borrowings from Duke Energy affiliates.

At June 30, 2014 and December 31, 2013, $27 million of tax-exempt bonds were classified as Long-term debt on the Condensed Balance Sheets due to being backstopped by a letter of credit, which gives Duke Energy Kentucky the ability to refinance these short-term obligation on a long-term basis.

5. RELATED PARTY TRANSACTIONS

Duke Energy Kentucky engages in related party transactions, which are generally performed at cost and in accordance with the applicable state and federal commission regulations. Refer to the Condensed Balance Sheets for balances due to or due from related parties. Material amounts related to transactions with related parties included in the Condensed Statements of Operations are presented in the following table.

	Six Months Ended June 30,	
(in thousands)	**2014**	**2013**
Corporate governance and shared service expenses [(a)]	$ 32,959	$ 33,505

(a) Duke Energy Kentucky is charged its proportionate share of corporate governance and other costs by an unconsolidated affiliate that is a consolidated affiliate of Duke Energy. Costs are primarily related to human resources, employee benefits, legal and accounting fees, as well as other third party costs. These amounts are recorded in Operation, maintenance and other within Operating Expenses on the Condensed Statements of Operations.

In addition to the amounts presented above, Duke Energy Kentucky records the impact on net income of other affiliate transactions, including rental of office space, participation in a money pool arrangement with Duke Energy and certain of its subsidiaries, other operational transactions and its proportionate share of certain charged expenses. The net impact of these transactions was not material for each of the six months ended June 30, 2014 and 2013.

As discussed in Note 8, certain trade receivables have been sold by Duke Energy Kentucky to CRC, an unconsolidated entity formed by a subsidiary of Duke Energy. The proceeds obtained from the sales of receivables are largely cash but do include a subordinated note from CRC for a portion of the purchase price.

6. DERIVATIVES AND HEDGING

COMMODITY PRICE RISK

Duke Energy Kentucky has limited exposure to market price changes of fuel and emission allowance costs incurred for its retail customers due to the use of cost tracking and recovery mechanisms. Duke Energy Kentucky does have exposure to the impact of market fluctuations in the prices of electricity, fuel and emission allowances associated with its generation output not utilized to serve retail operations or committed load (off-system, wholesale power sales). Duke Energy Kentucky employs established policies and procedures to manage its risks associated with these market fluctuations using various commodity and financial derivative instruments, including swaps, futures, forwards and options.

Duke Energy Kentucky does not have any material outstanding commodity derivatives.

INTEREST RATE RISK

Changes in interest rates expose Duke Energy Kentucky to risk as a result of its issuance of variable and fixed rate debt. Duke Energy Kentucky manages its interest rate exposure by limiting its variable-rate exposures to a percentage of total debt and by monitoring the effects of market changes in interest rates. To manage risk associated with changes in interest rates, Duke Energy Kentucky may enter into financial contracts; primarily interest rate swaps and U.S. Treasury lock agreements. Because Duke Energy Kentucky meets the criteria for regulatory accounting treatment any contracts entered into are treated as undesignated and any pretax gain or loss recognized from inception to termination of the hedges are recorded as a regulatory liability or asset and amortized as a component of interest expense over the life of the debt. As a result there is no mark-to-market impact on earnings. The notional amount of interest rate swaps outstanding was $27 million at June 30, 2014 and December 31, 2013.

CREDIT RISK

Where exposed to credit risk, Duke Energy Kentucky analyzes the counterparties' financial condition prior to entering into an agreement, establishes credit limits and monitors the appropriateness of those limits on an ongoing basis.

Duke Energy Kentucky's industry has historically operated under negotiated credit lines for physical delivery contracts. Duke Energy Kentucky may use master collateral agreements to mitigate certain credit exposures. The collateral agreements provide for a counterparty to post cash or letters of credit to the exposed party for exposure in excess of an established threshold. The threshold amount represents an unsecured credit limit, determined in accordance with the corporate credit policy. Collateral agreements also provide that the inability to post collateral is sufficient cause to terminate contracts and liquidate all positions.

Duke Energy Kentucky also obtains cash or letters of credit from customers to provide credit support outside of collateral agreements, where appropriate, based on its financial analysis of the customer and the regulatory or contractual terms and conditions applicable to each transaction.

See Note 7 for additional information on fair value disclosures related to derivatives.

7. FAIR VALUE MEASUREMENTS

Fair value is the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The fair value definition focuses on an exit price versus the acquisition cost. Fair value measurements use market data or assumptions market participants would use in pricing the asset or liability, including assumptions about risk and the risk inherent in the inputs to the valuation technique. These inputs can be readily observable, corroborated by market data or generally unobservable. Valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. A midmarket pricing convention (the midpoint price between bid and ask prices) is permitted for use as a practical expedient.

Fair value measurements are classified in three levels based on the fair value hierarchy:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. An active market is one in which transactions for an asset or liability occur with sufficient frequency and volume to provide ongoing pricing information.

Level 2 – A fair value measurement utilizing inputs other than quoted prices included in Level 1 that are observable, either directly or indirectly, for an asset or liability. Inputs include (i) quoted prices for similar assets or liabilities in active markets, (ii) quoted prices for identical or similar assets or liabilities in markets that are not active, (iii) and inputs other than quoted market prices that are observable for the asset or liability, such as interest rate curves and yield curves observable at commonly quoted intervals, volatilities, and credit spreads. A Level 2 measurement cannot have more than an insignificant portion of its valuation based on unobservable inputs. Instruments in this category include non-exchange-traded derivatives, such as over-the-counter forwards, swaps and options; certain marketable debt securities; and financial instruments traded in less than active markets.

Level 3 – Any fair value measurement which includes unobservable inputs for more than an insignificant portion of the valuation. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value. Level 3 measurements may include longer-term instruments that extend into periods in which observable inputs are not available.

The fair value accounting guidance permits entities to elect to measure certain financial instruments that are not required to be accounted for at fair value, such as equity method investments or the company's own debt, at fair value. Duke Energy Kentucky has not elected to record any of these items at fair value.

Transfers between levels represent assets or liabilities that were previously (i) categorized at a higher level for which the inputs to the estimate became less observable or (ii) classified at a lower level for which the inputs became more observable during the period. Duke Energy Kentucky's policy is to recognize transfers between levels of the fair value hierarchy at the end of the period. There were no transfers between levels 1, 2 or 3 during the six months ended June 30, 2014 and 2013.

Valuation methods of the primary fair value measurements disclosed below are as follows.

Commodity derivatives

Commodity derivatives with clearinghouses are classified as Level 1. Other commodity derivatives are primarily fair valued using internally developed discounted cash flow models which incorporate forward price, adjustments for liquidity (bid-ask spread) and credit or non-performance risk (after reflecting credit enhancements such as collateral), and are discounted to present value. Pricing inputs are derived from published exchange transaction prices and other observable data sources. In the absence of an active market, the last available price may be used. If forward price curves are not observable for the full term of the contract and the unobservable period had more than an insignificant impact on the valuation, the commodity derivative is classified as Level 3.

Interest rate derivatives

Most over-the-counter interest rate contract derivatives are valued using financial models which utilize observable inputs for similar instruments and are classified as Level 2. Inputs include forward interest rate curves, notional amounts, interest rates and credit quality of the counterparties.

QUANTITATIVE DISCLOSURES

The following tables provide recorded balances for assets and liabilities measured at fair value on a recurring basis on the Condensed Balance Sheets. Derivative amounts in the table below exclude cash collateral.

	June 30, 2014			
(in thousands)	Total Fair Value	Level 1	Level 2	Level 3
Derivative assets[a]	$ 2,591	$ —	$ —	$ 2,591
Derivative liabilities[b]	(5,830)	—	(5,830)	—
Net (liabilities) assets	$ (3,239)	$ —	$ (5,830)	$ 2,591

	December 31, 2013			
(in thousands)	Total Fair Value	Level 1	Level 2	Level 3
Derivative assets[a]	$ 350	$ —	$ —	$ 350
Derivative liabilities[b]	(4,731)	—	(4,731)	—
Net (liabilities) assets	$ (4,381)	$ —	$ (4,731)	$ 350

(a) Included in Other within Current Assets and Other within Investments and Other Assets on the Condensed Balance Sheets.
(b) Included in Other within Current Liabilities and Other within Deferred Credits and Other Liabilities on the Condensed Balance Sheets.

The following table provides a reconciliation of beginning and ending balances of assets and liabilities measured at fair value on a recurring basis where the determination of fair value includes significant unobservable inputs (Level 3).

	Derivatives (net)	
	Six Months Ended June 30,	
(in thousands)	2014	2013
Balance at beginning of period	$ 350	$ 433
Total pretax realized or unrealized gains included in earnings:		
Operating Revenues	829	106
Purchases, sales, issuances and settlements:		
Purchases	1,060	828
Settlements	(1,299)	(141)
Total gains (losses) included on the Condensed Balance Sheet as regulatory asset or liability	1,651	(732)
Balance at end of period	$ 2,591	$ 494

OTHER FAIR VALUE DISCLOSURES

The fair value of long-term debt, including current maturities, is summarized in the following table. Judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates determined are not necessarily indicative of the amounts the Duke Energy Kentucky could have settled in current markets. The fair value of long-term debt is determined using Level 2 measurements.

	June 30, 2014		December 31, 2013	
(in thousands)	Book value	Fair value	Book value	Fair value
Long-term debt, including current maturities	$ 338,421	$ 365,069	$ 339,053	$ 356,640

At both June 30, 2014 and December 31, 2013, the fair value of cash and cash equivalents, accounts and notes receivable, and accounts and notes payable are not materially different from their carrying amounts because of the short-term nature of these instruments and/or because the stated rates approximate market rates.

8. VARIABLE INTEREST ENTITIES

A variable interest entity (VIE) is an entity that is evaluated for consolidation by more than a simple analysis of voting control. The analysis to determine whether an entity is a VIE considers contracts with an entity, credit support for an entity, the adequacy of the equity investment of an entity and the relationship of voting power to the amount of equity invested in an entity. This analysis is performed either upon the creation of a legal entity or upon the occurrence of an event requiring reevaluation, such as a significant change in an entity's assets or activities. A qualitative analysis of control determines the party that consolidates a VIE. This assessment is based on (i) what party has the power to direct the most significant activities of the VIE that impacts its economic performance, and (ii) what party has rights to receive benefits or is obligated to absorb losses that are significant to the VIE. The analysis of the party that consolidates a VIE is a continual assessment.

NON-CONSOLIDATED VIEs

Duke Energy Kentucky had Receivables of $16,595 thousand and $24,534 thousand from CRC at June 30, 2014 and December 31, 2013, respectively. As discussed below, Duke Energy Kentucky does not consolidate CRC as it is not the primary beneficiary.

Duke Energy Kentucky is not aware of any situations where the maximum exposure to loss significantly exceeds the carrying values shown.

No financial support was provided to this non-consolidated VIE during the six months ended June 30, 2014 or the year ended December 31, 2013, or is expected to be provided in the future, that was not previously contractually required.

CRC

On a revolving basis, CRC buys certain accounts receivable arising from the sale of electricity and/or related services from Duke Energy Kentucky. Receivables sold are securitized by CRC through a facility managed by two unrelated third parties. The proceeds Duke Energy Kentucky receives from the sale of receivables to CRC are typically 75 percent cash and 25 percent in the form of a subordinated note from CRC. The subordinated note is a retained interest in the receivables sold. Cash collections from the receivable are the sole source of funds to satisfy the related debt obligation. Borrowings fluctuate based on the amount of receivables sold. The credit facility expires in November 2016.

CRC is considered a VIE because (i) equity capitalization is insufficient to support its operations, (ii) power to direct the most significant activities that impact economic performance of the entity are not performed by the equity holder, Cinergy Corp. (Cinergy), and (iii) deficiencies in net worth of CRC are not funded by Cinergy, but by Duke Energy. The most significant activity of CRC relates to the decisions made with respect to the management of delinquent receivables. Duke Energy consolidates CRC as it makes these decisions. Duke Energy Kentucky does not consolidate CRC.

The subordinated note held by Duke Energy Kentucky is stated at fair value and is classified within Receivables in the Condensed Balance Sheets. Carrying values of retained interests are determined by allocating carrying value of the receivables between assets sold and interests retained based on relative fair value. The allocated basis of the subordinated notes are not materially different than their face value because (i) the receivables generally turnover in less than two months, (ii) credit losses are reasonably predictable due to the broad customer base and lack of significant concentration, and (iii) the equity in CRC is subordinate to all retained interests and thus would absorb losses first. The hypothetical effect on fair value of the retained interests assuming both a 10 percent and a 20 percent unfavorable variation in credit losses or discount rates is not material due to the short turnover of receivables and historically low credit loss history. Interest accrues to Duke Energy Kentucky on the retained interests using the acceptable yield method. This method generally approximates the stated rate on the notes since the allocated basis and the face value are nearly equivalent. An impairment charge is recorded against the carrying value of both retained interests and purchased beneficial interest whenever it is determined that an other-than-temporary impairment has occurred.

Key assumptions used in estimating fair value in 2014 and 2013 are detailed in the following table.

	2014	2013
Anticipated credit loss ratio	**0.5%**	0.6%
Discount rate	**1.2%**	1.2%
Receivables turnover rate	**11.5%**	11.5%

The following table presents the gross and net receivables sold.

(in thousands)	June 30, 2014	December 31, 2013
Receivables sold	**$ 55,649**	$ 62,146
Less: Retained interests	**16,595**	24,534
Net receivables sold	**$ 39,054**	$ 37,612

The following table presents the retained interests, sales and cash flows.

(in thousands)	Six Months Ended June 30, 2014	2013
Sales		
Receivables sold	$ 275,390	$ 252,494
Loss recognized on sale	1,044	1,068
Cash flows		
Cash proceeds from receivables sold	$ 282,285	$ 254,501
Collection fees received	138	126
Return received on retained interests	584	566

Cash flows from the sale of receivables are reflected within Operating Activities on the Condensed Statements of Cash Flows.

Collection fees received in connection with the servicing of transferred accounts receivable are included in Operation, maintenance, and other on the Condensed Statement of Operations. The loss recognized on the sale of receivables is calculated monthly by multiplying the receivables sold during the month by the required discount which is derived monthly utilizing a three year weighted average formula that considers charge-off history, late charge history, and turnover history on the sold receivables, as well as a component for the time value of money. The discount rate, or component for the time value of money, is calculated monthly by summing the prior month-end London Interbank Offered Rate (LIBOR) plus a fixed rate of 1.00 percent.

9. EMPLOYEE BENEFIT PLANS

DEFINED BENEFIT RETIREMENT PLANS

Duke Energy Kentucky participates in qualified and non-qualified defined benefit pension plans and other post-retirement benefit plans sponsored by Duke Energy. Duke Energy allocates pension and other post-retirement obligations and costs related to these plans to Duke Energy Kentucky.

Net periodic benefit cost disclosed in the tables below for the qualified, non-qualified and other post-retirement benefit plans represent the cost of the respective plan for the periods presented. However, portions of the net periodic benefit cost disclosed in the tables have been capitalized as a component of property, plant and equipment.

Duke Energy uses a December 31 measurement date for its defined benefit retirement plan assets and obligations. Amounts presented in the tables below represent the amounts of pension and other post-retirement benefit cost allocated by Duke Energy for employees of Duke Energy Kentucky. Additionally, Duke Energy Kentucky is allocated its proportionate share of pension and other post-retirement benefit cost for employees of Duke Energy's shared services affiliate that provides support to Duke Energy Kentucky. These allocated amounts are included in the governance and shared services costs discussed in Note 5.

	Six Months Ended June 30,					
	2014			2013		
(in thousands)	Qualified Pension Plans	Non-Qualified Pension Plans	Other Post-retirement Benefit Plans	Qualified Pension Plans	Non-Qualified Pension Plans	Other Post-retirement Benefit Plans
Service cost	$ 694	$ —	$ 66	$ 821	$ —	$ 74
Interest cost on projected benefit obligation	2,049	3	189	2,019	3	180
Expected return on plan assets	(2,827)	—	(32)	(3,166)	—	(39)
Amortization of prior service cost (credit)	23	—	1	24	—	(19)
Amortization of loss	826	6	25	1,560	—	26
Other	38	—	—	42	—	—
Net periodic benefit costs	$ 803	$ 9	$ 249	$ 1,300	$ 3	$ 222

EMPLOYEE SAVINGS PLAN

Duke Energy Kentucky also participates in employee savings plans sponsored by Duke Energy. Most employees participate in a matching contribution formula where Duke Energy provides a matching contribution generally equal to 100 percent of employee before-tax and Roth 401(k) contributions and, as applicable, after-tax contributions of up to 6 percent of eligible pay per period.

As of January 1, 2014, for new and rehired non-union and certain unionized employees who are not eligible to participate in Duke Energy's defined benefit plans, an additional employer contribution of 4 percent of eligible pay per pay period is provided to the employee's savings plan account, which is subject to a three-year vesting schedule.

Duke Energy Kentucky's expense related to its proportionate share of pretax employer contributions and the additional 4 percent employer contribution was $434 thousand and $421 thousand for the six months ended June 30, 2014 and 2013, respectively.

10. INCOME TAXES

Duke Energy Kentucky files income tax returns in the U.S. with federal and various state governmental authorities. The taxable income of Duke Energy Kentucky is reflected in Duke Energy's U.S. federal income tax returns. Duke Energy Kentucky has a tax sharing agreement with Duke Energy where the separate return method is used to allocate tax expenses and benefits to Duke Energy Kentucky whose investments or results of operations provide these tax expenses and benefits. The accounting for income taxes essentially represents the income taxes that Duke Energy Kentucky would incur if it were a separate company filing its own tax return as a C-Corporation.

The effective tax rates for Duke Energy Kentucky are 35.3 percent and 35.4 percent for the six months ended June 30, 2014 and 2013, respectively.

11. SUBSEQUENT EVENTS

Management has evaluated these Unaudited Financial Statements and Notes for subsequent events up through August 22, 2014.