

**THE UNION LIGHT, HEAT AND POWER COMPANY**

**DBA Duke Energy of Kentucky**

**June 30, 2006**

**Condensed Financial Statements**

**(Unaudited)**

**THE UNION LIGHT, HEAT AND POWER COMPANY**  
**CONDENSED STATEMENTS OF OPERATIONS**

	<b>Year To Date</b>	
	<b>June 30</b>	
	<b>2006</b>	<b>2005</b>
	<i>(dollars in thousands)</i>	
	<i>(unaudited)</i>	
<hr/>		
<b>Operating Revenues</b>		
Electric	\$ 129,786	\$ 111,008
Gas	79,391	76,447
<b>Total Operating Revenues</b>	<b>209,177</b>	<b>187,455</b>
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<b>Operating Expenses</b>		
Natural gas and petroleum products purchased	55,635	50,824
Operation, maintenance, and other	59,465	33,204
Fuel used in electric generation and purchased power	53,337	79,436
Depreciation and amortization	18,637	10,287
Property and other taxes	4,925	3,084
<b>Total Operating Expenses</b>	<b>191,999</b>	<b>176,835</b>
<hr/>		
<b>Operating Income</b>	<b>17,178</b>	<b>10,260</b>
<hr/>		
<b>Other Income and Expenses, net</b>	<b>2,097</b>	<b>1,565</b>
<b>Interest Expense</b>	<b>7,854</b>	<b>3,448</b>
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<b>Income from Continuing Operations Before Income Taxes</b>	<b>11,421</b>	<b>8,737</b>
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<b>Income Tax Expense from Continuing Operations</b>	<b>3,510</b>	<b>3,030</b>
<b>Net (Loss) Income</b>	<b>\$ 7,911</b>	<b>\$ 5,707</b>

See Notes to Unaudited Consolidated Financial Statements

**THE UNION LIGHT, HEAT AND POWER COMPANY**  
**CONDENSED BALANCE SHEETS**

ASSETS	June 30, 2006	December 31, 2005
	<i>(dollars in thousands)</i> <i>(unaudited)</i>	
<b>Current Assets</b>		
Cash and cash equivalents	\$ 6,454	\$ 9,876
Receivables (net of allowance for doubtful accounts of \$232 at June 30, 2006 and \$162 at December 31, 2005)	9,653	37,452
Inventory	20,093	10,767
Other	6,235	4,500
<b>Total current assets</b>	<b>42,435</b>	<b>62,595</b>
<b>Investments and Other Assets</b>		
Intangible assets	10,827	1,093
Other	1,343	560
<b>Total investments and other assets</b>	<b>12,170</b>	<b>1,653</b>
<b>Property, Plant, and Equipment</b>		
Cost	1,419,817	634,079
Less accumulated depreciation and amortization	584,892	188,614
<b>Net property, plant, and equipment</b>	<b>834,925</b>	<b>445,465</b>
<b>Regulatory Assets and Deferred Debits</b>		
Deferred debt expense	4,651	3,111
Other	8,463	5,390
<b>Total regulatory assets and deferred debits</b>	<b>13,114</b>	<b>8,501</b>
<b>Total Assets</b>	<b>\$ 902,644</b>	<b>\$ 518,214</b>

See Notes to Unaudited Consolidated Financial Statements

**THE UNION LIGHT, HEAT AND POWER COMPANY**  
**CONDENSED BALANCE SHEETS**

**LIABILITIES AND COMMON STOCKHOLDER'S EQUITY**

	<b>June 30, 2006</b>	December 31, 2005
	<i>(dollars in thousands)</i> <i>(unaudited)</i>	
<b>Current Liabilities</b>		
Accounts payable	\$ 29,542	\$ 53,021
Notes payable and commercial paper	25,504	29,777
Taxes accrued	11,005	6,769
Interest accrued	4,529	1,374
Current maturities of long-term debt and preferred stock	1,286	1,233
Other	7,297	8,965
<b>Total current liabilities</b>	<b>79,163</b>	<b>101,139</b>
<b>Long-term Debt</b>	<b>265,409</b>	<b>105,503</b>
<b>Deferred Credits and Other Liabilities</b>		
Deferred income taxes	141,387	52,800
Investment tax credit	7,175	2,373
Accrued pension and other postretirement benefit costs	21,156	19,354
Regulatory liabilities	30,190	29,038
Asset retirement obligations	8,278	6,306
Other	5,660	5,242
<b>Total deferred credits and other liabilities</b>	<b>213,846</b>	<b>115,113</b>
<b>Common Stockholder's Equity</b>		
Common stock – \$15.00 par value; 1,000,000 shares authorized and 585,333 shares outstanding at June 30, 2006 and December 31, 2005	8,780	8,780
Paid-in capital	163,615	23,760
Retained earnings	174,154	166,242
Accumulated other comprehensive loss	(2,323)	(2,323)
<b>Total Common Stock Equity</b>	<b>344,226</b>	<b>196,459</b>
<b>Total Liabilities and Shareholder's Equity</b>	<b>\$ 902,644</b>	<b>\$ 518,214</b>

See Notes to Unaudited Consolidated Financial Statements

**THE UNION LIGHT, HEAT AND POWER COMPANY**  
**CONDENSED STATEMENTS OF CASH FLOWS**

	Year Ended June 30	
	2006	2005
	<i>(dollars in thousands)</i> <i>(unaudited)</i>	
<b>Cash Flows from Operating Activities</b>		
Net (loss) income	\$ 7,912	\$ 5,707
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	18,637	10,287
(Gains) losses on sales of equity investments and other assets		
Deferred income taxes	2,576	2,561
Regulatory asset/liability amortization	2,131	1,968
Accrued pension and postretirement benefit costs	1,802	1,114
(Increase) decrease in:		
Net realized and unrealized mark-to-market and hedging transactions	319	
Receivables	27,800	17,755
Inventory	7,353	1,189
Other current assets	4,169	(891)
Increase (decrease) in:		
Accounts payable	(23,479)	(25,889)
Taxes accrued	4,236	1,998
Other current liabilities	1,168	(54)
Regulatory asset/liability deferrals	(3,979)	1,446
Other assets	262	372
Other liabilities	(487)	(2,019)
	<u>50,420</u>	<u>15,544</u>
<b>Cash Flows from Investing Activities</b>		
Capital expenditures	(30,666)	(20,876)
Purchases of emission allowances	(13,902)	-
Sale of emission allowances	3,312	-
	<u>(41,256)</u>	<u>(20,876)</u>
<b>Cash Flows from Financing Activities</b>		
Issuance of long-term debt	113,558	-
Redemption of long-term debt	(15,591)	-
Notes payable and commercial paper	(110,553)	7,621
	<u>(12,586)</u>	<u>7,621</u>
<b>Net increase (decrease) in cash and cash equivalents</b>	<u>(3,422)</u>	<u>2,289</u>
<b>Cash and cash equivalents at beginning of period</b>	<u>9,876</u>	<u>4,197</u>
<b>Cash and cash equivalents at end of period</b>	<u>\$ 6,454</u>	<u>\$ 6,486</u>
<b>Supplemental Disclosure of Cash Flow Information</b>		
Non-cash financing and investing activities:		
Equity contribution from parent company for acquisition of net generating assets (Note 1(d))	\$ 139,855	\$ -

See Notes to Unaudited Consolidated Financial Statements

## NOTES TO CONDENSED FINANCIAL STATEMENTS

**ULH&P** (dba Duke Energy Kentucky), a Kentucky corporation organized in 1901, is a combination electric and gas public utility company that provides service in northern Kentucky. **ULH&P's** common stock is wholly owned by The Cincinnati Gas & Electric Company (CG&E), an Ohio corporation organized in 1837, which is wholly owned by Cinergy Corp., a Delaware corporation organized in 1993.

### 1. Basis of Presentation

#### (a) Nature of Operations

On April 3, 2006, in accordance with their previously announced merger agreement, Duke Energy Corporation (Old Duke Energy) and **Cinergy Corp.** merged into wholly owned subsidiaries of Duke Energy Holding Corp. (Duke Energy HC), resulting in Duke Energy HC becoming the parent entity. In connection with the closing of the merger transactions, Duke Energy HC changed its name to Duke Energy Corporation ("New Duke Energy" or "Duke Energy") and Old Duke Energy converted into a limited liability company named Duke Power Company LLC. As a result of the merger transactions, each outstanding share of **Cinergy** common stock was converted into 1.56 shares of Duke Energy common stock, and each share of common stock of Old Duke Energy was converted into one share of Duke Energy common stock, which resulted in the issuance of approximately 1.2 billion shares of Duke Energy common stock. See Note 2 for additional information regarding the merger. Both Old Duke Energy and New Duke Energy are referred to as Duke Energy herein.

**Cinergy Corp.**, a Delaware corporation organized in 1993, owns all outstanding common stock of its public utility companies, **CG&E** and **PSI**, as well as Cinergy Investments, Inc. (Investments) and Duke Energy Shared Services (DESS). Investments, which is **Cinergy's** non-regulated investment holding company, is involved in (a) cogeneration and energy efficiency investments and (b) natural gas and power marketing and trading operations, conducted primarily through one of **Cinergy's** subsidiaries, Cinergy Marketing & Trading, LP (Marketing & Trading). DESS provides administrative, management, and support services to **Cinergy's** subsidiaries.

CGE's principal subsidiary, **ULH&P**, a Kentucky corporation organized in 1901, provides electric and gas service in northern Kentucky.

These Financial Statements reflect all normal recurring adjustments that are, in the opinion of management, necessary to fairly present **ULHP's** financial position and results of operations. The results disclosed in the financial statements are not necessarily indicative of results for a full year. These statements should be read in conjunction with the Financial Statements and the notes thereto included in the **ULHP** Form 10-K for the year ended December 31, 2005 (2005 10-K). Also, certain amounts in the 2005 Condensed Financial Statements have been reclassified to conform to the 2006 presentation.

#### (b) Use of Estimates

To conform with generally accepted accounting principles (GAAP) in the United States, management makes estimates and assumptions that affect the amounts reported in the Financial Statements and Notes. Although these estimates are based on management's best available knowledge at the time, actual results could differ.

#### (c) Regulation

**Cinergy's** utility operating companies use the same accounting policies and practices for financial reporting purposes as non-regulated companies under GAAP. However, sometimes actions by the Federal Energy Regulatory Commission (FERC) and the state utility commissions result in accounting treatment different from that used by non-regulated companies. When this occurs, **ULH&P** applies the provisions of SFAS No. 71. In accordance with SFAS No. 71, **ULH&P**, records regulatory assets and liabilities (expenses deferred for future recovery from customers or amounts provided in current rates to cover costs to be incurred in the future, respectively) on their Balance Sheets.

(d) *Transfer of Generating Assets from CG&E to ULHP*

In January 2006, CG&E contributed to **ULH&P** 100 percent of its ownership interest in one generating unit and one peaking plant with a combined capacity of 727 megawatts (MWs) and its 69 percent interest in another generating station with an owned capacity of 414 MWs, as follows.

<u>Generating Plant</u>	<u>Location</u>	<u>Ownership Interest</u>	<u>Fuel Type</u>	<u>Owned MW Capacity</u>
East Bend	Boone County, Kentucky	69 %	Coal	414
Miami Fort	Hamilton County, Ohio	100 <sup>(1)</sup>	Coal	163
Woodsdale	Butler County, Ohio	100	Gas	564
				<u>1,141</u>

<sup>(1)</sup> Consists of 100 percent ownership in one generating unit at Miami Fort.

The transaction was effective as of January 1, 2006 at net book value. The final required regulatory approval for the plant transfer was received in November 2005 from the SEC under the Public Utility Holding Company Act of 1935. The Kentucky Public Service Commission (KPSC) and the Federal Energy Regulatory Commission had earlier issued orders approving aspects of the transaction. The transaction will not affect current retail electric rates for **ULH&P's** customers. Updated rates are expected to be implemented January 1, 2007 pursuant to a rate case to be filed in the second quarter of 2006 that incorporates the value of these assets into **ULH&P's** rate base.

In connection with the transfer of these assets, **ULH&P** accepted a capital contribution from CG&E and assumed certain liabilities of CG&E. In particular, **ULH&P** agreed to assume from CG&E all payment, performance, and other obligations of CG&E, with respect to (i) certain tax-exempt pollution control debt currently shown on the balance sheet of CG&E, (ii) certain of CG&E's outstanding *Accounts payable to affiliated companies*, and (iii) certain deferred tax liabilities related to the assets. **ULH&P** expects to repay the tax-exempt obligations with the proceeds from a future issuance of tax-exempt debt at **ULH&P**. The accounts payable obligations were repaid initially with the proceeds from short-term borrowings and eventually through the issuance of long-term senior unsecured debentures. The following table summarizes this transaction for **ULH&P**:

	<i>(in thousands)</i>
Assets Received	
Generating Assets	\$ 375,811
Inventory	<u>23,579</u>
<b>Total Assets Received</b>	\$ 399,390
Liabilities Assumed	
Debt	\$ 76,720
Accounts payable to affiliated companies	90,280
Deferred tax liabilities	90,575
Other	<u>1,960</u>
<b>Total Liabilities Assumed</b>	\$ <u>259,535</u>
<b>Contributed Capital from CG&amp;E</b>	\$ <u>139,855</u>

As part of this transaction, CG&E and **ULH&P** terminated the long-term wholesale power contract under which CG&E had previously supplied power to **ULH&P**. Further, CG&E also proposed to supply and **ULH&P** agreed to purchase back-up power from CG&E for planned and unplanned outages at the East Bend and Miami Fort plants through December 31, 2009 pursuant to a draft contract. The parties never executed this draft contract and **ULH&P** currently purchases back-up power, when needed, through the Midwest ISO energy markets. Given changes in circumstances, including the implementation of the Midwest ISO Energy Markets Tariff, CG&E and **ULH&P** are planning to propose an alternative arrangement for supplying back-up power to **ULH&P**. At this time, whether and the conditions under which the KPSC may allow **ULH&P** to recover any increased costs for an alternative arrangement for the supply of back-up power are unknown and CG&E and **ULH&P** cannot determine the magnitude of any potential increased costs for back-up power.

## 2. *Duke Energy/Cinergy Merger*

On April 3, 2006, the previously announced merger between Duke Energy and **Cinergy**, ULHP's ultimate parent, was consummated (see Note 1(a) for additional information on the merger). For accounting purposes, the effective date of the merger was April 1, 2006. The merger combines the Duke Energy and **Cinergy** regulated franchises as well as deregulated generation in the Midwestern United States (Midwest). The merger is anticipated to provide more regulatory, geographic, and weather diversity to Duke Energy's earnings. In connection with the merger, Duke Energy issued 1.56 shares of Duke Energy common stock for each outstanding share of **Cinergy** common stock, which resulted in the issuance of approximately 313 million shares of Duke Energy common stock. Based on the market price of Duke Energy common stock during the period, including the two trading days before, through the two trading days after, May 9, 2005, the date Duke Energy and **Cinergy** announced the merger, the transaction is valued at approximately \$9.1 billion and has resulted in preliminary goodwill for **Cinergy** of approximately \$4.3 billion. The amount of goodwill results from significant strategic and financial benefits expected to be realized by **Cinergy** includes:

- increased financial strength and flexibility;
- stronger utility business platform;
- greater scale and fuel diversity, as well as improved operational efficiencies for the merchant generation business;
- broadened electric distribution platform;
- improved reliability and customer service through the sharing of best practices;
- increased scale and scope of the electric and gas businesses with stand-alone strength;
- complementary positions in the Midwest;
- greater customer diversity;
- combined expertise; and
- significant cost savings synergies.

## 3. Common Stock and Stock-based Compensation

### *Common Stock Outstanding*

CG&E holds all of the common stock of ULH&P.

In January 2006, CG&E contributed approximately \$139.8 million in capital to ULH&P in conjunction with the transfer of certain generating assets to ULH&P. See note 1(e) for additional information.

## 4. Inventory

Inventory is recorded at the lower of cost or market value, primarily using the average cost method.

ULH&P	June 30, 2006	December 31, 2005
	<i>(in millions)</i>	
<b>Inventory</b>		
Fuel for use in electric production	\$ 10	\$ -
Other materials and supplies	8	1
Gas stored for current use	2	10
<b>Total Inventory</b>	<b>\$ 20</b>	<b>\$ 11</b>

## 5. Debt and Credit Facilities

During June 2006, Cinergy Corp. and its subsidiaries amended their multi-year syndicated \$2 billion revolving credit facility to extend the expiration date, reduce costs, and conform the terms to those found in the legacy Duke Energy facilities.

Cinergy's credit agreements contain various financial and other covenants. Failure to meet those covenants beyond applicable grace periods could result in accelerated due dates and/or termination of the agreements. As of June 30, 2006, Cinergy was in compliance with those covenants. In addition, some credit agreements may allow for acceleration of payments or termination of the agreements due to nonpayment or to the acceleration of other significant indebtedness of the borrower or some of its subsidiaries. None of the credit agreements contain material adverse change clauses or any covenants based on credit ratings.

Cinergy Corp.'s short-term borrowings consist primarily of unsecured revolving lines of credit, sale of commercial paper, and pollution control notes. Cinergy Corp.'s revolving credit facility and commercial paper program also support the short-term borrowing needs of ULH&P. Cinergy's pollution control notes are tax-exempt notes that are obtained to finance equipment or land development for pollution control purposes. In addition, ULH&P maintains uncommitted lines of credit. These facilities are not firm sources of capital but rather informal agreements to lend money, subject to availability, with pricing determined at the time of advance.

### *Long-term Debt*

In January 2006, ULH&P assumed responsibility for principal and interest payments on \$61 million of CG&E's long-term pollution control bonds in conjunction with the transfer of certain generating assets to ULH&P. The bonds will still remain on CG&E's balance sheet and ULH&P's obligation will be reflected as an intercompany payable from CG&E to ULH&P. See Note 1(a) for additional information.

In March 2006, ULH&P issued \$50 million principal amount of its 5.75% Debentures due March 10, 2016 and \$65 million principal amount of its 6.20% Debentures due March 10, 2036. Proceeds from the issuances were used to repay short-term indebtedness including short-term debt arising from the transfer of generating assets from CG&E to ULH&P, the redemption of long-term debentures and for other general corporate purposes.

In April 2006, ULH&P redeemed its entire \$15 million principal amount 7.65% Debentures due in 2025.

In August 2006, ULH&P issued approximately \$77 million principal amount of floating rate tax-exempt notes due August 1, 2027. Proceeds from the issuance will be used to refund a like amount of debt on September 1, 2006 currently outstanding at CG&E. The CG&E debt was assumed by ULH&P as part of the recent transfer of generating assets from CG&E to ULH&P. Approximately \$27 million of the floating rate debt was swapped to a fixed rate concurrent with closing.

## 6. Employee Benefit Obligations

As discussed in the 2005 10-K, **ULH&P** sponsors both pension and other postretirement benefit plans. Cinergy Corp.'s qualified defined benefit pension plans cover substantially all United States employees meeting certain minimum age and service requirements. Funding for the qualified defined benefit pension plans is based on actuarially determined contributions, the maximum of which is generally the amount deductible for tax purposes and the minimum being that required by the Employee Retirement Income Security Act of 1974, as amended. The pension plans' assets consist of investments in equity and debt securities. In addition, Cinergy sponsors non-qualified pension plans (plans that do not meet the criteria for certain tax benefits) that cover officers, certain other key employees, and non-employee directors. Cinergy also provides certain health care and life insurance benefits to retired United States employees and their eligible dependents. These benefits are subject to minimum age and service requirements. The health care benefits include medical coverage, dental coverage, and prescription drug coverage and are subject to certain limitations, such as deductibles and co-payments.

There were no qualified pension benefit contributions for either the six months ended June 30, 2006. Cinergy expects to make approximately \$120 million in qualified pension contributions during the remainder of 2006.

Cinergy's benefit plans' costs for the periods presented include the following components:

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
<i>(in millions)</i>		
<b>Qualified Pension Benefits</b>		
Service cost	\$ 25.4	\$ 19.2
Interest cost	55.2	48.1
Expected return on plans' assets	(48.1)	(44.1)
Amortization of transition (asset) obligation	-	(0.1)
Amortization of prior service cost	0.9	2.3
Amortization of actuarial loss	4.6	3.9
Net periodic benefit cost	<b>\$ 38.0</b>	<b>\$ 29.3</b>
<b>Non-Qualified Pension Benefits</b>		
Service cost	\$ 1.9	\$ 2.8
Interest cost	3.6	3.6
Amortization of prior service cost	0.6	1.0
Amortization of actuarial loss	1.0	1.2
Net periodic benefit cost	<b>\$ 7.1</b>	<b>\$ 8.6</b>
<b>Other Postretirement Benefits</b>		
Service cost	\$ 3.9	\$ 3.2
Interest cost	14.3	11.4
Amortization of transition (asset) obligation	-	0.2
Amortization of prior service cost	(0.2)	(0.4)
Amortization of actuarial loss	2.5	5.5
Net periodic benefit cost	<b>\$ 20.5</b>	<b>\$ 19.9</b>

The net periodic benefit costs for ULH&P for the six months ended June 30, 2006, and June 30, 2005, were \$2.0M and \$1.4M, respectively.

Upon consummation of the merger with Duke Energy, all defined benefit plan obligations were remeasured. ULH&P updated the assumptions used to determine its accrued benefit obligations and prospective net periodic benefit cost. The weighted-average assumptions used to determine benefit obligations are as follows:

	Qualified Pension Benefits	Non-Qualified Pension Benefits	Other Postretirement Benefits
Discount rate	6.00%	6.00%	6.00%
Salary increase	5.00%	5.00%	5.00%
Expected long-term rate of return on plan assets	8.50%	N/A	N/A

The assumed health care cost trend rates are as follows:

	Not Medicare Eligible	Medicare Eligible
Health care cost trend rate assumed for 2006	8.50 %	11.50 %
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.50 %	5.50 %
Year that the rate reaches the ultimate trend rate	2009	2012

## **7. Regulatory Matters**

### **(a) Regulatory Merger Approvals**

As discussed in Note 2, on April 3, 2006, the merger between Duke Energy and Cinergy was consummated to create a newly formed company, Duke Energy HC. As a condition to the merger approval, the Public Utilities Commission of Ohio (PUCO) and the Kentucky Public Service Commission (KPSC) required that certain merger related savings be shared with customers in Ohio and Kentucky, respectively. Each of the commissions also required Duke Energy HC, Cinergy, CG&E, and/or ULH&P to meet additional conditions. The KPSC's conditions include a requirement that ULH&P provide \$7.6 million in rate credits to ULH&P customers over five years, ending when new rates are established in the next rate case after January 1, 2008. As of June 30, 2006, ULH&P has returned \$1 million to customers on this rate credit.

In addition, the FERC approved the merger without conditions. On January 19, 2006, Public Citizen's Energy Program, Citizens Action Coalition of Indiana, Inc., Ohio Partners for Affordable Energy and Southern Alliance for Clean Energy requested rehearing of the FERC approval. On February 21, 2006, the FERC issued an order granting rehearing of FERC's order for further consideration. A decision by the FERC is expected in the third quarter of 2006.

### **(b) ULH&P Gas Rate Case**

In 2002, the KPSC approved ULH&P's gas base rate case which included, among other things, recovery of costs associated with an accelerated gas main replacement program. The approval authorized a tracking mechanism to recover such costs including depreciation and a rate of return on the program's capital expenditure. The Kentucky Attorney General has appealed to the Franklin Circuit Court the KPSC's approval of the tracking mechanism. In 2005, both ULH&P and the KPSC requested that the Court dismiss the case. At the present time, Cinergy and ULH&P cannot predict the timing or outcome of this litigation.

In February 2005, ULH&P filed a gas base rate case with the KPSC requesting approval to continue the tracking mechanism and for a \$14 million annual increase in base rates. A portion of the increase is attributable to including recovery of the current cost of the accelerated gas main replacement program in base rates. The KPSC did not rule on the base rate case request or the request to continue the tracking mechanism by October 1, 2005; consequently, the initial tracking mechanism expired on September 30, 2005. In accordance with Kentucky law, ULH&P implemented the full amount of the requested rate increase on October 1, 2005. In December 2005, the KPSC approved an annual rate increase of \$8.1 million and approved the tracking mechanism through 2011. Pursuant to the KPSC's order, ULH&P filed a refund plan in January 2006 for the excess revenues collected since October 1, 2005. In February 2006, the KPSC issued an additional order responding to a rehearing request made by the Attorney General. Its rehearing order re-approved ULH&P's refund plan, which resulted in refunds being provided to customers beginning in March 2006. In February 2006, the Attorney General appealed the KPSC's order to the Franklin Circuit Court, claiming that the order improperly allows ULH&P to increase its rates for gas main replacement costs in between general rate cases, and also claiming that the order improperly allows ULH&P to earn a return on investment for the costs recovered under the tracking mechanism which permits ULH&P to recover its gas main replacement costs. At this time, Cinergy and ULH&P cannot predict the outcome of this proceeding.

### **(c) ULHP Electric Rate Case**

In May 2006, ULH&P filed an application for an increase in its base electric rates. The application, which seeks an increase of approximately \$65 million in revenue, or approximately 28 percent, to be effective in January 2007, was filed pursuant to the KPSC's 2003 Order approving the transfer of 1,100 MW of generating assets from CG&E to ULH&P. ULH&P is also seeking reinstatement of its fuel cost recovery mechanism which has been frozen since 2001, and has proposed to refresh the pricing for the back-up power supply contract, to reflect current market pricing. At this time, ULH&P cannot predict the outcome of this proceeding.

**(d) Midwest ISO Revenue Sufficiency Guarantee (RSG)**

On April 25, 2006, the FERC issued an order on the Midwest ISO's revisions to its Transmission and Energy Markets Tariffs regarding its RSG. The FERC found that the Midwest ISO violated the tariffs when it did not charge RSG costs to virtual supply offers. The FERC, among other things, ordered the Midwest ISO to recalculate the rate and make refunds to customers, with interest, to reflect the correct allocation of RSG costs. DESS, on behalf of PSI, CG&E, and ULH&P, has filed a Request for Rehearing, and the matter is currently pending before the FERC. At this time, Cinergy, CG&E, ULH&P, and PSI cannot predict the outcome of this matter and whether it will have a material effect on their financial position or results of operations.

**8. Commitments and Contingencies**

**(a) Environmental**

*(i) Emission Reduction Rulemakings*

In October 1998, the Environmental Protection Agency (EPA) finalized its ozone transport rule, also known as the NO<sub>x</sub> State Implementation Plan (SIP) Call, which addresses wind-blown ozone and ozone precursors that impact air quality in downwind states.

ULH&P has installed selective catalytic reduction units and other pollution controls and implemented certain combustion improvements at various generating stations to comply with the NO<sub>x</sub> SIP Call.

The EPA finalized its Clean Air Interstate Rule (CAIR) in May 2005. The rule limits total annual SO<sub>2</sub> and NO<sub>x</sub> emissions and summer NO<sub>x</sub> emissions from electric generating facilities across the Eastern United States through a two-phased cap-and-trade program. Phase 1 begins in 2009 for NO<sub>x</sub> and in 2010 for SO<sub>2</sub>. Phase 2 begins in 2015 for both NO<sub>x</sub> and SO<sub>2</sub>. The rule requires SO<sub>2</sub> and NO<sub>x</sub> emissions to be cut by 70 percent and 65 percent, respectively, by 2015. The rule gives states the option of participating in the national trading program. If a state chooses not to participate, then the rule sets a fixed limit on that state's annual emissions.

The EPA finalized its Clean Air Mercury Rule (CAMR) in May 2005. The rule limits total annual mercury emissions from coal-fired power plants across the United States through a two-phased cap-and-trade program. Phase 1 begins in 2010 and Phase 2 begins in 2018. The rule gives states the option of participating in the national trading program. If a state chooses not to participate, then the rule sets a fixed limit on that state's annual emissions.

Numerous states, environmental organizations, industry groups, including some of which Cinergy is a member, and individual companies have challenged various portions of the rules. Those challenges are currently pending in the United States Circuit Court for the District of Columbia. On October 21, 2005, the EPA agreed to reconsider certain aspects of the CAMR as well as the determination not to regulate mercury under Section 112 of the Clean Air Act (CAA). On June 9, 2006, the EPA took final action on the issues being reconsidered and determined that its original decisions were reasonable and should not be changed. At this time, Cinergy cannot predict the outcome of these matters.

Cinergy has spent \$0.45 billion through 2005 to comply with Phase 1 of the CAIR and CAMR rules and currently estimates that it will spend an additional \$1.23 billion over the 2006-2011 time periods, for a total of \$1.68 billion. The projected expenditures include estimated costs to comply at plants that Cinergy owns but does not operate and could change when taking into consideration compliance plans of co-owners or operators involved. Moreover, as market conditions change, additional compliance options may become available and Cinergy's plans will be adjusted accordingly. CG&E receives partial recovery of depreciation and financing costs related to environmental compliance projects for 2005-2008 through its MBSSO. See Note 7(d) for more details.

The EPA made final state non-attainment area designations to implement the revised ozone standard and to implement the new fine particulate standard in June 2004 and April 2005, respectively. Several counties in which Cinergy operates have been designated as being in non-attainment with the new ozone standard and/or fine particulate standard. States with counties that are designated as being in non-attainment with the new ozone and/or

fine particulate standards are required to develop a plan of compliance by June 2007 and April 2008, respectively. Industrial sources in or near those counties are potentially subject to requirements for installation of additional pollution controls. In March 2005, various states, local governments, environmental groups, and industry groups, including some of which Cinergy is a member, filed petitions for review in the U.S. Court of Appeals for the D.C. Circuit to challenge the EPA's particulate matter non-attainment designations. Although the EPA has attempted to structure CAIR to resolve purported utility contributions to ozone and fine particulate non-attainment, at this time, Cinergy cannot predict the effect of current or future non-attainment designations on its consolidated financial position or results of operations.

In July 2005, the EPA issued its final regional haze rules and implemented guidelines in response to a 2002 judicial ruling overturning key provisions of the original program. The regional haze program is aimed at reducing certain emissions impacting visibility in national parks and wilderness areas. The EPA has announced that it can foresee no circumstances where the requirements of the regional haze rule would require utility controls beyond those required under CAIR. The EPA also found that states participating in the CAIR cap and trade program need not require electric generating units to adhere to best available retrofit technology requirements. The states have until December 2007 to finalize their SIPs addressing compliance with EPA regulations. The states may choose to implement more stringent guidelines than promulgated by the EPA, and therefore, it is not possible to predict whether the regional haze rule will have a material effect on Cinergy's financial positions or results of operations.

(ii) *Section 126 Petitions*

In March 2004, the state of North Carolina filed a petition under Section 126 of the CAA in which it alleges that sources in 13 upwind states including Ohio, Indiana, and Kentucky, significantly contribute to North Carolina's non-attainment with certain ambient air quality standards. In August 2005, the EPA issued a proposed response to the petition. The EPA proposed to deny the ozone portion of the petition based upon a lack of contribution to air quality by the named states. The EPA also proposed to deny the particulate matter portion of the petition based upon the CAIR Federal Implementation Plan (FIP), which would address the air quality concerns from neighboring states. On April 28, 2006, the EPA denied North Carolina's petition based upon the final CAIR FIP described above. North Carolina has filed a legal challenge to the EPA's denial.

(iii) *Carbon Dioxide (CO<sub>2</sub>) Lawsuit*

In July 2004, the states of Connecticut, New York, California, Iowa, New Jersey, Rhode Island, Vermont, Wisconsin, and the City of New York brought a lawsuit in the United States District Court for the Southern District of New York against Cinergy, American Electric Power Company, Inc., American Electric Power Service Corporation, The Southern Company, Tennessee Valley Authority, and Xcel Energy Inc. That same day, a similar lawsuit was filed in the United States District Court for the Southern District of New York against the same companies by Open Space Institute, Inc., Open Space Conservancy, Inc., and The Audubon Society of New Hampshire. These lawsuits allege that the defendants' emissions of CO<sub>2</sub> from the combustion of fossil fuels at electric generating facilities contribute to global warming and amount to a public nuisance. The complaints also allege that the defendants could generate the same amount of electricity while emitting significantly less CO<sub>2</sub>. The plaintiffs are seeking an injunction requiring each defendant to cap its CO<sub>2</sub> emissions and then reduce them by a specified percentage each year for at least a decade. In September 2005, the district court granted the defendants' motion to dismiss the lawsuit. The plaintiffs have appealed this ruling to the Second Circuit Court of Appeals. Oral argument was held before the Second Circuit Court of Appeals in June 2006. Cinergy is not able to predict whether resolution of these matters would have a material effect on its financial position or results of operations.

(iv) *Manufactured Gas Plant (MGP) Sites*

ULH&P has performed site assessments on certain of its sites where MGP activities are believed to have occurred at some point in the past and have found no imminent risk to the environment. At this time, ULH&P cannot predict whether investigation and/or remediation will be required in the future at any of these sites.

(v) *Ontario, Canada Lawsuit*

Cinergy, CG&E, ULH&P, and PSI understand that a class action lawsuit was filed in Superior Court in Ontario, Canada against Cinergy, CG&E, and PSI and approximately 20 other utility and power generation companies alleging various claims relating to environmental emissions from coal-fired power generation facilities in the United States and Canada and damages of approximately \$50 billion, with continuing damages in the amount of approximately \$4 billion annually. Cinergy, CG&E, and PSI understand that the lawsuit also claims entitlement to punitive and exemplary damages in the amount of \$1 billion. Cinergy, CG&E, and PSI have not yet been served in this lawsuit; however, if served, Cinergy, CG&E, and PSI intend to defend this lawsuit vigorously in court. At this time, Cinergy, CG&E, and PSI are not able to predict whether resolution of this matter would have a material effect on Cinergy's, CG&E's, and PSI's financial position or results of operations.

(vi) *Hurricane Katrina Lawsuit*

On April 19, 2006, Cinergy was named in the third amended complaint of a purported class action filed in the United States District Court for the Southern District of Mississippi. Plaintiffs claim that Cinergy, along with numerous other utilities, oil companies, coal companies and chemical companies, is liable for damages relating to losses suffered by victims of Hurricane Katrina. Plaintiffs claim that Cinergy's, and others', greenhouse gas emissions contributed to the frequency and intensity of storms such as Hurricane Katrina. Cinergy has not been served with this lawsuit; however, if served Cinergy intends to defend this lawsuit vigorously in court. At this time, Cinergy is not able to predict whether resolution of this matter would have a material effect on Cinergy's financial position or results of operations.

(vii) *Other Litigation and Legal Proceedings*

As part of their normal business, Cinergy, CG&E, ULH&P, and PSI are party to various financial guarantees, performance guarantees, and other contractual commitments to extend guarantees of credit and other assistance to various subsidiaries, investees, and other third parties. To varying degrees, these guarantees involve elements of performance and credit risk, which are not included on the Consolidated Balance Sheets. The possibility of Cinergy, CG&E, and PSI having to honor their contingencies is largely dependent upon future operations of various subsidiaries, investees, and other third parties, or the occurrence of certain future events. For further information, see Note 15.

In addition, Cinergy, CG&E, and PSI enter into various fixed-price, non-cancelable commitments to purchase or sell power (tolling arrangements or power purchase contracts), take-or-pay arrangements, transportation or throughput agreements, and other contracts that may or may not be recognized on the Consolidated Balance Sheets. Some of these arrangements may be recognized at market value on the Consolidated Balance Sheets as trading contracts or qualifying hedge positions included in unrealized gains or losses on MTM and hedging transactions.

## 9. Related Party Transactions

ULH&P engages in related party transactions. These transactions are generally performed at cost and in accordance with the applicable state and federal commission regulations. The Consolidated Balance Sheet of ULH&P reflect amounts payable to and/or receivables from related parties as Accounts payable and Receivables, respectively. The amounts for ULH&P, at June 30, 2006, were as follows:

	<u>June 30, 2006</u> <i>(in millions)</i>
<b>ULH&amp;P</b>	
Accounts payable	\$ 18
Receivables	-

## 10. Income Tax Expense

As of June 30, 2006, Cinergy had total provisions of approximately \$58 million for uncertain tax positions, as compared to approximately \$56 million as of December 31, 2005, including interest. Management is not aware of any issues for open tax years that upon final resolution are expected to have a material adverse effect on Cinergy's consolidated results of operations, cash flows, or financial position.

The effective tax rate for ULH&P, was 30.7% and 34.7% respectively for the six months ended June 30, 2006, and June 30, 2005

As a result of the Duke Energy/Cinergy merger consummation, Cinergy and its subsidiaries entered into a new tax sharing agreement with Duke Energy, where the separate return method is used to allocate benefits to the subsidiaries whose investments or results of operations provide these tax benefits. This new agreement with Duke Energy supersedes the previous agreement between Cinergy and its subsidiaries.

## 11. Severance

### *(viii) Merger-Related Obligations*

Several of Cinergy's, CG&E's, and PSI's benefit plans contain "change-in-control" clauses that provide enhanced, and/or accelerated benefits to management level employees in the event of a qualifying transaction such as occurred with the consummation of the merger with Duke Energy as discussed in Note 2. These include benefits paid pursuant to the LTIP and certain payments under Cinergy's Annual Incentive Plan. Certain employees are also entitled to additional severance and benefits in the event they are involuntarily terminated without "cause" or voluntarily terminate for "good reason" (as such terms are defined in their employment agreements) in connection with or following the merger.

On December 30, 2005, Cinergy entered into agreements with 28 employees to accelerate the payment of a portion of the amounts discussed above, otherwise expected to be paid after December 31, 2005. Payments totaling \$70 million were made in December pursuant to these agreements. The agreements amended the employees' employment agreements, and benefit plans in which they participate, to accelerate into 2005 the payment of certain amounts that they have previously earned or are expected to earn after December 31, 2005. Among other things, Cinergy prepaid performance shares under the LTIP and severance payments for certain individuals. In the event an employee who received such amounts voluntarily terminated his or her employment prior to the closing of the merger, the employee would have been obligated to repay all of the payments, and if the merger did not close on or prior to December 15, 2006, the employee would have been obligated to repay half of the payments, to reflect his or her estimated tax liability upon receipt of the accelerated payments; in each case, less any amounts that the employee has already earned through such date. None of the 28 employees invoked this payback provision. By accelerating these payments, Cinergy mitigated taxes and related expenses that it would otherwise have incurred if it had waited until after 2005 to make these payments.

The majority of these payments were recorded as prepaid compensation in Current Assets - Other. Approximately half of these payments were accounted for as a retention bonus and expensed over the period between January 1, 2006 and the closing of the merger with Duke Energy. The remainder, representing the half that executives must repay if the merger was never consummated, remained in Current Assets - Other until the merger closed and were accounted for as part of purchase/push-down accounting.

In addition to payments made in December, based on certain assumptions and using Cinergy's, CG&E's, and PSI's current best estimates, Cinergy's, CG&E's, and PSI's remaining contractual obligations that were triggered upon merger consummation, including severance payments for those executives that have indicated their intention to terminate for "good reason", were approximately \$90 million (\$42 million of which is related to severance), and these amounts were accounted for in April 2006 when the merger closed. The payments will be paid in 2006 and, under certain circumstances, in subsequent years. These payments only included amounts payable pursuant to existing benefit arrangements, employment contracts, and severance accepted by employees and contingent on the merger closing. These payments do not include the value of accelerated stock options and retirement benefits earned prior to the merger.