

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

**DBA Duke Energy of Kentucky**

**September 30, 2006**

**Condensed Financial Statements**

**(Unaudited)**

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

	<b>Year To Date</b>	
	<b>September 30</b>	
	<b>2006</b>	<b>2005</b>
	<i>(dollars in thousands)</i>	
	<i>(unaudited)</i>	
<hr/>		
<b>Operating Revenues</b>		
Electric	\$ 202,617	\$ 183,002
Gas	93,305	89,887
<b>Total Operating Revenues</b>	<u>295,922</u>	<u>272,889</u>
<hr/>		
<b>Operating Expenses</b>		
Natural gas and petroleum products purchased	62,303	57,397
Operation, maintenance, and other	88,252	50,182
Fuel used in electric generation and purchased power	88,300	128,464
Depreciation and amortization	28,190	15,547
Property and other taxes	7,655	3,618
<b>Total Operating Expenses</b>	<u>274,700</u>	<u>255,208</u>
<hr/>		
<b>Operating Income</b>	21,222	17,681
<hr/>		
<b>Other Income and Expenses, net</b>	2,911	2,219
<b>Interest Expense</b>	12,314	5,150
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<b>Income from Continuing Operations Before Income Taxes</b>	11,819	14,750
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<b>Income Tax Expense from Continuing Operations</b>	<u>3,475</u>	<u>5,409</u>
<b>Net Income</b>	<u>\$ 8,344</u>	<u>\$ 9,341</u>

See Notes to Unaudited Consolidated Financial Statements

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

ASSETS	September 30, 2006	December 31, 2005
	<i>(dollars in thousands)</i> <i>(unaudited)</i>	
<b>Current Assets</b>		
Cash and cash equivalents	\$ 5,550	\$ 9,876
Receivables (net of allowance for doubtful accounts of \$292 at September 30, 2006 and \$162 at December 31, 2005)	10,203	37,452
Inventory	20,012	10,767
Other	5,574	4,500
<b>Total current assets</b>	<b>41,339</b>	<b>62,595</b>
<b>Investments and Other Assets</b>		
Intangible assets	14,797	1,093
Other	264	560
<b>Total investments and other assets</b>	<b>15,061</b>	<b>1,653</b>
<b>Property, Plant, and Equipment</b>		
Cost	1,432,913	634,079
Less accumulated depreciation and amortization	592,776	188,614
<b>Net property, plant, and equipment</b>	<b>840,137</b>	<b>445,465</b>
<b>Regulatory Assets and Deferred Debits</b>		
Deferred debt expense	7,059	3,111
Other	8,992	5,390
<b>Total regulatory assets and deferred debits</b>	<b>16,051</b>	<b>8,501</b>
<b>Total Assets</b>	<b>\$ 912,588</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>September 30,</b> <b>2006</b>	<b>December 31,</b> <b>2005</b>
	<i>(dollars in thousands)</i> <i>(unaudited)</i>	
<b>Current Liabilities</b>		
Accounts payable	\$ 23,639	\$ 53,021
Notes payable and commercial paper	27,181	29,777
Taxes accrued	9,269	6,769
Interest accrued	2,004	1,374
Current maturities of long-term debt and preferred stock	1,334	1,233
Other	7,451	8,965
<b>Total current liabilities</b>	<b>70,878</b>	<b>101,139</b>
<b>Long-term Debt</b>	<b>281,100</b>	<b>105,503</b>
<b>Deferred Credits and Other Liabilities</b>		
Deferred income taxes	145,211	52,800
Investment tax credit	6,904	2,373
Accrued pension and other postretirement benefit costs	19,819	19,354
Regulatory liabilities	28,172	29,038
Asset retirement obligations	8,399	6,306
Other	8,032	5,242
<b>Total deferred credits and other liabilities</b>	<b>216,537</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 September 30, 2006 and December 31, 2005	8,780	8,780
Paid-in capital	163,615	23,760
Retained earnings	174,586	166,242
Accumulated other comprehensive loss	(2,908)	(2,323)
<b>Total Common Stock Equity</b>	<b>344,073</b>	<b>196,459</b>
<b>Total Liabilities and Shareholder's Equity</b>	<b>\$ 912,588</b>	<b>\$ 518,214</b>

See Notes to Unaudited Consolidated Financial Statements

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

	<b>Year Ended September 30</b>	
	<b>2006</b>	<b>2005</b>
	<i>(dollars in thousands)</i> <i>(unaudited)</i>	
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 8,344	\$ 9,341
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	28,190	15,547
(Gains) losses on sales of equity investments and other assets	(104)	-
Deferred income taxes	6,450	4,296
Regulatory asset/liability amortization	2,687	2,697
Accrued pension and postretirement benefit costs	2,989	2,039
(Increase) decrease in:		
Net realized and unrealized mark-to-market and hedging transactions	965	
Receivables	27,249	21,072
Inventory	7,434	(2,632)
Other current assets	4,830	(598)
Increase (decrease) in:		
Accounts payable	(29,382)	(13,286)
Taxes accrued	2,500	3,124
Other current liabilities	(885)	235
Regulatory asset/liability deferrals	(5,404)	944
Other assets	1,412	151
Other liabilities	(5,085)	(5,306)
	<b>52,190</b>	<b>37,624</b>
<b>Cash Flows from Investing Activities</b>		
Capital expenditures	(44,646)	(32,250)
Purchases of emission allowances	(21,704)	-
Sale of emission allowances	4,748	-
	<b>(61,602)</b>	<b>(32,250)</b>
<b>Cash Flows from Financing Activities</b>		
Issuance of long-term debt	190,552	-
Redemption of long-term debt	(76,590)	-
Notes payable and commercial paper	(108,876)	(1,683)
	<b>5,086</b>	<b>(1,683)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(4,326)</b>	<b>3,691</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>9,876</b>	<b>4,197</b>
<b>Cash and cash equivalents at end of period</b>	<b>\$ 5,550</b>	<b>\$ 7,888</b>
<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

### 1. Basis of Presentation

#### *(a) Nature of Operations and Basis of Consolidation*

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, Duke Energy Ohio (formerly known as 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.

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.

#### *(b) Presentation*

These Financial Statements reflect all normal recurring adjustments that are, in the opinion of management, necessary to fairly present ULH&P’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 ULH&P 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.

A review of the Securities and Exchange Commission (SEC) regulations has indicated that ULH&P’s financial statements are not required to use push-down accounting; and therefore, management has elected not to do so.

#### *(c) Regulation*

Duke Energy Ohio’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 ULH&P**

In January 2006, Duke Energy Ohio 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.

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

(1) 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. See note 7(c) for details on Duke Energy Kentucky rate proceedings.

In connection with the transfer of these assets, ULH&P accepted a capital contribution from Duke Energy Ohio and assumed certain liabilities of Duke Energy Ohio. In particular, ULH&P agreed to assume from Duke Energy Ohio all payment, performance, and other obligations of Duke Energy Ohio, with respect to (i) certain tax-exempt pollution control debt currently shown on the balance sheet of Duke Energy Ohio, (ii) certain of Duke Energy Ohio'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:

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

As part of this transaction, Duke Energy Ohio and ULH&P terminated the long-term wholesale power contract under which Duke Energy Ohio had previously supplied power to ULH&P. Further, Duke Energy Ohio also proposed to supply and ULH&P agreed to purchase back-up power from Duke Energy Ohio 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. Under the proposed settlement in its electric rate case (see note 7(c)), ULH&P will continue to use its best efforts to procure back-up power supply and to obtain Federal Energy Regulatory Commission approval, if necessary, as soon as possible. The revenue increase in the proposed settlement recovers all demand charges for back-up power. Effective on and after January 1, 2007, Duke Energy Kentucky shall recover energy charges for back-up power consistent with the KPSC's fuel adjustment cost regulations. ULH&P shall file, subject to KPSC's approval, a least cost back-up supply plan with the KPSC when such plan is completed but in no event later than its March 2007 fuel adjustment cost filing.

### *(e) 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.

## **2. Duke Energy/Cinergy Merger**

On April 3, 2006, the previously announced merger between Duke Energy and Cinergy was consummated (see Note 1 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, transaction is valued at approximately \$9.1 billion and has resulted in preliminary goodwill recorded at Duke Energy Ohio of approximately \$2.2 billion. The amount of goodwill results from significant strategic and financial benefits expected to be realized by Duke Energy Ohio including:

- 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**

Duke Energy Ohio holds all of the common stock of ULH&P.

In January 2006, Duke Energy Ohio 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 for additional information.

## **4. Inventory**

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

<b>ULH&amp;P</b>	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	<i>(in millions)</i>	
<b>Inventory</b>		
Fuel for use in electric production	\$ 9	\$ -
Other materials and supplies	9	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 September 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 Duke Energy of Ohio's long-term pollution control bonds in conjunction with the transfer of certain generating assets to ULH&P. The bonds will still remain on Duke Energy of Ohio's balance sheet and ULH&P's obligation will be reflected as an intercompany payable from Duke Energy of Ohio to ULH&P. See Note 1 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 Duke Energy of Ohio to ULH&P, the redemption of long-term debentures and for other general corporate purposes.

In April 2006, ULH&P redeemed all of its \$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 Duke Energy Ohio. The Duke Energy Ohio debt was assumed by ULH&P as part of the recent transfer of generating assets from Duke Energy Ohio to ULH&P. Approximately \$27 million of the floating rate debt was swapped to a fixed rate concurrent with closing.

## **6. Employee Benefit Obligations**

Duke Energy Kentucky participates in pension and other postretirement benefit plans sponsored by Cinergy. Cinergy'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 three months ended March 31, 2006 or June 30, 2006. Duke Energy contributed approximately \$124 million to the legacy Cinergy qualified pension plans in third quarter 2006. Additional contributions are not planned for 2006.

Duke Energy Kentucky's net periodic benefit costs as allocated by Cinergy were as follows:

	Successor <sup>(1)</sup>	
	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
<b>Qualified Pension Benefits</b>	\$ 1.9	\$ 1.2
<b>Other Postretirement</b>	\$ .9	\$ .8

The net periodic benefit costs for ULH&P for the nine months ended September 30, 2006, and September 30, 2005, were \$2.8M and \$2.0M, respectively.

Upon consummation of the merger with Duke Energy, all defined benefit plan obligations were remeasured. Cinergy Corp. updated the assumptions used to determine their accrued benefit obligations and prospective net periodic benefit cost to be allocated to Duke Energy Ohio.

## 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 Holding Corp. (subsequently renamed Duke Energy Corporation). 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 consumers in Ohio and Kentucky, respectively. The commissions also required Duke Energy Ohio and ULH&P to meet additional conditions. Key elements of these conditions include:

The KPSC required that ULH&P provide \$8 million in rate reductions to Duke Energy Kentucky customers over five years, ending when new rates are established in the next rate case after January 1, 2008. As of September 30, 2006, ULH&P has returned \$1 million to customers on this rate reduction.

In addition, The FERC approved the merger without conditions. In January 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. In February 2006, the FERC issued an order granting rehearing of FERC's order for further consideration. A decision by the FERC is expected in the fourth quarter of 2006.

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

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 certain costs including depreciation and a rate of return on the program's capital expenditures. The Kentucky Attorney General appealed to the Franklin Circuit Court the KPSC's approval of the tracking mechanism as well as the KPSC's subsequent approval of annual rate adjustments under this tracking mechanism. In 2005, both ULH&P and the KPSC requested that the court dismiss these cases. At the present time, 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 recovery

of the current cost of the accelerated main replacement program in base rates. In December 2005, the KPSC approved an annual rate increase of \$8 million and re-approved the tracking mechanism through 2011. In February 2006, the Kentucky 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, ULH&P cannot predict the outcome of this litigation.

***(c) ULH&P 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 \$67 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 Duke Energy Ohio to ULH&P. ULH&P also seeks to reinstate 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. After ULH&P supplemented its filing in June 2006, the KPSC issued an order in June 2006, shortening the notice period for new rates from 30 to 20 days and suspending rates for six months, until January 6, 2007. ULH&P has reached a settlement agreement in principle with all parties to this proceeding resolving all the issues raised in the proceeding. Among other things, the settlement agreement provides for a \$49 million increase in ULH&P's base electric rates. The KPSC is expected to render a decision on the settlement agreement during the fourth quarter of 2006. At this time, ULH&P cannot predict the outcome of this proceeding.

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

In April 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. Duke Energy Shared Services, on behalf of ULH&P, has filed a Request for Rehearing, and the matter is currently pending before the FERC. At this time ULH&P cannot predict the outcome of this matter and whether it will have a material effect on its consolidated financial position, cash flows 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. The EPA's final rule, which applies to 22 states in the eastern United States including Ohio and Kentucky, required states to develop rules to reduce NO<sub>x</sub> emissions from utility and industrial sources.

Cinergy, Duke Energy Ohio, ULH&P, and PSI have 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. Cinergy also utilizes the NO<sub>x</sub> emission allowance market to buy or sell NO<sub>x</sub> emission allowances as appropriate. As of September 30, 2006, Duke Energy Ohio has incurred approximately \$275 million in capital costs to comply with this program and does not anticipate significant additional costs.

The EPA finalized its CAIR in May 2005. The rule limits total annual and summertime NO<sub>x</sub> emissions and annual SO<sub>2</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 region wide 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 emissions allowance trading program. If a state chooses not to participate, then the rule sets a fixed limit on the emissions from that state's affected sources.

The EPA finalized its 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 emissions allowance trading program. If a state chooses not to participate, then the rule sets a fixed limit on annual mercury emissions from that state's coal-fired power plants.

Numerous states, environmental organizations, industry groups, including some of which Duke Energy Ohio 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, Duke Energy Ohio cannot predict the outcome of these legal challenges.

Duke Energy Ohio has spent approximately \$150 million through 2005 to comply with Phase 1 of the CAIR and CAMR rules and currently estimates that it will spend an additional approximately \$500 million over the 2006-2011 time period. The projected expenditures include estimated costs to comply at plants that Duke Energy Ohio 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 Duke Energy Ohio's plans will be adjusted accordingly. Duke Energy Ohio receives partial recovery of depreciation and financing costs related to environmental compliance projects for 2005-2008 through its MBSSO. See Note 13 for more details. Duke Energy Ohio believes all costs determined to have been prudently incurred to comply with such rules will be recovered through rates approved by the PUCO or KPSC.

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 Duke Energy Ohio 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 Duke Energy Ohio 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, Duke Energy Ohio cannot predict the effect of current or future non-attainment designations on its consolidated financial position, cash flows 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 Duke Energy Ohio's consolidated financial position, cash flows 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), that 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 Duke Energy Ohio, 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. Duke Energy Ohio is not able to predict whether resolution of these matters would have a material effect on its consolidated financial position, cash flows 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*

Duke Energy Ohio, ULH&P, and PSI understand that a class action lawsuit was filed in Superior Court in Ontario, Canada against Duke Energy Ohio 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. Duke Energy Ohio and PSI have not yet been served in this lawsuit; however, if served, Duke Energy Ohio and PSI intend to defend this lawsuit vigorously in court. At this time, Duke Energy Ohio and PSI are not able to predict whether resolution of this matter would have a material effect on Duke Energy Ohio's and PSI's financial position or results of operations.

*(vi) Hurricane Katrina Lawsuit*

On April 19, 2006, Duke Energy Ohio 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 Duke Energy Ohio's, and others', greenhouse gas emissions contributed to the frequency and intensity of storms such as Hurricane Katrina. Duke Energy Ohio has not been served with this lawsuit; however, if served Cinergy intends to defend this lawsuit vigorously in court. It is not possible to predict with certainty whether Duke Energy Ohio will incur any liability or to estimate the damages, if any, that Duke Energy Ohio might incur in connection with this matter.

*(vii) Other Litigation and Legal Proceedings*

As part of their normal business, Duke Energy Ohio, ULH&P, and PSI are involved in other legal, tax and regulatory proceedings arising in the ordinary course of business, some of which could involve substantial amounts. Management believes that the final disposition of these proceedings will not have a material adverse effect on Duke Energy Ohio's consolidated results of operations, cash flows or financial position.

As part of its normal business, Duke Energy Ohio is party to various financial guaranties, performance guaranties, and other contractual commitments to extend guaranties of credit and other assistance to various subsidiaries, investees, and other third parties. To varying degrees, these guaranties involve elements of performance and credit risk, which are not included on the Consolidated Balance Sheets. The possibility of Duke Energy Ohio having to honor its contingencies is largely dependent upon future operations of various subsidiaries, investees, and other third parties, or the occurrence of certain future events.

In addition, Duke Energy Ohio enters 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 September 30, 2006, were as follows:

	<u>September 30, 2006</u>	
	<i>(in millions)</i>	
<b>ULH&amp;P</b>		
Accounts payable	\$	13
Receivables	\$	(3)

**10. Income Tax Expense**

Although the outcome of tax audits is uncertain, management believes that adequate provisions for income and other taxes have been made for potential liabilities resulting from such matters. Management is not aware of any issues for open tax years that upon final resolution are expected to have a material adverse effect on ULH&P's consolidated results of operations, cash flows or financial position.

The effective tax rate for ULH&P, was 29.4% and 36.7% respectively for the nine months ended September 30, 2006, and September 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.