COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR AN ORDER APPROVING THE ACCOUNTING TREATMENT RELATING TO INCOME TAX EXPENSE FOR 2005 AND SUBSEQUENT YEARS	)))))	CASE NO. 2005-00180

O R D E R

On April 29, 2005, Louisville Gas and Electric Company ("LG&E") filed an application for authority to establish regulatory liabilities for the excess deferred state income taxes resulting from the enactment of House Bill 272 during the 2005 Regular Session of the Kentucky General Assembly. House Bill 272[1] amends KRS 141.040 and reduces the Kentucky corporate income tax rate from 8.25 percent to 7.00 percent for tax years beginning January 1, 2005, and from 7.00 percent to 6.00 percent for tax years beginning January 1, 2007. LG&E also seeks approval of an accounting treatment to flow back the excess deferred state income taxes for book purposes only.

The federal Internal Revenue Code and Kentucky income tax law require a utility to normalize any income tax timing differences[2] on its books for regulated accounting purposes as a precondition to the use of accelerated depreciation methods for tax purposes. The normalization method requires a utility to defer the difference between

[1] House Bill 272 amended several Kentucky statutes relating to revenues and taxation issues. KRS 141.040 deals with the Kentucky corporate income tax rates.

[2] Tax timing differences are due to differences between the application of generally accepted accounting principles in recognizing revenues and expenses and the provisions of the income tax laws and related treasury regulations.

its actual income tax expense under federal and Kentucky law and its book income tax for regulated accounting purposes, resulting in ratepayers paying a normalized level of income tax expense through rates. The normalized level of tax expense is based on the tax rate in effect at the time the deferral occurs, and is based upon the assumption that the timing differences between book and tax depreciation that produced the deferred taxes will reverse in future periods at the same tax rate. The reduction in Kentucky income taxes resulting from the passage of House Bill 272 changed the assumption that Kentucky deferred income taxes would reverse at the same tax rate, resulting in excess Kentucky deferred income taxes.

While the vast majority of deferred income taxes are related to the use of accelerated depreciation methods, other types of transactions can result in deferred income taxes.[3] Under the provisions of the Tax Reform Act of 1986, utilities are prohibited from flowing back excess deferred taxes related to depreciation timing differences faster than under the "average-rate" assumption method. The average-rate assumption method for calculating the reversal of deferred taxes results in the normalization of the excess included in the utility's reserve for deferred taxes. The excess deferred income taxes associated with depreciation timing differences are commonly referred to as "protected" excess deferred taxes. All other excess deferred income taxes not associated with depreciation timing differences are referred to as "unprotected" excess deferred taxes.

[3] Examples of these transactions include costs deferred and recovered in subsequent periods as a result of pension costs, post-retirement benefits other than pensions, and regulatory decisions.

LG&E seeks authority to establish separate regulatory liabilities for the protected and unprotected excess Kentucky deferred taxes resulting from the enactment of House Bill 272. LG&E determined that the regulatory liability for its protected excess Kentucky deferred income taxes should be $16,340,000 and the regulatory liability for its unprotected excess Kentucky deferred income taxes should be $41,000.[4] LG&E proposed for accounting purposes to flow back the protected excess Kentucky deferred income taxes using the average-rate assumption method, noting that this approach was consistent with previous Commission decisions and the requirements for tax normalization. LG&E also proposed for accounting purposes to flow back the unprotected excess Kentucky deferred income taxes in 2005 by reducing its income tax expense by $25,000.[5] LG&E stated that this approach for the unprotected amount was reasonable due to the immaterial size of the amount and that it was "administratively prudent" to flow back the unprotected amount in one year rather than amortizing the amount over a period of years.[6]

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[4] Application Exhibit 3. The proposed regulatory liabilities are for LG&E's electric and gas operations combined. In its response to the Commission Staff's First Data Request dated May 18, 2005, Item 3, LG&E separated the proposed regulatory liabilities and the proposed reduction in the income tax expense for 2005 between electric and gas operations.

[5] As noted on Exhibit 3, there is a federal income tax effect resulting from the reduction in the Kentucky income tax rate. The adjustment for unprotected excess Kentucky deferred income taxes, net of the federal tax effect, is $25,000. However, when establishing the regulatory liability, it is necessary to gross-up the net adjustment for taxes, resulting in the regulatory liability for unprotected excess Kentucky deferred income taxes of $41,000.

[6] Application at 8.

The Commission issued a procedural schedule and data request on May 18, 2005. LG&E filed its responses to the data request on May 26, 2005. The Commission has not received any requests for intervention in this proceeding.

The Commission has reviewed the application and data responses and finds that LG&E's proposals should be approved. The reduction in the Kentucky income tax rate resulting from the passage of House Bill 272 affects LG&E's calculation of its Kentucky deferred income taxes. It is appropriate to establish regulatory liability accounts to recognize the excess Kentucky deferred income taxes. LG&E's proposal to flow back the protected excess Kentucky deferred income taxes is reasonable and consistent with the provisions of the Tax Reform Act of 1986 and prior Commission precedent.[7] Considering the relatively minimal amount of unprotected excess Kentucky deferred income taxes, LG&E's proposal to flow back this amount as a reduction in income tax expense in 2005 is reasonable and will result in the elimination of the deferred liability as of year end 2005. These accounting treatments will not affect the rates currently paid by LG&E's customers.

The Commission notes that House Bill 272 provides for a second reduction in the Kentucky corporate income tax rate effective January 1, 2007. While accepting LG&E's explanation as to why it could not seek prior approval of the proposed regulatory liabilities in this case,[8] the Commission expects LG&E to request prior

[7] Case No. 10064, Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company, final Order dated July 1, 1988 at 60-62.

[8] House Bill 272 was enacted on March 18, 2005 but applied to the tax year beginning January 1, 2005. LG&E stated that the enactment date did not allow for advance approval from the Commission of the proposed regulatory liabilities.

approval for any further regulatory asset or liability accounts relating to additional excess Kentucky deferred income taxes that result from the January 1, 2007 tax rate reduction.

IT IS THEREFORE ORDERED that:

1. LG&E is authorized to establish on its books for accounting and reporting purposes regulatory liabilities of $16,340,000 for its protected excess Kentucky deferred income taxes and $41,000 for its unprotected excess Kentucky deferred income taxes.

2. LG&E shall flow back its protected excess Kentucky deferred income taxes using the average-rate assumption methodology, as described in the application.

3. LG&E shall reduce its income tax expense for 2005 by $25,000 related to its unprotected excess Kentucky deferred income taxes.

Done at Frankfort, Kentucky, this 30th day of June, 2005.

By the Commission

ATTEST:

Executive Director