COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR AN ORDER APPROVING THE ACCOUNTING TREATMENT RELATING TO INCOME TAX EXPENSE FOR 2005 AND SUBSEQUENT YEARS	)))))	CASE NO. 2005-00181

O R D E R

On April 29, 2005, Kentucky Utilities Company ("KU") filed an application for authority to establish regulatory assets and 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. KU 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.

KU seeks authority to establish regulatory liability and asset accounts for the protected and unprotected excess Kentucky deferred taxes resulting from the enactment of House Bill 272. KU determined that a Kentucky jurisdictional regulatory liability for its protected excess Kentucky deferred income taxes should be $9,424,000, while a Kentucky jurisdictional regulatory asset[4] for its unprotected excess Kentucky deferred income taxes should be $303,000.[5] KU 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. KU also proposed for accounting purposes to flow back the unprotected excess Kentucky deferred income taxes in 2005 by increasing its Kentucky jurisdictional income tax expense by $185,000.[6] KU 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

[4] A regulatory asset is necessary because there is a Kentucky deferred income tax deficiency for the unprotected excess Kentucky deferred income taxes. The deferred tax deficiency is primarily related to deferred taxes associated with pensions and post-retirement benefits other than pensions.

[5] Application Exhibit 3 and Response to the Commission Staff's First Data Request dated May 18, 2005, Item 3. In its application KU stated the amounts for the proposed regulatory liability and asset on a total company basis. The total company regulatory liability for the protected excess Kentucky deferred income taxes was $11,028,000 and the total company regulatory asset for the unprotected excess Kentucky deferred income taxes was $355,000. In its response to Item 3, KU provided the Kentucky jurisdictional amounts for the excess Kentucky deferred income taxes.

[6] 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 Kentucky jurisdictional unprotected excess Kentucky deferred income taxes, net of the federal tax effect, is $185,000. However, when establishing the regulatory asset, it is necessary to gross-up the net adjustment for taxes, resulting in the Kentucky jurisdictional regulatory asset for unprotected excess Kentucky deferred income taxes of $303,000.

unprotected amount in one year rather than amortizing the amount over a period of years.[7]

The Commission issued a procedural schedule and data request on May 18, 2005. KU 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 KU's proposals should be approved. The reduction in the Kentucky income tax rate resulting from the passage of House Bill 272 affects KU's calculation of its Kentucky deferred income taxes. It is appropriate to establish Kentucky jurisdictional regulatory liability and asset accounts to recognize the excess Kentucky deferred income taxes. KU'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.[8] Considering the relatively minimal amount of unprotected excess Kentucky deferred income taxes, KU's proposal to flow back this amount as an increase in Kentucky jurisdictional income tax expense in 2005 is reasonable and this will result in the elimination of the deferred asset as of year end 2005. These accounting treatments will not affect the rates currently paid by KU'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 KU's explanation as to why it could not seek prior approval of the proposed regulatory

[7] Application at 8.

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

liabilities in this case,[1] the Commission expects KU to request prior 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. KU is authorized to establish on its books for accounting and reporting purposes a Kentucky jurisdictional regulatory liability of $9,424,000 for its protected Kentucky jurisdictional excess Kentucky deferred income taxes and a Kentucky jurisdictional regulatory asset of $303,000 for its unprotected Kentucky jurisdictional excess Kentucky deferred income taxes.

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

3. KU shall increase its Kentucky jurisdictional income tax expense for 2005 by $185,000 related to its unprotected Kentucky jurisdictional excess Kentucky deferred income taxes.

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

By the Commission

ATTEST:

Executive Director

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