

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

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PUBLIC SERVICE  
COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY POWER COMPANY )  
FOR APPROVAL OF AN AMENDED COMPLIANCE )  
PLAN FOR PURPOSES OF RECOVERING )  
ADDITIONAL COSTS OF POLLUTION CONTROL )  
FACILITIES AND TO AMEND ITS ENVIRONMENTAL )  
COST RECOVERY SURCHARGE TARIFF )

CASE NO.  
2005-00068

**PETITION FOR REHEARING**

Comes Kentucky Power Company (“KPCo” or the “Company”), by and through counsel, and moves the Commission for a rehearing pursuant to KRS 278.400 on those portions of its Order of September 7, 2005 which address the tax effects of certain new federal income tax laws on the “Calculation of Gross-Up Factor for Rate of Return” (specifically discussed at pp. 23-27 of the Order, and Appendix B). The Commission’s Order accepted the proposal of the KIUC to reflect both the new IRS Section 199 deduction and the new (lower) Kentucky income tax rate under HB 272 in the gross-up factor for Big Sandy’s environmental surcharge rate base. (Order, pp. 26-27.) This Petition should be granted because, as demonstrated herein, the rate of return methodology adopted in the PSC’s Order is flawed as applied to KPCo, and results in an overstatement of the tax benefits to be received by KPCo under the referenced tax changes, and a corresponding understatement of the Company’s gross-up factor. The effect of the Order will be that, contrary to the mandate of KRS 278.183, KPCo will not fully recover its costs of compliance with the Federal Clean Air Act.

As required by KRS 278.400, KPCo seeks rehearing on the following issues:

(1) Whether, under KRS 278.183, the effect of the changes to the federal income tax code (IRC Section 199 deduction) and the state income tax rate (HB 272) should be estimated through a mis-use of the gross-up factor for rate of return, or accurately reflected as a negative expense item in the Environmental Surcharge Tariff;

(2) Whether, under KRS 278.183, if the referenced tax changes are to be reflected in the calculation of the gross-up factor for rate of return purposes in the Environmental Surcharge, the calculation of the gross-up factor should be modified to more accurately reflect the true economic benefits of the Section 199 tax change, and the amount of the tax benefit related to KPCo's environmental facilities; and

(3) Whether, in any event, under KRS 278.183, an annual "true-up" mechanism should be recognized in the ECR Tariff which will allow the estimated tax benefits reflected in the environmental surcharge to be adjusted to reflect the actual tax benefits received by KPCo under IRC Section 199 and HB 272.

## **I. INTRODUCTION**

The Company hereby withdraws its objection to having the effect of the Section 199 deduction and the lowering of the effective Kentucky tax rate reflected in the environmental surcharge proceeding. Indeed, the Company proposed to have the resulting change in the level of tax expense reflected as a line item on the ECR surcharge tariff – a method which will accurately reflect the benefits of these changes as they flow through the environmental surcharge. The Commission's Order rejected this proposal, saying that "[b]y offering the suggestion in its brief, Kentucky Power has prevented the parties from conducting any discovery or otherwise investigating the reasonableness of the suggestion." (Order, p. 26.) KPCo requests that rehearing be granted in order to allow the parties and the Commission the opportunity to evaluate this alternative approach – one which the Company submits will alleviate the complex

and erroneous “gross-up factor” adjustment adopted in the Commission’s Order. Alternatively, rehearing should be granted because the calculation of the gross-up factor as set forth in the Commission’s Order does not take into account two factors essential to correctly implementing the tax changes via the gross-up factor: (1) the full amount of the Section 199 deduction cannot be assigned directly to KPCo’s rate of return, as the Order contemplates; instead, KPCo’s benefit from the Section 199 deduction can only be calculated on KPCo’s portion of the Section 199 deduction as allocated within the Expanded Affiliated Group (EAG); and (2) any rate of return adjustment in the environmental surcharge must capture and reflect only the relative tax benefits attributable to the environmental facilities, so that the Section 199 tax benefits associated with non-environmental investment are not reflected in the environmental surcharge.

## **II. ARGUMENT**

### **A. The Commission’s Order Erred in Holding that the Benefits of the IRC Section 199 Deduction Should be Reflected in the Gross-Up Factor.**

The Commission’s Order makes two errors concerning the proper treatment of the IRC Section 199 deduction which the Commission is respectfully requested to reconsider upon rehearing. These errors are as follows:

1. Per the Commission’s Order, Page 25 – “This gross-up factor approximates the income tax effect on the additional revenues generated by the environmental surcharge. It is not designed to exactly match the actual income tax calculations KPCo makes annually when it prepares its federal and state income tax returns.” This statement fundamentally mischaracterizes the nature and purpose of the gross-up factor. This factor is a reflection of existing income tax rates, not deductions, and is applied to estimated after-tax net income in order to determine the level of pre-tax revenue necessary to generate that income. The gross-up factor is not designed to be an estimate of income tax expense; indeed, this perceived

“equivalency” has led the Commission’s Order to simplistically treat the IRS Section 199 deduction as a change in tax rate.

KPCo agrees that in the most basic case the benefit of the new Section 199 deduction could be captured by a corresponding (1:1) adjustment to the gross-up factor – so that the same result would be achieved either way.<sup>1</sup> However, two factors present in this proceeding preclude such a methodology from being employed. First, KPCo is not a stand-alone company; it therefore does not directly receive the IRC Section 199 benefit. Rather, as a member of the AEP System, which files its federal income tax return on a consolidated basis, KPCo will enjoy only so much of the Section 199 tax benefit as it receives through the consolidated return. This fact brings into play the “qualified production activity income” (QPAI) and the EAG analysis presented by Mr. Kelley in his rebuttal testimony. Because of this complexity, the Commission’s proposed treatment of the IRC Section 199 deduction as a direct change in KPCo’s effective tax rate will always produce a mismatch between the tax benefit reflected in the environmental surcharge, and the Section 199 tax benefit actually received by KPCo through the AEP System. The Commission is respectfully requested to apply ratemaking methodology in the environmental surcharge that is designed to accurately reflect the factual and legal circumstances confronting the utility. Indeed, KRS 278.183 directs that “a utility shall be entitled to the current recovery of its costs of complying with the Federal Clean Air Act. . . .” This statutory goal is clearly not attained under the “rough estimate” rate of return methodology employed for the Section 199 deduction under the PSC’s current order.

2. The Commission’s gross-up factor, as set forth in Attachment B to the Order, does not properly take into account the fact that the IRC Section 199 tax deduction is based on

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<sup>1</sup> This “adjustment” would still need to be modified to reflect only the benefit associated with the environmental investment, discussed *infra*.

100% of the manufacturing (generation) assets, which include environmental investment as well as the basic generating equipment. For KPCo, the cost of environmental equipment is roughly 60% of its total plant-in-service (using net book value as of June 30, 2005). KPCo submits that the Section 199 tax benefit should therefore be allocated on a 60-40 basis, with 60% of the tax benefit being reflected in and through the environmental surcharge. The Commission's Order, Attachment B, does not recognize the fact (and the law) that, under KRS 278.183, 100% of the Section 199 benefit cannot be assigned to the environmental investment of KPCo.

These two errors in the Commission's current approach are essentially legal matters created by the tax laws (Section 199) and the Commission's errors in applying KRS 278.183. KPCo thus suggested in its brief that the actual tax benefits associated with IRC Section 199 and HB 272 be shown as a line item on the tariff (as a negative expense) so that the actual amount of the tax benefit would be reflected in the ECR, as required by KRS 278.183. The Order rejected this simpler, more direct, and more accurate approach, declaring that KPCo's suggestion, having been made in the brief, "has prevented the parties from conducting any discovery or otherwise investigating the reasonableness of the suggestion." Order, p. 26. Certainly KPCo never intended its proposal as a ploy to defeat discovery or to frustrate investigation. To the contrary, the suggestion in the brief was made in recognition of the merits of the issue, and KPCo's desire to see the actual tax benefit passed on to the Company's customers via the environmental surcharge. Simply put, the Company's proposal is to reflect the actual amount of the Section 199 benefits in the rates under the ECR tariff, rather than a hypothetical calculation based on inaccurate assumptions. However, if this concept needs discovery or investigation, the Company believes that KRS 278.183 and KRS 278.400 require that a rehearing be granted to accomplish these goals.

**B. The Commission's Order Errs in Adopting a Gross-Up Factor that is not Representative of the Actual Income Tax Deduction to be Enjoyed by KPCo.**

As stated above, the Company respectfully suggests that the “simplified” approach taken in the Commission’s Order (i.e., apply the Section 199 benefit through an adjustment to the gross-up factor), is so flawed as to merit full reconsideration, rejection and substitution with a line item on the ECR tariff for the effect of the deduction. Alternatively, however, KPCo requests the Commission to modify its Order requiring the Section 199 deduction to be reflected in the gross-up factor so as to allow the Company to adjust the gross-up factor for both of the following factors: (1) The percentage of the Section 199 deduction (i.e., tax benefit) actually received by KPCo<sup>2</sup>; and (2) The percentage of the Section 199 deduction associated with the environmental facilities located at Big Sandy.<sup>3</sup> The failure of the Order to reflect these two conditions in the ECR Tariff (i.e., Attachment B) will result in an overstatement of tax benefit to be received by KPCo as a matter of law.

The errors contained in the PSC’s ruling can be demonstrated factually. KPCo’s current calculation of the estimated Section 199 deduction for Tax Year 2005, and a comparison with the approach put forth in the PSC’s Order is as follows<sup>4</sup>:

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<sup>2</sup> That is, the IRC Section 199 EAG methodology directs that KPCo likely will not receive 100% of the tax benefit if the Section 199 deduction were applied separately to KPCo. (See Kelley Testimony at p. 4.)

<sup>3</sup> KRS 278.183 requires that the utility be allowed to recover the cost of environmental facilities. By including the full Section 199 deduction in the rate of return calculation, the Commission’s Order will capture income tax benefits not associated with the Company’s environmental investment.

<sup>4</sup> See attached schedules.

Estimated Total 2005 Allocated Section 199 Deduction		\$636,000
Estimate reduction in 2005 Taxes from Section 199	State Federal	\$44,520 \$207,018 \$251,538
% Net Environmental Facilities at Big Sandy		<u>59.59%</u>
Estimated amount of Section 199 tax reduction associated with environmental facilities		\$149,891
Tax Benefit of Section 199 as per PSC adjustment to gross-up factor		<u>\$213,460</u>
Overstatement of PSC adjustment		(\$63,569)
% Overstatement of Section 199 Benefit		42.41%

This calculation demonstrates that the methodology included in the Commission’s Order produces an excessive level (i.e., 42.41%) of tax benefits associated with the Section 199 deduction, which should properly be assigned to the Company’s non-environmental investment. This methodology, when employed within the gross-up factor, will overstate the tax benefits, and thereby correspondingly deny KPCo recovery of its environmental costs as mandated by KRS 278.183.

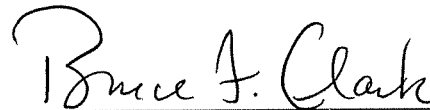
**C. The Order Should Allow for an Annual “True-Up Mechanism.”**

Finally, regardless of whether rehearing is granted on the rate of return treatment of the Section 199 deduction, the Company respectfully requests that it be allowed the right to annually adjust the rates under the ECR mechanism which are associated with the Section 199 deduction to reflect the actual tax benefit received by KPCo (which are to be passed on to the Company’s customers). KRS 278.183 mandates that a utility “shall recover” the costs of compliance with the Clean Air Act – and without a “true-up” mechanism, this statutory mandate will be violated.

**III. CONCLUSION**

For the reasons set forth above, KPCo respectfully seeks a rehearing on the issues presented herein.

Respectfully submitted,



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**CERTIFICATE OF SERVICE**

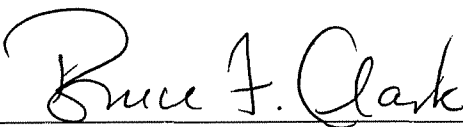
I hereby certify that a true and accurate copy of the foregoing Petition for Rehearing was served via United States Postal Service, First Class Mail, postage prepaid, upon:

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Richard G. Raff  
Public Service Commission  
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on this the 27th day of September, 2005.

  
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Bruce F. Clark

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**Kentucky Power Company  
Environmental Order  
Section 199 Deductions**

- KPCo's Best Estimate as to the level of Section 199 deductions for the six months ending June 30, 2005 is \$318,000
- This amount is used for financial reporting purposes and audited by the Company's external auditors
- The Company's best estimate as to the annual level of Section 199 deduction is \$636,000
- The estimated annual reduction in State and Federal income tax are \$251,538 (State at \$44,520 and Federal at \$207,018)
- The Percentage the Company Net Environmental Production Facilities are of the Company's Total Net Production Facilities at June 30, 2005 is 59.59% ( $\$169,152,228/\$283,864,209$ )
- Therefore, the Company Best Estimate as to the Reduction in State and Federal Income Taxes as a Result of the Section 199 Deduction on the environmental Facilities is \$149,891 ( $\$251,538 \times 59.59\%$ )
- The Revenue Requirement Difference between the Old Gross up Factor and the New Gross up factor on the Big Sandy Environmental Facilities is \$213,460 ( $\$14,387,771 - \$14,173,771$ )

The annual amount that will flow through the Environmental surcharge is about 50% greater than the Company's best estimate as to the amount that should flow through the Environmental Surcharge ( $\$213,460/\$149,891$ ).

In fact the amount that will flow through the Environmental Surcharge is about 85% of the Company's total reduction in taxes as a result of this deduction, when only 59.59% should flow through the Environmental Surcharge.

Kentucky Power Company  
Environmental Surcharge  
Section 199 Deduction

<u>Ln No</u> (1)	<u>Description</u> (2)	<u>Amount</u> (3)	<u>Reduction in Taxes</u> (4)
1	Total Company's Annual Estimate for Financial Reporting Purposes	\$636,000	
2	Kentucky State Tax Rate	<u>7.00%</u>	
3	State Income Tax Reduction		\$44,520
4	Reduction in Federal Taxable Income	\$591,480	
5	Federal Tax Rate	<u>35.00%</u>	
6	Federal Income Tax Reduction		<u>\$207,018</u>
7	Total Company Annual Reduction in Income Taxes		\$251,538
8	Percent Environmental Facilities are of the Total Company's Production Facilities		<u>59.59%</u>
9	Annual Reduction in Income Taxes Associated with Section 199 Deduction on Environmental Facilities		<u><u>\$149,891</u></u>

Kentucky Power Company  
Big Sandy Environmental Facilities  
Percentage of Total Company Production Facilities

Ln  
No

1	Big Sandy Environmental Facilities Investment at June 30, 2005	\$189,168,203
2	Less: Environmental Facilities Accumulated Depreciation at June 30, 2005	<u>\$20,015,975</u>
3	Net Big Sandy Environmental Facilities at June 30, 2005	<u>\$169,152,228</u>
4	KPCo's Total Production Facilities Investment at June 30 2005	\$459,155,789
5	Less: Production Facilities Accumulated Depreciation at June 30, 2005	<u>\$175,291,580</u>
6	Net KPCo's Production Facilities Investment at June 30 2005	<u>\$283,864,209</u>
7	Percentage Environmental Facilities are of Total Company Production Facilities	<u>59.59%</u>

Kentucky Power Company  
 Big Sandy Environmental Surcharge Calculations  
 New Gross up Factor Versus Old Gross up Factor  
 at June 30, 2005

Ln No (1)	<u>Description</u> (2)	<u>New Gross up Factor</u> (3)	<u>Old Gross up Factor</u> (4)	<u>Difference</u> (5)
1	Total Big Sandy Environmental Facilities Investment	\$189,168,203	\$189,168,203	
	Less:			
2	Accumulated Depreciation	\$20,015,975	\$20,015,975	
3	Acc. Deferred Income Tax	<u>\$26,845,295</u>	<u>\$26,845,295</u>	
4	Net Big Sandy Environmental Facilities Investment	\$142,306,933	\$142,306,933	
5	Weighted Average Cost of Capital	<u>9.96%</u>	<u>10.11% *</u>	
6	Annual Return	<u>\$14,173,771</u>	<u>\$14,387,231</u>	
7	Difference Between New and Old Gross up Factors			<u><u>(\$213,460)</u></u>

\* Reflects the change in state rate from 8.25% to 7%