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July 17, 2007

RECEIVED

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**PUBLIC SERVICE
COMMISSION**

VIA HAND DELIVERY

Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40601

**RE: Application of Kentucky Utilities Company for an Order Authorizing
Inclusion of Investment Tax Credits in Calculation of Environmental
Surcharge and Declaring Appropriate Ratemaking Methods for Base Rates**
KPSC Case No. 2007-00178

Dear Ms. O'Donnell:

Enclosed please find and accept for filing the original and ten copies of the Comments of Kentucky Utilities Company in the above-referenced matter. Please confirm your receipt of this filing by placing the stamp of your Office with the date received on the enclosed additional copies and return them to me in the enclosed self-addressed stamped envelope.

Should you have any questions please contact me at your convenience.

Very truly yours,

Kendrick R. Riggs

KRR/ec

cc: Parties of Record

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COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES)
COMPANY FOR AN ORDER AUTHORIZING)
INCLUSION OF INVESTMENT TAX CREDITS IN)
CALCULATION OF ENVIRONMENTAL) CASE NO. 2007-00178
SURCHARGE AND DECLARING APPROPRIATE)
RATEMAKING METHODS FOR BASE RATES)

COMMENTS OF KENTUCKY UTILITIES COMPANY

Kentucky Utilities Company (“KU”) hereby submits its Comments concerning the Application KU filed with the Commission on May 4, 2007, seeking inclusion in the calculation of its environmental surcharge of that portion of KU’s federal investment tax credit that is related to environmental projects approved for recovery through the environmental surcharge and seeking a declaration of the appropriate rate-making treatment of the credits in KU’s base rates. KU submits these Comments in accord with the Commission’s July 6, 2007 Order in this proceeding, which states: “If all parties agree the case may be submitted for adjudication based on the existing record without a hearing, all parties shall file comments, if any, no later than [July 17, 2007].” Because on July 10, 2007, in accord with the Commission’s May 29, 2007 scheduling Order in this proceeding, all parties in fact agreed that this case may be submitted for decision without a hearing, these Comments are appropriate and timely. Therefore, in support of its Application, KU states as follows:

The federal Energy Policy Act of 2005 became law on August 8, 2005.¹ The Act created several investment tax credits designed to spur the development and construction of certain kinds of generation facilities. One such credit is the Qualifying Advanced Coal Project Credit,² which

¹ Energy Policy Act of 2005, 42 U.S.C. §§ 15801-16524 (2005).

² See 26 U.S.C. § 48A.

allows the Secretary of the Treasury to grant up to \$1.3 billion in tax credits to advanced coal projects, \$800 million for integrated gasification combined-cycle projects and \$500 million for projects using other advanced coal-based generation technologies.

The Qualifying Advanced Coal Project Credit statute³ sets out two key categories of criteria for eligibility to receive an advanced coal-based generation technology credit (“Advanced Coal Technology ITC”): high-efficiency and low-emissions. Specifically, to qualify for a Advanced Coal Technology ITC a project must: (1) have a “design net heat rate of 8530 Btu/kWh (40 percent efficiency)”; and (2) be designed to remove 99% of sulfur dioxide and 90% of mercury, and emit no more than 0.07 lbs of nitrous oxide and 0.015 lbs of particulate matter per MMBtu.⁴ The qualifying advanced coal project also must meet these general criteria: have a nameplate rating of 400 MW or greater, use at least 75% coal for fuel, have 50% or more electrical power output, and be located at one site.⁵

Because KU and Louisville Gas and Electric Company’s (“LG&E”) (collectively, the “Companies”) Trimble County Unit No. 2 (“TC2”) project plans met the Advanced Coal Technology ITC requirements, on June 28, 2006, the Companies jointly filed an application with the U.S. Department of Energy (“DoE”) to obtain a \$125 million Advanced Coal Technology ITC for the construction of TC2.⁶ On September 27, 2006, the Companies submitted an application for the credit to the U.S. Internal Revenue Service (“IRS”), along with additional certification documents that, if the IRS approved the Companies’ application, would allow the

³ 26 U.S.C. § 48A.

⁴ 26 U.S.C. § 48A(f).

⁵ 26 U.S.C. § 48A.

⁶ *In the Matter of: Application of Kentucky Utilities Company for an Order Authorizing Inclusion of Investment Tax Credits in Calculation of Environmental Surcharge and Declaring Appropriate Ratemaking Methods for Base Rates*, Case No. 2007-00178 (“KU ITC Case”), Application ¶ 8 (May 4, 2007) (“Application”).

Companies to begin claiming the tax credit as eligible expenditures are made.⁷ On October 27, 2006, the IRS notified the Companies that the TC2 project received DoE certification.⁸

On November 29, 2006, the IRS informed the Companies that it too had accepted the Project's application and had allocated a total Advanced Coal Technology ITC of \$125 million.⁹

On March 22, 2007, the IRS approved a Closing Agreement required in connection with claiming the \$125 million tax credit.¹⁰

To account for the credit, KU will use its long-standing method of adjusting rate base by its pro rata share of the unamortized balance of the Advanced Coal Technology ITC. In so doing, KU's revenue requirement associated with its investment in TC2 will be lower than it otherwise would be due to the award of the credit. Thus, KU's customers will benefit by paying lower rates. This is sometimes referred to as the "ratable restoration" method because it reduces the utility's rate base by the amount of the credit and then restores the rate base as the credit is amortized over the life of the asset. KU uses this method due to an irrevocable election KU made decades ago under 26 U.S.C. § 46(f)(1).¹¹ Because of the benefit to customers, as well as the fact that KU must account for the credit in this way due to its irrevocable 26 U.S.C. § 46(f)(1) election, KU respectfully requests that the Commission approve its proposed accounting treatment for the Advanced Coal Technology ITC.

KU further proposes to include in the calculation of the environmental surcharge a pro rata amount of its Advanced Coal Technology ITC associated with environmental pollution control equipment for TC2.¹² The environmental pollution control equipment represents

⁷ Application ¶ 8.

⁸ Application ¶ 8.

⁹ Application ¶ 9.

¹⁰ Application ¶ 10.

¹¹ KU ITC Case, Direct Testimony of Kent W. Blake at 4 (May 4, 2007) ("Blake").

¹² The Commission approved the recovery of this project (Project No. 23) as part of KU's Environmental Surcharge Compliance Plan in its December 22, 2006 Order in Case No. 2006-00206.

approximately 23% of the “qualified investment” in TC2.¹³ Therefore, the inclusion of this pro rata allocation of the credit should result in approximately twenty-three percent of the advanced coal ITC being allocated to KU’s environmental surcharge rate base.¹⁴ The reductions in the rate base for the Advanced Coal Technology ITC must be ratably restored over the useful life of the air quality control system portion of TC2, which presently is set at 28.8 years, and could be provided to customers through a combination of the environmental surcharge cost recovery (“ECR”) mechanism and base rates.¹⁵ The reductions in rate base for the balance of the Advanced Coal Technology ITC must be ratably restored over the regulatory life of the balance of the plant, which is presently set at 41.5 years, and will be provided to customers through base rates.¹⁶

KU proposes also to exclude the ECR rate base from Kentucky jurisdictional rate base, and to determine the percentage of Kentucky jurisdictional rate base (excluding ECR) to total company rate base when allocating capitalization in the next electric base rate case.¹⁷ Because the ECR revenue requirement is derived by the rate base methodology, this proposal provides consistency between Kentucky jurisdictional rate base and capitalization, as well as ensuring that the total ECR rate base not recovered in base rates is excluded from the determination of base rates. KU has used this same methodology for many years to allocate the appropriate amount of capital to Kentucky and Virginia retail jurisdictions and wholesale jurisdictions.¹⁸ In addition,

¹³ Blake at 7.

¹⁴ Blake Exhibit KWB-2 is a chart showing the actual expenditures for 2006 and the remaining estimated construction expenditures (including all “qualified investment”) for TC2 through the expected in-service date of 2010, including the pollution control equipment that is approved for recovery through KU’s environmental surcharge and the pro rata amount of Advanced Coal Technology ITC associated with that investment.

¹⁵ Blake at 8.

¹⁶ Blake at 8.

¹⁷ Blake at 9.

¹⁸ Blake Exhibit KWB-5 illustrates this proposal.

consistent with prior Commission practice KU proposes to exclude ECR revenues and expenses not recovered in base rates in the next electric base rate case.¹⁹

KU further requests that the Commission declare the proposed rate base and capitalization treatments of the Advanced Coal Technology ITC and the proposed allocation of rate base to be the appropriate rate-making methods for the determination of base rates to ensure that no double counting of investment tax credits and deferred taxes exists between the environmental surcharge and base rates.²⁰ The receipt of the Advanced Coal Technology ITC impacts both KU's ECR and base rates. The ratemaking treatment for which KU is seeking Commission approval is related to both the ECR and to future base rate treatment. Decisions made and applied to the ECR also impact base rates and capitalization due to the adjustments made to remove from base rates all impacts of the ECR. KU's proposal to exclude the ECR rate base from Kentucky jurisdictional rate base, and to determine the percentage of rate base (excluding ECR) to total company rate base when allocating capitalization in its next base rate case provides consistent treatment of the credit between base rates and the ECR and more accurately reflects the removal of the total ECR rate base when determining base rates. It also provides important certainty about the ratemaking implementation of KU's 26 U.S.C. § 46(f)(1) election and thus reduces the risk that KU could lose the credit due to inconsistent ratemaking treatment. Because the ECR revenue requirement is derived by the rate base methodology, this proposal provides consistency between Kentucky jurisdictional rate base and Kentucky jurisdictional capitalization, and also ensures that the entire ECR rate base is excluded from the determination of base rates. KU believes that proper ratemaking treatment for issues that impact both the ECR and base rates should be determined concurrently to ensure consistent ratemaking

¹⁹ Blake at 10.

²⁰ KU ITC Case, Response of Kentucky Utilities Company to First Data Request of Commission Staff No. 6 (June 26, 2007).

treatment across both mechanisms to ensure there is no double under- or over- recovery between the operation of the ECR and base rates going forward, and to establish essential certainty about the ratemaking implementation of KU's investment tax credits required by federal law and long-recognized by the Commission.

KU further believes it is appropriate for the Commission to determine at this time the proper base rate treatment of the Advanced Coal Technology ITC because KU has expended significant time and effort to obtain the credit for the benefit of KU's customers. Certainly KU's initiative in obtaining the credit was prudent and will result in a significant reduction in the net cost to KU's customers of constructing TC2, meriting a degree of assurance concerning balanced base rate treatment of the Advanced Coal Technology ITC, including the prevention of double over- or under-recovery by establishing a proper relationship between ECR and base rates.

Providing for a particular base rate treatment in this proceeding will not prejudice the Commission or any potential interveners in a subsequent base rate proceeding because any base rate treatment the Commission prescribes in this proceeding, like any determination previously made by the Commission, may be subject to challenge in a later base rate proceeding.

Conclusion

For these reasons, KU requests the Commission enter an order on or before August 31, 2007: (1) authorizing the inclusion in the calculation of KU's environmental surcharge of that portion of KU's Advanced Coal Technology ITC that is related to projects approved for recovery through the environmental surcharge; (2) approving the revised ES Forms 2.00 and 2.10; (3) declaring the proposed rate base and capitalization treatments of the Advanced Coal Technology ITC and the proposed allocation of Kentucky jurisdictional rate base to be the appropriate rate-making methods for the determination of base rates; and (4) approving KU's long-standing accounting method of adjusting rate base by its pro rata share of the unamortized balance of the

Advanced Coal Technology ITC, pursuant to the irrevocable election KU made decades ago under 26 U.S.C. § 46(f)(1).

Dated: July 17, 2007

Respectfully submitted,



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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the foregoing Comments was served on the following persons on the 17th day of July, 2007, U.S. mail, postage prepaid:

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