

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND)	
ELECTRIC COMPANY FOR AN ORDER)	
AUTHORIZING INCLUSION OF INVESTMENT TAX)	CASE NO.
CREDITS IN CALCULATION OF ENVIRONMENTAL)	2007-00179
SURCHARGE AND DECLARING APPROPRIATE)	
RATEMAKING METHODS FOR BASE RATES)	

O R D E R

On May 4, 2007, Louisville Gas and Electric Company ("LG&E") filed an application seeking authorization to include certain investment tax credits in its environmental surcharge calculations, approval of revisions to monthly environmental surcharge reporting formats, and a declaration that its proposed rate base and capitalization treatments of the investment tax credits and proposed allocation of its Kentucky jurisdictional rate base is the appropriate rate-making method for the determination of base rates. The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), and Kentucky Industrial Utility Customers, Inc. ("KIUC") sought and were granted intervention.

The Commission's May 29, 2007 Order established a procedural schedule that provided for discovery, the opportunity to request a public hearing, and the filing of comments. On July 10, 2007, LG&E filed a statement indicating it believed this case could be submitted for decision without a hearing and, on July 17, 2007, LG&E filed comments on the case. KIUC did not indicate whether the case could be submitted for

decision without a hearing, but did file comments on July 13, 2007. The AG did not request a hearing and did not file comments on the application.

BACKGROUND

The Energy Policy Act of 2005 became law on August 8, 2005. This legislation created several investment tax credits designed to encourage the development and construction of certain kinds of generation facilities. One of the tax credits is the Qualifying Advanced Coal Project Credit, which provides tax credits for integrated gasification combined-cycle projects and projects using other advanced coal-based generation technologies.¹ To be eligible for the advanced coal-based generation technology tax credit ("ACGT Tax Credit"), the project must meet specific criteria for high efficiency and low emissions.² The ACGT Tax Credit is 15 percent of all qualifying investments, with a maximum credit allocated to any one project of \$125 million.³

LG&E and Kentucky Utilities Company ("KU") currently are constructing Trimble County Unit No. 2 ("Trimble 2").⁴ Trimble 2 will be a state-of-the-art, super-critical,

¹ Up to \$800 million in tax credits can be granted for integrated gasification combined-cycle projects and up to \$500 million in tax credits can be granted for projects using other advanced coal-based generation technologies.

² The specific requirements are listed in the Application at 3 and 26 U.S.C. § 48A.

³ The ACGT Tax Credit could be forfeited or reduced if the utility fails to secure required certifications, does not complete the project within a specified time frame, or the project does not produce the total nameplate generating capacity. See Application, Exhibit 5, Department of Treasury – Internal Revenue Service Closing Agreement, at 2.

⁴ LG&E and KU were granted a Certificate of Public Convenience and Necessity to construct Trimble 2 in Case No. 2004-00507, Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for a Certificate of Public Convenience and Necessity, and a Site Compatibility Certificate, for the Expansion of the Trimble County Generating Station, final Order dated November 1, 2005.

pulverized coal-fired generating unit that will employ the latest technology to achieve efficiency and low environmental impact. Trimble 2 will be owned by LG&E, KU, the Illinois Municipal Electric Agency ("IMEA"),⁵ and the Indiana Municipal Power Agency ("IMPA").⁶

Trimble 2 meets the requirements for the ACGT Tax Credit. LG&E and KU have submitted applications to the U. S. Department of Energy ("DOE") and the Internal Revenue Service ("IRS") seeking the ACGT Tax Credit. Trimble 2 has received DOE certification. The IRS has accepted the Trimble 2 application, allocated a total ACGT Tax Credit of \$125 million, and approved a Closing Agreement required in connection with claiming the tax credit.⁷ Because IMEA and IMPA are exempt from federal income taxation, neither will receive a portion of the ACGT Tax Credit. LG&E and KU will share the tax credit in proportion to their respective ownership interests in Trimble 2.

LG&E's share of the ACGT Tax Credit will be 19 percent of \$125 million, or \$23.75 million. The ACGT Tax Credit can be recognized by LG&E on its books in the same manner as qualifying investments are booked. LG&E made initial entries in December 2006 to record its respective share of the progress expenditure credits claimed in 2006. LG&E will continue to record the progress expenditure credits until the projected in-service date for Trimble 2, which is currently expected to be 2010. At that time, LG&E will have recorded the entire \$23.75 million ACGT Tax Credit on its books.

⁵ IMEA is a not-for-profit municipal corporation and a unit of local government in Illinois.

⁶ IMPA is a not-for-profit corporation and political subdivision of Indiana.

⁷ Application at 3-4 and Exhibits 2 through 6.

Amortization entries for the ACGT Tax Credit will begin when Trimble 2 goes into service for tax purposes in 2010 and will continue over the regulatory life of the unit. The air quality control system currently has an estimated regulatory life of 28.8 years and the remainder of the plant has an estimated regulatory life of 41.5 years.⁸

LG&E has determined that it must use the same rate treatment for the ACGT Tax Credit as it utilized for all post-1971 investment tax credits. In 1972, LG&E elected a rate treatment under the tax code⁹ wherein LG&E would reduce its cost of service by the amount of the tax credit it amortizes each year. This rate treatment is referred to as the "ratable flow through" method.¹⁰ While the original tax code section has been repealed, current provisions in the tax code¹¹ have retained the same tax treatment. LG&E stated that if it failed to normalize the tax credit utilizing the ratable flow through method, it would result in LG&E having to forfeit the credit along with other negative consequences. LG&E noted that in previous rate cases the Commission has

⁸ Application at 6-7.

⁹ 26 U.S.C. § 46(f)2.

¹⁰ The utility's capitalization reflects the cost of new plant as reduced by the effect of the total tax credit. Under the ratable flow through method, during a rate case the utility's capitalization is increased by the amount of the unamortized tax credit balance. The tax credit is amortized over the life of the asset. Depreciation expense on the new plant is lower due to the tax credit and the amortization of the tax credit is "grossed up" for income taxes in order to ensure ratepayers receive the full benefit of the tax credit. See Blake Direct Testimony at 3-4 and Response to the Commission Staff's First Data Request dated June 12, 2007, Item 5.

¹¹ 26 U.S.C. § 50. See Response to the Commission Staff's First Data Request dated June 12, 2007, Item 2(b), page 4 of 4. In addition, IRS Notice 2006-24 states that 26 U.S.C. § 50 applies to the ACGT Tax Credit. See Application at 5-6 and Exhibit 5.

consistently applied the ratable flow through method as the appropriate rate-making treatment for investment tax credits.¹²

ANALYSIS OF PROPOSALS

In its application,¹³ LG&E has requested the Commission issue an Order that:

- Authorizes the inclusion in the calculation of LG&E's environmental surcharge of that portion of LG&E's ACGT Tax Credit that is related to projects approved for recovery through the environmental surcharge;
- Approves revisions to the monthly environmental surcharge formats ES Forms 2.00 and 2.10 to reflect the ACGT Tax Credit; and
- Declares the proposed rate base and capitalization treatments of the ACGT Tax Credit and the proposed allocation of electric rate base to be the appropriate rate-making methods for the determination of base rates.

Inclusion in Environmental Surcharge Calculations

The air quality control system for Trimble 2 was included as a project in the environmental compliance plan amendment approved by the Commission in Case No. 2006-00208.¹⁴ The air quality control system for Trimble 2 represents approximately 23 percent of the qualified investment in Trimble 2.

Because the ratable flow through method reduces LG&E's cost of service by the amount of the investment tax credit amortization recorded in any calendar year, LG&E has proposed to include in the calculation of its monthly environmental surcharge a pro

¹² Application at 6.

¹³ Id. at 9.

¹⁴ Case No. 2006-00208, The Application of Louisville Gas and Electric Company for Approval of Its 2006 Compliance Plan for Recovery by Environmental Surcharge, final Order dated December 22, 2006.

rata amount of the ACGT Tax Credit associated with the air quality control system for Trimble 2. LG&E would include the amortization of the ACGT Tax Credit in the expense month filing corresponding to the month in which Trimble 2 goes into service, currently expected in 2010. The amortization of the tax credit will be a reduction to the monthly environmental surcharge revenue requirement shown on ES Form 2.00. Until Trimble 2 goes into service, LG&E has stated it would report as information the unamortized balance of the ACGT Tax Credit on ES Form 2.10 in the first expense month following the issuance of a final Order in this proceeding.¹⁵

In its comments, KIUC stated that LG&E's proposal on the environmental surcharge treatment of the ACGT Tax Credit was appropriate and it had no objection.¹⁶

The Commission has reviewed the information concerning the rate-making treatment for the ACGT Tax Credit and agrees that LG&E is required to follow the ratable flow through method. The Commission has reviewed LG&E's proposal to reflect the amortization of that portion of the ACGT Tax Credit associated with the Trimble 2 air quality control system in the determination of its monthly environmental surcharge revenue requirements once Trimble 2 goes into service. The Commission finds the proposal is reasonable and consistent with the application of the ratable flow through method. In addition, the Commission finds it is reasonable for LG&E to begin reporting as information the unamortized balance of the ACGT Tax Credit in its monthly environmental surcharge filings.

¹⁵ Response to the Commission Staff's First Data Request dated June 12, 2007, Item 7.

¹⁶ KIUC Comments at 1.

Revisions to Monthly Surcharge Reporting Formats

In conjunction with the recognition of the ACGT Tax Credit in the determination of the monthly environmental surcharge revenue requirement, LG&E proposed that ES Forms 2.00 and 2.10 be revised. On ES Form 2.00, a line item titled "Less Investment Tax Credit Amortization" would be included in the section of the form labeled "Determination of Pollution Control Operating Expenses." On ES Form 2.10, a column labeled "Monthly ITC Amortization Credit" would be included.¹⁷ KIUC did not comment on LG&E's proposed revision of the surcharge reporting formats.

The Commission has reviewed the proposed revisions to ES Forms 2.00 and 2.10 and finds the revisions are reasonable and should be approved.

Rate-Making Treatment for Future Base Rate Case

In addition to including the effect of the ACGT Tax Credits in its monthly environmental surcharge calculations, LG&E requested that the Commission declare in this case that its proposed rate base and capitalization treatments of the ACGT Tax Credit and the proposed allocation of the rate base to be the appropriate rate-making treatment for the determination of base rates. LG&E proposed to exclude the environmental surcharge rate base from the electric rate base. The percentage of this reduced electric rate base compared to the total company rate base would be utilized to allocate capitalization in LG&E's next electric base rate case. LG&E provided sample calculations reflecting its proposal for rate base and capitalization calculations.¹⁸

¹⁷ Blake Direct Testimony, Exhibit KWB-4.

¹⁸ Id., Exhibit KWB-5.

LG&E argued that its proposed treatment was necessary to ensure that no double-counting of the ACGT Tax Credit resulted from the recognition of the tax credit in both the environmental surcharge and base rates.¹⁹ LG&E expressed its belief that proper rate-making treatment for issues that impact both the environmental surcharge and base rates should be determined concurrently to ensure consistent rate-making treatment across both mechanisms. LG&E also stated deciding this issue in this case provided important certainty about the rate-making implementation of the ratable flow through method and reduced the risk that LG&E could lose the tax credit due to inconsistent rate-making treatment.²⁰

KIUC opposed determining the appropriate rate-making treatment in this case, arguing it would be better to defer this issue to the next base rate case when a full record would exist. KIUC contended that LG&E has proposed to change the methodology for all environmental surcharge costs, not just the ACGT Tax Credit. KIUC compared LG&E's proposal with the Commission's previous approach to allocating capitalization. KIUC argued that the LG&E proposal would result in a different outcome than the present Commission methodology, but acknowledged it was difficult to estimate the effect.²¹

¹⁹ The ACGT Tax Credit associated with the balance of the investment in Trimble 2, exclusive of the air quality control systems, would be recognized in LG&E's base rates.

²⁰ Response to the Commission Staff's First Data Request dated June 12, 2007, Item 6.

²¹ KIUC Comments at 1-2.

The Commission has compared the rate-making treatment LG&E proposed in this case with the approach utilized in two previous LG&E cases where the environmental surcharge was excluded in the determination of base rates.²² LG&E's proposal does not appear to be consistent with the Commission's treatment of the environmental surcharge and the allocation of capitalization presented in Case Nos. 1998-00426 and 2003-00433. The Commission notes that in discussing its proposal on rate base and capitalization, LG&E did not refer to these previous decisions or explain why the current proposal was more reasonable than the rate-making treatment in previous cases.

Based on its review and the arguments of LG&E and KIUC, the Commission finds that it is not reasonable in this case to establish the appropriate base rate case rate-making treatment for the environmental surcharge and ACGT Tax Credit. Therefore, the Commission finds that LG&E's proposal should be denied. The Commission notes that the avoidance of double-counting any component of the environmental surcharge in the determination of base rates has been an issue in every base rate case since the inception of the environmental surcharge statute. While LG&E has proposed what it believes to be consistent rate-making treatment between the environmental surcharge and base rates, it has failed to explain why the approach utilized by the Commission in previous LG&E cases is no longer reasonable. Lastly, as noted by LG&E in its application, the Commission has long recognized that the

²² Case No. 1998-00426, Application of Louisville Gas and Electric Company for Approval of an Alternative Method of Regulation of Its Rates and Service, final Order dated January 7, 2000 and Case No. 2003-00433, An Adjustment of the Gas and Electric Rates, Terms, and Conditions of Louisville Gas and Electric Company, final Order dated June 30, 2004.

appropriate rate-making treatment for tax credits is affected by the tax normalization requirements of the tax code.

IT IS THEREFORE ORDERED that:

1. LG&E's request for authorization to include in the calculation of its environmental surcharge the portion of the ACGT Tax Credit related to the air quality control system at Trimble 2 being recovered through the environmental surcharge is approved.

2. LG&E's proposed revisions to ES Forms 2.00 and 2.10 are approved. LG&E shall use the revised formats beginning with the first monthly environmental surcharge report filed after the date of this Order.

3. LG&E shall include the ACGT Tax Credit in its surcharge calculations in the first monthly environmental surcharge report filed after Trimble 2 goes into service.

4. LG&E's request to declare the proposed rate base and capitalization treatments of the ACGT Tax Credit and the proposed allocation of electric rate base to be the appropriate rate-making methods for the determination of base rates is denied.

5. In the event that the ACGT Tax Credit is reduced or forfeited, LG&E shall notify the Commission in writing within 10 days of LG&E receiving the notice of reduction or forfeiture.

Done at Frankfort, Kentucky, this 7th day of September, 2007.

By the Commission

ATTEST:


Executive Director

Case No. 2007-00179