COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC JOINT APPLICATION OF KENTUCKY UTILITIES COMPANY AND LOUISVILLE GAS AND ELECTRIC COMPANY FOR AN ORDER APPROVING THE ESTABLISHMENT OF REGULATORY LIABILITIES AND REGULATORY ASSETS	))))))	CASE NO. 2018-00304

ORDER

On September 12, 2018, Kentucky Utilities Company (KU) and Louisville Gas and Electric Company (LG&E) (jointly, KU/LG&E) filed a joint application, pursuant to KRS 278.220, seeking authorization to establish regulatory liabilities to account for excess accumulated deferred income taxes (ADIT) created by recent Kentucky state tax reform. KU/LG&E also requested authorization to establish regulatory assets to account for expenses incurred by the companies to repair damage and restore service caused by severe thunderstorms beginning on July 20, 2018.

By Order dated September 19, 2018, the Commission established a procedural schedule for the processing of this matter. The procedural schedule provided for a deadline for intervention requests and two rounds of discovery upon KU/LG&E's application. The only intervenor in this matter is the Attorney General of the Commonwealth of Kentucky, by and through the Office Rate Intervention (Attorney General). A formal evidentiary hearing was conducted on November 29, 2018. KU/LG&E filed responses to post-hearing data requests on December 5, 2018. The Attorney General filed its post-hearing brief on December 6, 2018. KU/LG&E filed their reply brief on December 11, 2018. The matter now stands submitted to the Commission for a decision.

BACKGROUND

In support of the request for authorization to establish regulatory liabilities associated with certain changes in Kentucky's tax law, KU/LG&E state that the 2018 Kentucky General Assembly adopted House Bills 366 and 487, which, among other things, reduced the state corporate income tax rate from 6 percent to 5 percent for taxable years beginning on or after January 1, 2018.[1] KU/LG&E point out that the reduction in the state corporate income tax rate will decrease their income tax expense and, thus, result in income savings for their customers.[2] KU/LG&E further point out that previous ADIT benefits on their books as of December 31, 2017, will now reverse at 5 percent rather than at the 6 percent rate, creating excess deferred taxes.[3]

With respect to the excess ADIT resulting from the reduction in the state corporate income tax rate, KU/LG&E request permission to record net regulatory liabilities by the end of 2018. KU/LG&E estimate the net regulatory liabilities including gross-ups to be approximately $19.4 million for KU, $12.5 million for LG&E's electric operations, and $3.1 million for LG&E's gas operations.[4] With respect to the income tax expense savings created by the reduced state corporate income tax rate, KU/LG&E state that they have not established regulatory liabilities but will address the non-mechanism related savings

[1] Joint Application at paragraph 11.

[2] *Id.* at paragraph 12.

[3] *Id.*

[4] Joint Application at paragraph 13.

as part of their pending rate case filings to ensure that all aspects of the state tax reform are appropriately considered.[5]

KU/LG&E propose to account for the state corporate tax rate reduction by amortizing all protected excess ADIT using the Average Rate Assumption Method (ARAM) and amortizing all unprotected excess ADIT over a 15-year amortization period.[6] Further, KU/LG&E propose to continue to treat all property-related excess ADIT as protected and to amortize the unprotected excess ADIT beginning when new base rates take effect.[7] KU/LG&E assert that this proposal to amortize the excess ADIT created by the reduction in the state corporate income tax rate is consistent with how they amortize the excess ADIT created by the reduction in the federal corporate income tax rate pursuant to the Tax Cut and Jobs Act.[8]

In support of the request to establish regulatory assets for the restoration expenses related to the July 20, 2018 thunderstorms (July Storm), KU/LG&E state that the storm caused extensive and widespread damage to its distribution and transmission facilities. KU/LG&E inform that the storm took down 1,200 wires, damaged 200 poles, and left nearly 174,000 of their customers without power.[9] KU/LG&E indicate that the repair efforts took upwards of four days to fully restore electric service to their customers.[10] At their peak, KU/LG&E state that the restoration efforts involved nearly 1,200 employees

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[5] *Id.*

[6] Joint Application at paragraph 14.

[7] *Id.*

[8] *Id.*

[9] Joint Application at paragraph 17.

[10] *Id.* at paragraph 19.

and contractors, including mutual assistance crews from nearby states.[11] KU/LG&E estimate the operations and maintenance expenses in connection with the repair and restoration efforts to be approximately $4.7 million for KU and $2.4 million for LG&E, which excludes normal operations expenses currently embedded in base rates.[12] Based upon the number of customers impacted and the cost of the damage, KU/LG&E assert that the July Storm ranks among the top five most damaging storms to hit the KU/LG&E system.[13] KU/LG&E contend that the expenses incurred for the July Storm approach the combined operations and maintenance (O&M) expense budgets for storm damage of approximately $9.3 million (KU $3.9 million and LG&E $5.4 million) embedded in base rates.[14] KU/LG&E further state that total Kentucky storm damage O&M costs for 2018 as of the date of the filing of the application, including the July Storm expenses, will be approximately $14.3 million (KU $6.8 million and LG&E $7.5 million).[15]

ATTORNEY GENERAL'S POSITION

The Attorney General recommends that KU/LG&E's request for authority to establish regulatory liabilities for the excess ADIT be granted, noting that there is nothing in the record to support a denial of the companies' proposal for regulatory liabilities.[16] The

[11] *Id.* at paragraph 20.

[12] *Id.* at paragraph 22.

[13] Joint Application at paragraph 18.

[14] *Id.* at 24.

[15] *Id.*

[16] Attorney General's Post-Hearing Brief at 2.

Attorney General, however, recommends that KU/LG&E's request to establish regulatory assets for the expenses related to the July Storm repair and restoration costs be denied.[17]

The Attorney General states that the Commission has approved regulatory assets for storm damage expense only when a utility has established that those were extraordinary and nonrecurring expenses that could not have been reasonably anticipated or included in the utility's planning.[18] The Attorney General points out that the Commission recently restated this standard in Case No. 2016-00180,[19] involving Kentucky Power Company's request for authorization to establish regulatory assets for storm damage expenses occurring in 2015.[20] Because the Commission in Case No. 2016-00180 requires a utility to receive approval prior to deferring a regulatory asset for storm damage expenses, the Attorney General argues that a utility cannot rely upon the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 980-340-25-1 as authority to establish deferral accounting for storm damage expenses to the extent those expenses were incurred prior to the fourth quarter of any year.[21] The Attorney General asserts that approval by the Commission of the deferral request would also implicitly determine that the storm damage expenses were reasonably incurred.[22] Thus, the Attorney General contends that "the decisions as to whether or not these costs

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[17] Attorney General's Post-Hearing Brief at 1.

[18] *Id.* at 4.

[19] Case No. 2016-00180, *Application of Kentucky Power Company for an Order Approving Accounting Practices to Establish Regulatory Assets and Liabilities Related to the Extraordinary Expenses Incurred by Kentucky Power Company in Connection With Two 2015 Major Storm Events* (Ky. PSC Nov. 3, 2016).

[20] Attorney General's Post-Hearing Brief at 4.

[21] *Id.* at 5.

[22] *Id.*

will be deferred *and* ultimately will be recoverable are in front of the Commission now for its decision."[23]

The Attorney General contends that KU/LG&E's request for deferral of the July Storm expenses should be denied because those costs were not extraordinary in magnitude compared to the expense level built into base rates nor when determining their impact to year-end financial results.[24] Although acknowledging that the storm damage costs at issue exceed the amount embedded in base rates, the Attorney General argues that both KU and LG&E were under budget for storm restoration expenses the prior two calendar years.[25] The Attorney General notes that, on a combined basis, KU/LG&E were approximately $9.5 million over budget in 2014, $0.5 million under in 2015, $3.5 million under budget in 2016, and $4.3 million under budget in 2017 for storm damage expenses.[26] The Attorney General then points out that KU/LG&E's actual storm damage expenses, on a combined basis, are approximately $7.885 million higher than the companies' budgeted levels as of October 2018.[27] The Attorney General contends that the July Storm expenses were neither extraordinary nor nonrecurring when compared to the data from just the past four years.[28] The Attorney General further contends that the magnitude of the July Storm expenses was not extraordinary because these costs would

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[23] *Id.* (emphasis in original).

[24] *Id.* at 9.

[25] *Id.*

[26] *Id.* at 10.

[27] *Id.*

[28] *Id.*

have a minimal financial impact on KU/LG&E as the companies would still be under budget by $7 million for O&M and earnings per share would still exceed expectations.[29]

The Attorney General contends that the Commission should measure materiality of the expenses at issue as a percentage of rate base consistent with the approach performed in Case No. 2000-00120,[30] involving a base rate application filed by Kentucky-American Water Company.[31] The Attorney General asserts that the percentage of rate base method is appropriate because a utility's rate of return is ordinarily determined using rate base, and the method would provide an objective measure as to the impact on earnings that expensing the cost may have.[32] The Attorney General calculated the July Storm expense as a percentage of rate base and compared that calculation to the following storm expenses incurred by KU/LG&E, for which KU/LG&E were granted authority to defer: 2011 LG&E Storm, 2009 KU and LG&E Ice Storms, 2008 KU and LG&E Ike Storms, and 2003 KU Ice Storm.[33] The Attorney General asserts that the July Storm costs as a percentage of rate base for either KU or LG&E do not exceed the 0.1386 percentage of rate base that the Commission determined in Case No. 2000-00120 to be immaterial with respect to reorganization costs, which were the largest costs deferred by Kentucky-American Water Company.[34] Regarding the prior storm expenses for which

[29] *Id.* at 10–11.

[30] Case No. 2000-00120, *Application of Kentucky-American Water Company to Increase its Rates* (Ky. PSC Nov. 27, 2000).

[31] *Id.* at 11.

[32] *Id.*

[33] *Id.* at 12–13.

[34] *Id.* at 13. The Attorney General calculated the July Storm costs for KU to be 0.10077 percent of its rate base and LG&E's to be 0.06976 percent.

KU/LG&E were authorized to establish regulatory assets, the Attorney General avers that the ratios of the costs to rate base did exceed the threshold set in Case No. 2000-00120, except the 2009 KU Ice Storm.[35] The Attorney General maintains that the ratios of storm costs as a percentage of rate base for every single event cited by KU/LG&E as precedent, except for the 2009 KU Ice Storm, exceeds the ratios in the instant matter.[36] The Attorney General points out that KU was authorized to establish a regulatory asset for the 2009 KU Ice Storm because the storm costs incurred by KU combined with that of LG&E's $24.1 million regulatory asset for incremental O&M resulted in a combined incremental O&M expense of $26 million, which, according to the Attorney General, was three times the combined request in the instant matter.[37]

Lastly, the Attorney General argues that KU/LG&E has underspent on vegetation management expenses the past several years, which ultimately benefits shareholders but creates unnecessary reliability risks.[38] The Attorney General contends that chronic underspending on vegetation management will ultimately lead to higher costs for customers because robust vegetation management reduces the risk of storm damage, which, in turn, reduces storm damage expense.[39]

KU/LG&E'S POSITION

KU/LG&E contend that the Commission should approve the proposed regulatory liabilities to account for the excess ADIT created by the reduction in the state corporate

[35] Attorney General Post-Hearing Brief at 13.

[36] *Id.*

[37] *Id.*

[38] *Id.* at 13–14.

[39] *Id.* at 14.

income tax rate.[40] KU/LG&E state that the reduction in the state corporate income tax rate stems from the passage of the Kentucky Tax Reform Act and that the Commission has previously approved regulatory liabilities for utilities when the utility has incurred an expense resulting from a statutory directive.[41]

KU/LG&E also contend that the Commission should approve its proposed regulatory assets for the July Storm expenses.[42] KU/LG&E maintain that the scope of the damage caused by the July Storm was significant, noting that the storm ranks among the top five most damaging storms to hit the KU/LG&E system based on the number of customers impacted and the cost of the damage.[43] KU/LG&E state that the $7.2 million July Storm-related costs ($4.8 million incurred by KU and $2.4 million by LG&E) approach their combined O&M expense budgets for storm damage of approximately $9.3 million (KU $3.9 million and LG&E $5.4 million) that are currently embedded in base rates and exceed those in the case of KU.[44] KU/LG&E further state that the July Storm damage alone exceeds the $6.3 million for storm damage expenses included in the forecasted test year in their pending rate cases (KU $3.0 million and LG&E $3.3 million).[45] KU/LG&E assert that storm damages in base rates are normalized based on a historic average and do not include any storms for which regulatory treatment has been granted.[46] KU/LG&E

[40] Reply Brief of Kentucky Utilities Company and Louisville Gas and Electric Company to Attorney General's Post-Hearing Brief (KU/LG&E Reply Brief) at unnumbered page 1.

[41] *Id.* at 2.

[42] *Id.*

[43] *Id.* at 3.

[44] *Id.* at 4.

[45] *Id.*

[46] *Id.* at 5.

aver that it would be inappropriate to include the costs of such extraordinary events in the normalization calculation of storm damages used in base rates because of the unpredictable nature of such events and the lack of the ability to control the occurrence and timing of such.[47] KU/LG&E argue that doing so would unnecessarily cause base rates to be higher.[48]

KU/LG&E assert that the Commission's decision in Case No. 2016-00180 did not pre-empt FASB ASC 980.[49] Rather, KU/LG&E contend that the criteria established in Case No. 2016-00180 are cumulative or in addition to the standards in FASB ASC 980.[50] KU/LG&E argue that the central issue to be determined by the Commission with respect to their request to establish regulatory assets is whether the July Storm costs were extraordinary or reoccurring.[51] KU/LGE maintain that the evidence clearly shows that July Storms were extraordinary and nonrecurring in nature.[52]

KU/LG&E argue that Case No. 2000-00120 is factually distinguishable from the instant matter and should not be relied upon in determining the materiality of the July Storm costs.[53] KU/LG&E assert that the Commission's decision in cases where the companies were granted authority to book regulatory assets or liabilities were not based on a percentage of rate base methodology to determine materiality but rather was based

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[47] *Id.*

[48] *Id.*

[49] *Id.* at 6.

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] *Id.* at 7.

on the amount of storm damage expense embedded in base rates.[54] KU/LG&E contend that using balance sheet metrics, such as rate base, to measure the materiality of changes to the income statement is arbitrary.[55] KU/LG&E assert that measuring the level of storm damage expense compared to the amount included in base rates is a rational relationship between the event at issue and the income statement.[56]

KU/LG&E take issue with the Attorney General's argument that historical deviations between budgeted and actual storm damages purportedly show the July Storm damages are neither extraordinary nor nonrecurring.[57] KU/LG&E contend that the Attorney General's argument erroneously assumes that weather did not vary over the prior four-year period and that storm expenses do not vary in direct proportion to weather, when, in fact, the opposite is true for both instances.[58] KU/LG&E further contend that the Attorney General's argument fails to account for the fact that, to the extent storm damage expense is under budget in a particular year or years, the normalization of the storm damages in the budgeting process for a future test year reduces the ongoing storm damage expense levels to the benefit of customers.[59]

Regarding the Attorney General's claim that their underspending on vegetation management expenses has resulted in increased reliability risks, KU/LG&E counter that

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[54] *Id.* at 7–8.

[55] *Id.* at 8.

[56] *Id.*

[57] *Id.* at 8–9.

[58] *Id.* at 9.

[59] *Id.*

the evidentiary record refutes this claim.[60] KU/LG&E point out that the testimony at the hearing in this matter clearly demonstrates that they have increased the most recent five-year tree-trimming budget by $37 million as compared to the prior five-year period.[61] KU/LG&E further point out that the actual spending on vegetation management was less than the budgeted amount in 2016 and 2017 due to mild weather and fewer occurrences of severe storms, which results in relatively less activity for vegetation management crews.[62] KU/LG&E contend that its reliability performance in recent years has been outstanding, noting that their System Average Interruption Frequency Index (SAIFI) and System Average Interruption Duration Index (SAIDI),[63] on a combined basis, in 2016 and 2017 was the lowest in their history.[64] Lastly, KU/LG&E argue that the extensive damage caused by the July Storm was not as a result of underspending on vegetation management but rather the result of 70-80 miles per hour winds.[65] KU/LG&E point out that they spent $2.7 million or 7.5 percent less than what was budgeted in 2017, which arguably affected 1.7 percent of the total circuits; however, the July Storm affected well over 30 percent of their circuits and over 50 percent in Lexington where 85,000 customers were impacted.[66]

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[60] *Id.* at 10.

[61] *Id.* at 10–11.

[62] *Id.* at 11.

[63] SAIDI is a reliability index, which measures the average outage duration for each customer served. SAIFI measures the average number of interruptions that a customer would experience.

[64] KU/LG&E Reply Brief at 11.

[65] *Id.* at 12.

[66] *Id.*

DISCUSSION

As we noted in Case No. 2008-00436:

> A regulatory asset is created when a rate-regulated business is authorized by its regulatory authority to capitalize an expenditure that under traditional accounting rules would be recorded as a current expense. The reclassification of an expense to a capital item allows the regulated business the opportunity to request recovery in future rates of the amount capitalized. The authority for establishing regulatory assets arises under the Commission's plenary authority to regulate utilities under KRS 278.040 and the Commission's authority to establish a system of accounts under KRS 278.220. Historically, the Commission has exercised its discretion to approve regulatory assets where a utility has incurred: (1) an extraordinary, nonrecurring expense which could not have reasonably been anticipated or included in the utility's planning; (2) an expense resulting from a statutory or administrative directive; (3) an expense in relation to an industry sponsored initiative; or (4) an extraordinary or nonrecurring expense that over time will result in a saving that fully offsets the cost.[67]

Having reviewed the record and being otherwise sufficiently advised, the Commission finds that KU/LG&E's request for authorization to establish regulatory liabilities to account for excess ADIT created by the reduction in the state corporate income tax rate is reasonable and should be approved. The Commission notes that the reduction in the state corporate income tax rate was made pursuant to certain changes to Kentucky's tax code during the 2018 legislation session. Because of the excess ADIT results from a statutory change in Kentucky's tax code, KU/LG&E should be authorized to establish, for accounting purposes only, net regulatory liabilities for the excess ADIT. The Commission also finds KU/LG&E's request to amortize the protected excess ADIT

[67] Case No. 2008-00436, *Application of East Kentucky Power Cooperative, Inc. for an Order Approving Accounting Practices to Establish a Regulatory Asset Related to Certain Replacement Power Costs Resulting From Generation Forced Outages* (Ky. PSC Dec. 23, 2008) Final Order at 3-4.

using the ARAM and amortizing all unprotected excess ADIT over a 15-year amortization period is reasonable and should be approved. The Commission notes that this proposed amortization of the excess ADIT is consistent with what was approved in Case No. 2018-00034.[68]

With respect to KU/LG&E's request for authorization to establish deferral accounting for the repair and restoration expenses associated with the July Storm, the Commission finds that those costs are extraordinary and nonrecurring and could not have been reasonably anticipated or included in KU/LG&E's planning. Accordingly, the Commission finds that KU/LG&E should be authorized to establish, for accounting purposes only, regulatory assets based on the incremental, actual storm-related costs for the damage and service restoration expenses incurred by the companies as a result of the July Storm. We note that the July storm caused extensive and widespread damage to KU/LG&E's system, resulting in almost 174,000 customers without service and requiring the companies to incur approximately $7.1 million, on a combined basis, in incremental O&M expenses to repair and restore service. The cost of the July Storm amounts to almost 76 percent of KU/LG&E's combined O&M expense budgets for storm damage of approximately $9.3 million, which are currently embedded in their base rates. Segregated by company, KU's July Storm costs are approximately $4.7 million, which exceeds the $3.9 million storm damage budget that is currently embedded in its base rates. LG&E's July Storm cost are approximately $2.4 million and amounts to 44 percent of the $5.4 million storm damage budget embedded in its base rates. Because the Commission has historically reviewed requests by electric utilities for deferral accounting

[68] Case No. 2018-00034, *Kentucky Industrial Utility Customers, Inc. v. Kentucky Utilities Company and Louisville Gas and Electric Company* (Ky. PSC Mar. 20, 2018).

related to storm damage expenses based upon the level of those costs embedded in base rates, we will decline to adopt the measure proposed by the Attorney General to measure the materiality of storm-related costs as compared to rate base. We also note that there is nothing in the record to support a finding that KU/LG&E's underspending in vegetation management the last few years were profit motivated nor that it exacerbated or exposed the companies to increased risk in reliability. Lastly, contrary to the Attorney General's claim that the decision in this matter implicates both the request for deferral and the recovery of those costs, the Commission finds that our decision in applications requesting authority to establish regulatory assets, such as the requests by KU/LG&E in this matter, is limited to permitting the utility to establish, for accounting purposes only, deferral accounting to capitalize an expenditure that would otherwise be recorded as a current expense. Our decision in this matter does not touch upon the issue of rate recovery of such costs.

IT IS THEREFORE ORDERED that:

1. KU/LG&E are authorized to establish regulatory liabilities for the excess ADIT created by the reduction in the Kentucky corporate income tax rate.

2. KU/LG&E are authorized to establish regulatory assets for the actual, incremental costs incurred to repair and restore service resulting from the July Storm.

3. The regulatory liabilities and assets accounts established in this case are for accounting purposes only.

4. The amount, if any, of the regulatory liabilities and assets authorized herein that is to be amortized and included in rates, shall be determined in KU/LG&E's pending rate cases.

5. This case is closed and removed from the Commission's docket.

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By the Commission

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