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	))))	CASE NO. 2006-00456

O R D E R

On October 27, 2006, Kentucky Utilities Company ("KU") filed an application for authority to establish regulatory 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.

In Case No. 2005-00181,[2] KU sought authority to establish regulatory liabilities for excess deferred state income taxes and approval of an accounting treatment to flow back the excess deferred state income taxes associated with the reduction in the Kentucky corporate income tax rate from 8.25 percent to 7.00 percent. The

[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] Case No. 2005-00181, Application of Kentucky Utilities Company for an Order Approving the Accounting Treatment Relating to Income Tax Expense for 2005 and Subsequent Years, final Order dated June 30, 2005.

Commission's June 30, 2005 Order approved KU's request and directed KU to request prior Commission approval for any further regulatory asset or liability accounts relating to additional excess deferred state income taxes resulting from the January 1, 2007 tax rate reduction. The current application reflects the change in the tax rate from 7.00 percent to 6.00 percent beginning January 1, 2007.[3]

The federal Internal Revenue Code and Kentucky income tax law require a utility to normalize any income tax timing differences[4] 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 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.

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[3] The Commission has not received any requests for intervention in this proceeding.

[4] 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.

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.[5] 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.

KU seeks authority to establish separate regulatory liabilities for the protected and unprotected excess Kentucky deferred taxes resulting from the enactment of House Bill 272. KU determined that the Kentucky jurisdictional regulatory liability for its protected excess Kentucky deferred income taxes should be $9,447,000 and the Kentucky jurisdictional regulatory liability for its unprotected excess Kentucky deferred income taxes should be $131,000.[6] KU proposed for accounting purposes to flow back

[5] 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.

[6] Application at 7-8 and Exhibit 3. Exhibit 3 shows the proposed regulatory liability for protected excess Kentucky deferred income taxes on a total company basis to be $10,863,000, with the Kentucky jurisdictional amount being $9,447,000 and other jurisdictions being $1,416,000. Exhibit 3 also shows the proposed regulatory liability for unprotected excess Kentucky deferred income taxes on a total company basis to be $149,000, with the Kentucky jurisdictional amount being $131,000 and other jurisdictions being $18,000.

the protected excess Kentucky deferred income taxes using the average-rate assumption method, noting that this approach is 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 2006 by reducing its Kentucky jurisdictional income tax expense by $80,000.[7] KU stated that this approach for the unprotected amount is reasonable due to the immaterial size of the amount, and that it is "administratively prudent" to flow back the unprotected amount in one year rather than amortizing the amount over a period of years.[8]

The Commission has reviewed the application 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 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

[7] Application Exhibit 3 and Exhibit 4. There is a federal income tax effect resulting from the reduction in the Kentucky income tax rate. The adjustment for unprotected excess Kentucky deferred income taxes, net of the federal tax effect, on a total company basis is $91,000. However, when establishing the regulatory liability, it is necessary to gross-up the net adjustment for taxes, resulting in the regulatory liability for unprotected excess Kentucky deferred income taxes on a total company basis of $149,000. On a Kentucky jurisdictional basis, the reduction in income tax expense is $80,000 and the corresponding regulatory liability is $131,000.

[8] Application at 8-9. KU proposed, and the Commission approved, the same treatment for the unprotected excess Kentucky deferred income taxes in Case No. 2005-00181. However, in that case, there was a Kentucky deferred income tax deficiency for the unprotected excess Kentucky deferred income taxes and the flow back in one year produced an increase in income tax expense.

the provisions of the Tax Reform Act of 1986 and prior Commission precedent.[9] Considering the relatively minimal amount of unprotected excess Kentucky deferred income taxes, KU's proposal to flow back this amount as a reduction in Kentucky jurisdictional income tax expense in 2006 is reasonable and will result in the elimination of the deferred liability as of year end 2006. These accounting treatments will not affect the rates currently paid by KU's customers.

IT IS THEREFORE ORDERED that:

1. KU is authorized to establish on its books for accounting and reporting purposes Kentucky jurisdictional regulatory liabilities of $9,447,000 for its protected excess Kentucky deferred income taxes and $131,000 for its unprotected 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 reduce its Kentucky jurisdictional income tax expense for 2006 by $80,000 related to its unprotected Kentucky jurisdictional excess Kentucky deferred income taxes.

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[9] Case No. 10064, Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company, final Order dated July 1, 1988, at 60-62; Case No. 2005-00180, Application of Louisville Gas and Electric Company for an Order Approving the Accounting Treatment Relating to Income Tax Expense for 2005 and Subsequent Years, final Order dated June 30, 2005; and Case No. 2005-00181.

Done at Frankfort, Kentucky, this 11th day of December, 2006.

By the Commission

ATTEST:

Executive Director