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March 3, 2006

**HAND DELIVERY**

**RECEIVED**

MAR 03 2006

PUBLIC SERVICE  
COMMISSION

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

**RE: Application of Louisville Gas and Electric Company for an Adjustment of its Gas and Electric Rates, Terms and Conditions**  
**Case No. 2003-00433**

**Application of Kentucky Utilities Company for an Adjustment of its Electric Rates, Terms and Conditions**  
**Case No. 2003-00434**

Dear Ms. O'Donnell:

Enclosed please accept for filing two originals and five copies each of Louisville Gas and Electric Company's and Kentucky Utilities Company's Memorandum Opposing Use of Effective Tax Rates in the above-referenced matters. Please confirm your receipt of these filings 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 or need any additional information, please contact me at your convenience.

Very truly yours,

Kendrick R. Riggs

KRR/ec  
Enclosures  
cc: Parties of Record

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COMMONWEALTH OF KENTUCKY

MAR 03 2006

BEFORE THE PUBLIC SERVICE COMMISSION

PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND )  
ELECTRIC COMPANY FOR AN ADJUSTMENT ) CASE NO. 2003-00433  
OF THE GAS AND ELECTRIC RATES, )  
TERMS AND CONDITIONS )

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES )  
COMPANY FOR AN ADJUSTMENT ) CASE NO. 2003-00434  
OF THE ELECTRIC RATES, TERMS AND )  
CONDITIONS )

LOUISVILLE GAS AND ELECTRIC COMPANY'S  
AND KENTUCKY UTILITIES COMPANY'S  
MEMORANDUM OPPOSING USE OF EFFECTIVE TAX RATES

On August 12, 2004, the Commission, in response to the Attorney General's ("AG") July 23, 2004 Petition for Rehearing, issued an Order granting rehearing "to determine whether it is appropriate to use the effective Kentucky income tax rates, what those tax rates are, and whether their use would have impacted the revenue increases granted." By Order dated December 14, 2005, the Commission created a procedural schedule concerning these topics on rehearing, providing for discovery and setting a due date of March 3, 2006, for parties to move for hearing or submit memoranda supporting their positions.

**I. The Commission Should Decline To Use The Effective Tax Rate**

The Companies (Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU")) continue to maintain that the Commission's June 30, 2004 Orders were correct concerning these tax-related issues, namely by holding it is reasonable to use the Kentucky Corporate Income Tax Rate for the Companies. The June 30, 2004 Orders correctly recognized that the Commission has used the state statutory tax rate in the Companies' past rate

cases. In the absence of a more known and measurable and thus reliable tax rate, it is reasonable to continue to use the statutory rate in these cases; indeed, effective tax rates fluctuate year to year based on changes in property, payroll, and sales factors.<sup>1</sup> As explained by Mr. Rives at the hearing, the Companies' respective effective state income tax rates in 2002 were less than the statutory rates because of credits and apportionment adjustments from out-of-state activities, which may not be present at all or to the same extent in the future.<sup>2</sup> The continuous change in credits and out-of-state activities make the effective tax rate more uncertain and complicated than the statutory rate used in the June 30, 2004 Orders.<sup>3</sup> In contrast, the Kentucky statutory income tax rate is objective, known and measurable, easily understood and verified, and not distorted by non-recurring items or apportionment adjustments from out-of-state activities. The evidence of record thus support's the Commission's determination on this issue in the June 30, 2004 orders.

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<sup>1</sup> Companies' January 20, 2006 Response to the Commission's January 6, 2006 Data Request No. 1.

<sup>2</sup> Rives LG&E and KU Rebuttal, pp. 9-10.; See Response of LG&E to PSC 2-15(c)(2) and (3); Response of KU to PSC 2-15(c)(2) and (3).

<sup>3</sup> The Commission's decision to use an effective tax rate in Case No. 2001-00092 apparently did not involve the issues related to out-of-state taxation of off-system sales. In that case, the Commission approved the use of the effective state tax rate on a "trial" basis until the next rate case and expressed reservation about the use of the effective rate because of a significant fluctuation in the effective rate from one year to the next. Case No. 2001-00092, Order at pages 59-60 (January 31, 2005). Then, in the utility's next gas rate case, the Commission approved the use of the 7 percent corporate income tax rate in Kentucky without comment on the "trial" policy from the earlier order. Case No. 2005-00042, Order at pages 49-50 (December 22, 2005).

In addition, as shown below, the use of the effective tax rate on the calculation of the income in the electric revenue requirements has a minimal effect:

**Impact of State Tax Rate on Revenue Increases**

<u>Company</u>	<u>Using Statutory Rate<sup>4</sup></u>	<u>Using Effective Rate<sup>5</sup></u>	<u>Per June 30, 2004 Order<sup>6</sup></u>
LG&E	\$ 45,608,365	\$45,103,769	\$ 43,400,000
KU	\$ 49,775,329	\$49,359,219	\$ 46,100,000

This demonstrates that whether the Commission uses the statutory rate or the effective tax rates identified by the Companies in the analysis of net operating income, there is only a *de minimis* impact on the Commission’s determination on the reasonableness of the “Per June 30, 2004 Order” revenue requirement increases (“Approved Increases”). Moreover, the Approved Increases remain well within the range of reasonableness set forth in the June 30, 2004 Orders: the Order concerning LG&E found a reasonable range of revenue increase of \$39,591,950-\$51,875,465;<sup>7</sup> the Order concerning KU found a reasonable range of revenue increase of \$44,097,178-\$55,235,088.<sup>8</sup> Thus, the record of evidence continues to clearly support the Commission’s determination on the reasonableness of the Approved Increases.

Concerning the Commission’s stated objective of determining what are the effective tax rates, the Companies stated in response to the Commission’s January 6, 2006 Data Requests that the effective state tax rate for LG&E is 8.07% (Kentucky-only is 7.87%), whereas KU’s is 7.98% (Kentucky-Virginia-Tennessee rate is 7.90%).<sup>9</sup> Although none of these rates is appropriate because the statutory rate is more known and measurable, and thus reliable, with

<sup>4</sup> Case No. 2003-00434, Order, p. 59; Case No. 2003-000433, Order, p. 68.

<sup>5</sup> See LG&E’s and KU’s August 2, 2004 Data Responses to the PSC’s Orders of July 26, 2004. As stated in the Companies’ January 20, 2006 Response to the January 6, 2006 Data Request of the AG, the effective tax rates used in this calculation are 8.07% for LG&E and 7.98% for KU.

<sup>6</sup> Case No. 2003-00434, Order, p. 59; Case No. 2003-000433, Order, p. 68.

<sup>7</sup> Case No. 2003-000433, Order, p. 68.

<sup>8</sup> Case No. 2003-00434, Order, p. 59.

<sup>9</sup> Companies’ January 20, 2006 Responses to the Commission’s January 6, 2006 Data Requests No. 2.

respect to LG&E's effective rate, if one is chosen, 8.07% is appropriate because LG&E customers benefit from LG&E's activities that give rise to Indiana income taxes, and because they enjoy the benefits on these activities, they should pay the costs.<sup>10</sup> Likewise, KU's Kentucky-only effective tax rate of 7.98% is appropriate for KU because it matches the company's activities that benefit Kentucky customers with the state income tax cost only of those activities.<sup>11</sup> These rates (8.07% and 7.98%) are reflected in the "Effective Rate" column in the table above.

In sum, the Commission correctly determined the use of the statutory tax rate because it is the more known and measurable and thus reliable tax rate for purposes of calculating the electric revenue requirements for LG&E and KU.

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<sup>10</sup> Id.

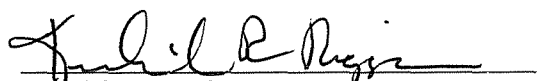
<sup>11</sup> Id.

## Conclusion

The Commission should issue orders in both proceedings affirming the June 30, 2004 Orders in all respects and denying the Attorney General's request for adopting the effective corporate state income tax rates as the appropriate measure for calculating tax expense for the electric operations of LG&E and KU.

Dated: March 3, 2006

Respectfully submitted,



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## CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the foregoing Memorandum was served on the following persons on the 3rd day of March 2006, U.S. mail, postage prepaid:

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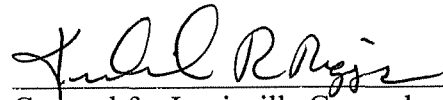
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