LG&E ENERGY

LG&E Energy LLC
220 West Main Street (40202)
P.O. Box 32030
Louisville, Kentucky 40232

May 26, 2005

RECEIVED
MAY 26 2005
PUBLIC SERVICE COMMISSION

Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602-0615

RE: ***APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR AN ORDER APPROVING THE ACCOUNTING TREATMENT RELATING TO INCOME TAX EXPENSE FOR 2005 AND SUBSEQUENT YEARS***
CASE NO. 2005-00180

and

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR AN ORDER APPROVING THE ACCOUNTING TREATMENT RELATING TO INCOME TAX EXPENSE FOR 2005 AND SUBSEQUENT YEARS
CASE NO. 2005-00181

Dear Ms. O'Donnell:

Enclosed please find an original and ten (10) copies of Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company's ("KU") responses to the First Data Request of Commission Staff dated May 18, 2005, in the above-referenced dockets.

Should you have any questions concerning the enclosed, please do not hesitate to contact me at 502-627-3324.

Sincerely,

Robert M. Conroy
Manager, Rates

cc: Hon. Elizabeth E. Blackford
Hon. Michael L. Kurtz

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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MAY 26 2005

PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR AN ORDER APPROVING THE ACCOUNTING TREATMENT RELATING TO INCOME TAX EXPENSE FOR 2005 AND SUBSEQUENT YEARS	**) CASE NO.) 2005-00180**

and

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR AN ORDER APPROVING THE ACCOUNTING TREATMENT RELATING TO INCOME TAX EXPENSE FOR 2005 AND SUBSEQUENT YEARS	**) CASE NO.) 2005-00181**

RESPONSE OF
LOUISVILLE GAS AND ELECTRIC COMPANY
AND
KENTUCKY UTILITIES COMPANY
TO
FIRST DATA REQUEST OF COMMISSION STAFF
DATED MAY 18, 2005

FILED: MAY 26, 2005

LOUISVILLE GAS AND ELECTRIC COMPANY
KENTUCKY UTILITIES COMPANY

CASE NOS. 2005-00180 and 2005-00181

Response to First Data Request of Commission Staff Dated May 18, 2005

Question No. 1

Responding Witnesses: Ronald L. Miller and Valerie L. Scott

Q-1. Refer to Exhibit 2 of the Application. In determining the amount of the regulatory liability account, the federal income tax rate of 35 percent was utilized.

a. Should this calculation also have reflected the impact of the new Internal Revenue Code Section 199, the "Domestic Manufacturing Deduction?" Explain the response.

b. If yes to part (a), provide revisions to Exhibits 2 through 4 reflecting the change in the tax code.

A-1. a. No. Financial Accounting Standards Board (FASB) Staff Position FSP No. FAS 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004*, was issued December 21, 2004 (see attached) and concluded that the deduction for domestic production activities should be accounted for as a special deduction and not as a rate reduction. The special deduction is treated as a permanent difference in the tax calculation, therefore, there is no adjustment applicable to the Company's deferred taxes.

b. Not applicable.

FASB STAFF POSITION

No. FAS 109-1

Title: Application of FASB Statement No. 109, *Accounting for Income Taxes,* to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004

Date Posted: December 21, 2004

1. The Board directed the FASB staff to issue this FASB Staff Position (FSP) that provides guidance on the application of FASB Statement No. 109, *Accounting for Income Taxes,* to the provision within the American Jobs Creation Act of 2004 (the Act) that provides a tax deduction on qualified production activities.[1]

Background and Issue

2. On October 22, 2004, the Act was signed into law by the President. This Act includes a tax deduction of up to 9 percent (when fully phased-in) of the lesser of (a) "qualified production activities income," as defined in the Act, or (b) taxable income (after the deduction for the utilization of any net operating loss carryforwards). This tax deduction is limited to 50 percent of W-2 wages paid by the taxpayer.

3. As a result of the Act, an issue has arisen as to whether that deduction should be accounted for as a special deduction or a tax rate reduction under Statement 109.

FASB Staff Position

4. The FASB staff believes that the qualified production activities deduction's characteristics are similar to special deductions illustrated in paragraph 231 of Statement 109 because the qualified production activities deduction is contingent upon the future performance of specific activities, including the level of wages. Accordingly, the FASB staff believes that the deduction should be accounted for as a special deduction in accordance with Statement 109.

5. The FASB staff also observes that the special deduction should be considered by an enterprise in (a) measuring deferred taxes when graduated tax rates are a significant factor and (b) assessing whether a valuation allowance is necessary as required by paragraph 232 of Statement 109. See Appendix A for an example of the application of paragraphs 27 and 232 of Statement 109 for the impact of the qualified production activities deduction upon enactment of the Act in 2004.

[1] This FSP refers to and describes a provision within the Act. While those comments reflect the best efforts of the FASB staff to describe relevant aspects of the Act, this FSP shall not be considered a definitive interpretation of any provision of the Act for any purpose.

Effective Date and Transition

6. This FSP is effective upon issuance.

7. An enterprise that previously recognized the qualified production activities deduction as a tax rate reduction shall restate its financial statements in accordance with paragraph 27 of APB Opinion No. 20, *Accounting Changes,* to reflect the deduction as a special deduction as prescribed in paragraphs 231 and 232 of Statement 109, and shall provide the disclosures required by paragraph 28 of Opinion 20 and paragraph 14 of FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements,* if applicable.

Appendix A

EXAMPLE OF TREATING THE QUALIFIED PRODUCTION ACTIVITIES DEDUCTION AS A SPECIAL DEDUCTION

The following example illustrates how an enterprise with a calendar year-end would apply paragraphs 27 and 232 of Statement 109 to the qualified production activities deduction at December 31, 2004.[2] In particular, this example illustrates the methodology used to evaluate the qualified production activities deduction's effect on determining the need for a valuation allowance on an enterprise's existing net deferred tax assets.

Assumed facts:

• Expected taxable income (excluding the qualified production activities deduction and net operating loss carryforwards) for the year 2005	$21,000
• Expected qualified production activities income (QPAI) for the year 2005	$50,000
• Net operating loss carryforwards at December 31, 2004, which expire in 2005	$20,000
• Expected W-2 wages for 2005	$10,000
• Assumed statutory income tax rate	35%
• Qualified production activities deduction: 3% of the lesser of (1) QPAI or (2) taxable income (after deducting the net operating loss carryforwards). Limited to 50% of W-2 wages.	$30

[2] The example intentionally is not comprehensive (for example, it excludes state and local taxes).

Conclusion:

The enterprise would not recognize a valuation allowance for the net operating loss carryforwards at December 31, 2004, because expected taxable income in 2005 (after deducting the qualified production activities deduction) exceeds the net operating loss carryforwards, as presented below:

Analysis to compute the qualified production activities deduction

Expected taxable income (excluding the qualified production activities deduction and net operating loss carryforwards) for the year 2005	$21,000
Less net operating loss carryforwards[3]	20,000
Expected taxable income (after deducting the net operating loss carryforwards)	$ 1,000
Qualified production activities deduction	$ 30

Analysis to determine the effect of the qualified production activities deduction on the need for a valuation allowance for deferred tax assets for the net operating loss carryforwards

Expected taxable income after deducting the qualified production activities deduction	$20,970
Net operating loss carryforwards	20,000
Expected taxable income exceeds the net operating loss carryforwards	$ 970

[3] The Act requires that net operating loss carryforwards be deducted from taxable income in determining the qualified production activities deduction. Therefore, the qualified production activities deduction will not result in a need for a valuation allowance for an enterprise's deferred tax asset for net operating loss carryforwards. However, the staff observes that certain types of tax credit carryforwards are not deducted in determining the qualified production activities deduction and, therefore, could require a valuation allowance.

LOUISVILLE GAS AND ELECTRIC COMPANY
KENTUCKY UTILITIES COMPANY

CASE NOS. 2005-00180 and 2005-00181

Response to First Data Request of Commission Staff Dated May 18, 2005

Question No. 2

Responding Witnesses: Ronald L. Miller and Valerie L. Scott

Q-2. Concerning the new Internal Revenue Code Section 199:

a. Does this new section result in excess deferred federal income taxes for LG&E and KU?

b. If yes to part (a), explain why LG&E and KU have not proposed an accounting treatment for the excess deferred federal income taxes resulting from this change in the tax code.

A-2. a. No. Internal Revenue Code ("IRC") Section 199 will have no impact on excess deferred income taxes. Excess deferred income taxes result from differences in the amount of taxes provided at one tax rate and the reversal of temporary differences and the related deferred taxes at different tax rates. As discussed in response to the Question No.1, part (a) , in accordance with FSP No. FAS 109-1, the deduction for domestic production activities is accounted for as a special deduction, or permanent difference, and will have no impact on deferred income taxes.

b. Not applicable.

LOUISVILLE GAS AND ELECTRIC COMPANY
KENTUCKY UTILITIES COMPANY

CASE NOS. 2005-00180 and 2005-00181

Response to First Data Request of Commission Staff Dated May 18, 2005

Question No. 3

Responding Witnesses: Ronald L. Miller and Valerie L. Scott

Q-3. Concerning the regulatory liability balance shown on Exhibit 2:

a. For LG&E, separate the protected amount, unprotected amount, and total regulatory liability balance between electric and gas operations.

b. For KU, separate the protected amount, unprotected amount, and total regulatory liability balance between Kentucky jurisdictional and other jurisdictional operations.

A-3. a. Please see the table below for a detailed breakdown.

Unprotected - LG&E	State Adjustment 12/31/04	Federal Effect	Net Adjustment	Tax Gross-up	Regulatory Liability
Electric	$ 190,000	($ 67,000)	$ 123,000	$ 78,000	$ 201,000
Gas	(151,000)	53,000	(98,000)	(62,000)	(160,000)
Subtotal	$ 39,000	($ 14,000)	$ 25,000	$ 16,000	$ 41,000
Protected – LG&E					
Electric	$13,363,000	($4,677,000)	$ 8,686,000	$5,530,000	$14,216,000
Gas	1,997,000	(699,000)	1,298,000	826,000	2,124,000
Subtotal	$15,360,000	($5,376,000)	$9,984,000	$6,356,000	$16,340,000
Grand Total	**$15,399,000**	**($5,390,000)**	**$10,009,000**	**$6,372,000**	**$16,381,000**

b. Please see the table below for a detailed breakdown.

Unprotected – KU	State Adjustment 12/31/04	Federal Effect	Net Adjustment	Tax Gross-up	Regulatory Liability
KY Jurisdictional	($ 285,000)	$ 100,000	($ 185,000)	($ 118,000)	($ 303,000)
Other Jurisdictional	(49,000)	17,000	(32,000)	(20,000)	(52,000)
Subtotal	($ 334,000)	$ 117,000	($ 217,000)	($ 138,000)	($ 355,000)
Protected – KU					
KY Jurisdictional	$8,859,000	($3,101,000)	$ 5,758,000	$3,666,000	$9,424,000
Other Jurisdictional	1,507,000	(527,000)	980,000	624,000	1,604,000
Subtotal	$10,366,000	$(3,628,000)	$6,738,000	$4,290,000	$11,028,000
Grand Total	**$10,032,000**	**($3,511,000)**	**$6,521,000**	**$4,152,000**	**$10,673,000**

LOUISVILLE GAS AND ELECTRIC COMPANY
KENTUCKY UTILITIES COMPANY

CASE NOS. 2005-00180 and 2005-00181

Response to First Data Request of Commission Staff Dated May 18, 2005

Question No. 4

Responding Witnesses: Ronald L. Miller and Valerie L. Scott

Q-4. For KU, explain why Exhibit 2 shows a state deferred tax deficiency related to the unprotected amount.

A-4. KU has a net deferred tax asset balance related to its unprotected deferred taxes at December 31, 2004. Therefore, as future deductible temporary differences (and the related deferred tax assets) reverse at lower tax rates, tax benefits associated with those deductions are reduced. Exhibit No. 3 filed with KU's accounting order application indicates that the deficiency is primarily attributable to deferred tax assets related to SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and pension liabilities.