

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE EFFECTS OF THE FEDERAL TAX)
REFORM ACT OF 1986 ON THE RATES OF) CASE NO. 9780
KENTUCKY UTILITIES COMPANY)

O R D E R

On December 11, 1986, the Commission established this case for the purpose of determining the effects of the Tax Reform Act of 1986 ("Tax Reform Act") on the rates of Kentucky Utilities Company ("KU"). The Order initially establishing these proceedings was directed to all utilities with revenues in excess of \$1 million. The Commission limited its investigations to the major utilities since the impact on smaller privately owned utilities was relatively insignificant. After a review of the initial filings, the Commission disposed of a number of cases due to the minimal impact on rates and the extent of the Commission's regulation of certain competitive telecommunications utilities. At this time, 15 utilities remain under the purview of this examination.

On January 26, 1987, KU filed testimony and other exhibits in response to the Commission's Order. KU proposed and submitted notice that the new rates be implemented in two phases: Phase One, effective for billings from March 1, 1987, through December 31, 1987; and Phase Two, effective for billings on and after January 1, 1988. The proposed Phase One rates reflected a

decrease in annual revenue of \$9,760,000 from the test year while the proposed Phase Two rates reflected an additional decrease of \$3,233,000 for a total decrease of \$12,993,000. The Commission, by Order dated February 24, 1987, directed KU to place its proposed Phase One rates into effect on an interim basis subject to change pending the Commission's final determination in this case. As a result of the findings and determinations herein, the revenues of KU will be decreased by \$9,760,000 for 1987 and thereafter an additional \$9,575,000 for a total decrease of \$19,335,000 annually. The overall reduction in revenue requirements for the 15 utilities subject to these proceedings is in excess of \$75 million.

Motions to intervene were filed by the Utility and Rate Intervention Division of the Office of the Attorney General ("AG"); Utility Rate Cutters of Kentucky, Inc., ("URC"); and Kentucky Industrial Utility Customers ("KIUC"). All motions to intervene were granted by the Commission. Thomas C. DeWard, on behalf of the AG, and David H. Kinloch, on behalf of URC, submitted prefiled testimony in this case. KIUC did not submit testimony, but filed comments through its counsel.

A public hearing was held at the Commission's offices in Frankfort, Kentucky, on May 4, 1987.

COMMENTARY

In its Order of December 11, 1986, the Commission expressed the opinion that the focus of this proceeding should be reflecting the effects of the Tax Reform Act in rates. Thus, the Commission considered the three primary issues in this matter to be: (1)

determining the amount of the revenue change required due to the Tax Reform Act; (2) determining the appropriate date of any rate change; and (3) distributing the revenue change among rate schedules.

The Commission required that a 12-month period ending no more than 90 days from December 11, 1986, the date of the Order establishing this case, should be used to determine the effects of the Tax Reform Act. KU proposed and the Commission has accepted the 12-month period ending November 30, 1986, as the test period for determining the reasonableness of the proposed rates.

PROCEDURAL ISSUES

Single-Issue Approach

Throughout these proceedings, there have been objections to the methodology used by the Commission in determining the reasonableness of each utility's rates subsequent to the Tax Reform Act. Certain utilities have characterized the Commission's actions as "single-issue" rate-making. Implicit in their objections is the notion that single-issue rate-making is contrary to law.¹

This notion was rebutted by, among others, Kentucky Utilities Company ("KU"). In his opening argument, in Case No. 9780,² counsel for KU stated that this proceeding is soundly based. KU recognized that there was good reason to focus the proceeding on

¹ Other states have upheld single-issue rate-making proceedings, see for example, Consumers Power Company v. Michigan Public Service Commission, Mich. App., 237 NW 2d 189 (1975).

² Case No. 9780, The Effects of the Federal Tax Reform Act of 1986 on the Rates of Kentucky Utilities Company.

the tax changes.³ In its post-hearing brief, KU further stated its agreement with the Commission's position that retaining the savings resulting from tax reform was not a proper way for KU to improve its earnings and indicated that a focused proceeding, expeditiously passing the tax savings to ratepayers, was reasonable as long as KU was permitted to maintain its test-period rate of return.⁴

Those complaining of single-issue rate adjustments overlook the Commission's long established practice of adjusting rates for fuel cost charges through Fuel Adjustment Clause ("FAC") and Purchased Gas Adjustment Clause ("PGA") proceedings. Each of these involves setting rates solely on the changes of the cost of coal or natural gas.

Apart from the propriety of single-issue rate-making, however, it must be pointed out that from the outset these cases have never been limited to a single issue. The order of December 11, 1986, did indicate that the Tax Reform Act was the focus of these investigations. However, it stated at page 2:

If, aside from the Tax Reform Act, a utility feels that its rates are insufficient, it has the discretion by statute to file a full rate case with the Commission. By initiating this case the Commission is in no way prohibiting or restricting any utility from filing a rate case encompassing all rate-making issues in a separate proceeding.

This Order was clarified on January 21, 1987, in Case No. 9799, The Effects of the Federal Tax Reform Act of 1986 on the

³ Hearing Transcript, May 4, 1987, page 9.

⁴ Brief for KU, filed May 22, 1987, page 4.

Rates of Continental Telephone Company ("Continental"). That Order states:

Because of the breadth of this investigation and the number of parties involved, it is necessary to categorize some information into a consistent, well-defined scope. That scope is explained in the December 11, 1986, Order. The information as it relates to the specific changes occasioned by the Tax Reform Act should be filed as the December 11, 1986, Order requires. The expected effects of those changes on rates should be filed as well. Simply because the Commission deems certain information necessary, and deems it necessary to be filed in a particular format does not preclude the filing of other information a party believes is pertinent.

For these reasons, the Commission ORDERS that:

- (1) All parties shall comply with the December 11, 1986, Order;
- (2) Any party may file any additional information it deems relevant;
- (3) Any party may file alternative proposals for the resolution of this investigation.

Thus, there is not, nor has there been, any limitation on any party filing additional information up to and including an adjustment of all rates. The Commission focused its attention primarily on the Tax Reform Act because of the potentially extraordinary impact of this act on the finances and rates of utilities.

Federal income taxes are in one sense an assessment by the federal government on the utilities for their proportionate share of the federal government's budget. Under accepted regulatory rate-making practices, these federal income taxes are included as part of a utility's expenses that are used to establish rates. Thus, through the rate-making process, the utility can be thought of as a collection agent for federal taxes and a conduit through which federal taxes are transferred from ratepayers to the federal government. Because the Tax Reform Act represents such a historic

change in federal tax policy, the Commission determined that it was in the best interests of all concerned--utilities and rate-payers alike--to reflect these tax changes in each company's rates as expeditiously as possible. For that reason, the initial concern was the reduction of the corporate tax rate from 46 percent to 34 percent and other relatively minor adjustments caused by the changes in the Federal Tax Code. As we explained in our December 11, 1986, Order:

First, it would be extremely cumbersome and expensive for the Commission to simultaneously initiate rate cases covering all utilities affected by this Order. Many utilities may not wish to incur the time-consuming and expensive task of preparing a complete rate case at this time. A proceeding that recognizes only the effects of the Tax Reform Act would minimize the time and expense of both the Commission and the utilities.

Secondly, the Commission does not view retaining the savings that result from tax reform as a proper way for a utility to improve its earnings. Likewise, if the Tax Reform Act should result in major cost increases, these costs should be recognized in rates expeditiously....

Finally, by initiating limited cases for every major utility, the expertise of all interested parties can be pooled to assure that all aspects of the Tax Reform Act are fairly reflected in utility rates.

In an effort to fairly reflect only the effects of the Tax Reform Act in the companies' rates, the Commission, to the extent possible, and with the acquiescence of the companies, narrowed the scope of the analysis. All quantifiable aspects of the revenue requirement effects of the Tax Reform Act have been considered, and therefore the rate adjustments ordered herein should have no effect on the utility's earnings.

In summary, the Tax Reform Act is a unique and historic change in tax law that substantially affects the cost of providing utility service. The primary considerations in narrowing the scope of these proceedings were that: (1) the cost change generated by the Tax Reform Act was clearly beyond the control of the utility; (2) the cost change generated by the Tax Reform Act affected all major privately owned utilities in a similar manner; (3) the cost change generated by the Tax Reform Act had a major impact on the cost of service of utilities; and, (4) the cost change generated by the Tax Reform Act was effective at a specified date which was scheduled to occur quickly, requiring expeditious action on the part of the Commission.

For all of the reasons previously stated, the procedure used by the Commission is one that is efficient, reflective of sound regulatory methods, responsive to the substantive and procedural rights of all parties, and consistent with the jurisdiction of the Commission.

Burden of Proof

Several utilities have suggested that the Commission bears the burden of proving the reasonableness of the rates that have been adjusted to reflect the effects of the Tax Reform Act. Continental, for example, cites KRS 278.430. However, this statute refers to appeals of Commission orders to circuit court. It obviously is not applicable to a proceeding before the Commission itself.

In its Order of December 11, 1986, the Commission on its own motion took the extraordinary step of establishing these

investigations in response to the historic Tax Reform Act of 1986. There is no statute assigning a burden of proof in this type of special case. KRS 278.250 is particularly noteworthy. After giving the parties a hearing and carefully reviewing the record, the Commission has determined the fair, just, and reasonable rates for each respective utility as prescribed by KRS 278.030. We believe that this procedure is consistent with our statutory responsibilities.

Testimony of URC

The URC filed testimony in each of these cases. However, its witness did not appear at the hearing and was not subject to cross-examination. Several of the parties moved to strike URC's prefiled testimony. After considering the nature of the testimony filed by URC, the Commission will treat it as comment rather than evidence and weigh it accordingly.

DETERMINATION OF THE IMPACT OF THE TAX REFORM ACT

Excess Deferred Taxes

A reduction in the corporate tax rates results in an excess or surplus deferred tax reserve, since deferred taxes resulting from depreciation-related and non-depreciation-related tax timing differences were provided by ratepayers at a higher tax rate than the rate at which they will be flowed back.

On January 1, 1979, the federal corporate income tax rate decreased from 48 to 46 percent. Utilities, in general, flowed back deferred taxes at the new statutory tax rate, which resulted in an excess provision for deferred taxes. The Commission recognized the existence of these excess deferred taxes and in

subsequent rate proceedings required that the excess be returned to the ratepayer over a 5-year amortization period.

The change in tax rates under the Tax Reform Act from 46 percent to 34 percent creates a substantial excess provision for deferred taxes. The Tax Reform Act requires that deferred taxes related to depreciation timing differences be flowed back no faster than under the "average-rate assumption method." Under this method an average rate is calculated and, as timing differences reverse, the accumulated deferred taxes are credited to income at the average rate, reducing the excess deferred taxes to zero over the remaining life of the property. Moreover, the Tax Reform Act provides that if a regulatory commission requires a more rapid reduction of the excess provision for deferred taxes, book depreciation must be used for tax purposes. The Tax Reform Act does not, however, have specific provisions for the excess deferred taxes that are not related to depreciation. Therefore, the excess deferred taxes have been generally characterized as "protected" (depreciation-related) and "unprotected" (not related to depreciation).

The treatment requested for the unprotected excess deferred taxes by the parties in these cases varies. The AG's witness has not recommended the flow back over an accelerated time period in these cases. Mr. DeWard stated that it would be more appropriate to consider this issue in a general rate proceeding. This would allow companies to retain those benefits to offset some of the negative impacts of the Tax Reform Act, such as reduced cash flow. The Commission recognizes the existence of the excess deferred

taxes and is of the opinion that these taxes provided by ratepayers in previous years should be returned in an equitable manner. However, the various options for returning these benefits could not be fully explored within the context of this expedited proceeding. Therefore, the issue regarding accelerated amortization of excess deferred taxes will be considered in future general rate proceedings and not in the present, limited proceeding.

The primary position taken by most utilities on this issue was that deferred income taxes should be amortized, as timing differences reverse, using the tax rates in effect at the time they originated or using the average rate assumption method. Therefore, adjustments have been made to insure that deferred taxes resulting from timing differences that are reversing are included at the rate provided, as required under the Tax Reform Act.

In its post-hearing brief, KIUC recommended that \$42 million be refunded to the ratepayers for unprotected excess deferred taxes previously collected. The Commission has stated that it will consider the accelerated amortization of excess deferred taxes in future general rate case proceedings. However, the Commission must point out for the record that the \$42 million to which KIUC refers does not represent the amount of unprotected excess deferred taxes. According to KU, the \$42 million represents the amount of accumulated deferred taxes available for non-depreciation related timing differences at the 34 percent federal

tax rate.⁵ This information was presented in support of KU's position that there were no excess deferred taxes but that there existed a deferred tax deficiency. The record in this case provides no conclusive evidence to support KU's position with regard to a deferred tax deficiency. However, the \$42 million clearly does not represent an amount of unprotected deferred taxes as KIUC contends.

Therefore, the Commission is of the opinion and finds that KU's position with regard to excess deferred taxes is unsupported by the record and that KIUC's recommendation of a \$42 million refund be denied in that the \$42 million referred to accumulated deferred taxes rather than an excess of unprotected deferred taxes.

Rate Base Adjustments

In addition to adjusting tax expense to reflect the reduction in the tax rate, most utilities involved in these proceedings have proposed that the effects on cash flow be recognized in determining the effect on revenue requirements. Two views have been advanced as to how cash flow requirements are increased by the Tax Reform Act. The first is that rate base is increased due to the Tax Reform Act's reduction in temporary timing differences between the book and tax return income tax expense. This reduction in timing differences reduces deferred taxes. Since deferred taxes serve as a deduction from rate base, the effect is to increase

⁵ KU's Response to Staff Information Request No. 1, Item Nos. 8-9, filed March 27, 1987.

rate base. The second view is that the Tax Reform Act results in a greater current tax liability and, consequently, additional cash flow requirements. This additional cash flow must be provided for in additional capital requirements that increase the overall cost of service.

In its determination, the Commission has not distinguished between these two viewpoints, and has generally allowed adjustments to reflect the level of additional cash flow requirements it considers appropriate without regard to whether the result flows from a reduction in deferred taxes or an increase in capital requirements. The effect on revenue requirements is essentially the same.

The objective of the Commission in giving recognition to those aspects of the Tax Reform Act that affect capital requirements is to leave the company in the same earnings position as before the rate change in this case. A number of utilities, in determining the revenue requirements impact of the rate base adjustments, applied the rate of return granted in their last general rate case. The Commission finds this approach to be inappropriate. To apply the allowed return, where it is greater than the test-year actual return, to the incremental increase in rate base would result in improving the earnings position for the utility with respect to return on rate base achieved prior to the implementation of the Tax Reform Act rate adjustment. The Commission, therefore, considers it more appropriate to use the test-year actual rate of return rather than the rate of return granted in the last rate case. This will maintain the company's rate of

return at the test year level and will neither improve nor reduce the company's earnings position.

A number of adjustments were proposed by the various utilities as adjustments to rate base and cash flow. In evaluating the appropriateness of these adjustments, the Commission has concluded that adjustments which reflect changes resulting from the application of the Tax Reform Act to test year operations are acceptable. However, those adjustments that reflect the application of the Tax Reform Act to future operations are not. In other words, the Commission will not allow adjustments for those aspects of the Tax Reform Act which are dependent upon the addition of plant to the system. Such adjustments are beyond the end of the test year and relate to serving additional customers or growth in the system. In the absence of corresponding revenue and capitalization adjustments, the recognition of such post-test year adjustments would create a mismatch between revenue, capitalization, and rate base. The derivation of such revenue and capitalization adjustments are speculative in nature and not generally allowed by this Commission in rate cases. The Commission has, therefore, excluded from the determination of revenue requirements herein all adjustments which are affected by the Tax Reform Act on a post-test year basis.

Based upon the various adjustments proposed in one or more of these cases, following is a synopsis of the Commission's findings and determinations:

Rate Base Adjustments Allowed

The decrease in deferred taxes resulting from changes in the tax code relating to unbilled revenue, uncollectible accounts, certain business expenses, superfund taxes, and test-period investment tax credits ("ITC") has been included since it meets the criterion of being based upon the application of the Tax Reform Act to actual test year operations, is unrelated to plant growth, and does not create a mismatch between test-year rate base and pro forma revenues and capitalization.

Rate Base Adjustments Disallowed

1. Depreciation Several utilities proposed to recognize the effect of the Tax Reform Act's new Modified Accelerated Cost Recovery System ("MACRS") on rate base. Generally, MACRS will result in lower depreciation expense per tax return, which results in a greater current tax liability in the future. MACRS did not become effective, however, until January 1, 1987, and is applicable only to property placed in service after that date. This is a post-test year occurrence for all utilities participating in these proceedings. As previously noted, the Commission finds it inappropriate to recognize such post-test period adjustments.

2. ITC Based Upon Future Plant Additions The Commission has disallowed proposed adjustments to recognize the loss of ITC on plant placed in service subsequent to the test year since the inclusion of plant and capital associated with said ITCs is not generally allowed by the Commission for rate-making purposes.

3. Capitalized Overheads The Tax Reform Act's capitalization requirements for interest, pension and benefit costs, and so

forth, are not effective until January 1, 1987, and thus will only pertain to construction after this date. Because of the post-test year nature of this adjustment, the Commission has not included these adjustments in this proceeding.

4. Contributions in Aid of Construction The Tax Reform Act provision requiring contributions to be included as taxable income on the tax return of the utility is not effective until January 1, 1987, and thus will relate only to post-test period construction. The Commission has, therefore, disallowed adjustments proposing to reflect loss of cash flow resulting from the taxability of contributions.

Implementation Date

The Tax Reform Act, which reduces the top corporate tax rate to 34 percent, produces an effective tax rate for 1987 of 40 percent. This is the blended or average rate based on the current tax rate of 46 percent, which is in effect for the first 6 months of 1987, and the 34 percent rate which becomes effective July 1, 1987. The current rates of most utilities are based on the 46 percent tax rate which was in effect at the time the rates were set by the Commission. Therefore, since January 1, 1987, most utilities have charged rates based on a tax rate of 46 percent which is in excess of the 1987 blended rate of 40 percent.

Generally, in order to reflect the effects of the Tax Reform Act during 1987 and beyond, the Commission has two basic options: adjust rates retroactive to January 1, 1987, based on the 1987 blended tax rate of 40 percent and adjust rates January 1, 1988, based on the 34 percent tax rate, or make one adjustment effective

July 1, 1987, based on a 34 percent tax rate, to achieve the same overall effect. By this second approach, most companies will have charged rates for the first half of 1987 based on a 46 percent tax rate and for the second half of 1987 based on a 34 percent tax rate. This will result in rates (and tax collections) for 1987 that equate to a blended tax rate of 40 percent.

In response to concerns of some utilities concerning the July 1, 1987, rate change, the Commission cites Section 15 of the Internal Revenue Code of 1986 which prescribes the method of computing taxes in 1987 for calendar year taxpayers. That section requires that "tentative taxes" for 1987 be computed by applying both the 46 percent tax rate and the 34 percent tax rate to taxable income for the entire calendar year; and the tax for the calendar year shall then be the sum of each tentative tax in proportion to the number of days in each 6-month period as compared to the number of days in the entire taxable year.

The Commission is of the opinion that a one-time adjustment, based on a 34 percent tax rate, effective July 2, 1987, will meet the transitional requirements of calendar year 1987 and achieve the Commission's goals for this proceeding as set out in its Order of December 11, 1986.

In this case, KU's interim Phase One rates have reflected the 40 percent tax rate effective for billings from March 1, 1987. KU has proposed Phase Two rates to reflect the full reduction to the 34 percent tax rate to become effective for billings on and after January 1, 1988.

The Commission is of the opinion that this method will result in substantially the same effect as that achieved by a one-time adjustment effective July 2, 1987.

Revenue Requirements

The Commission is of the opinion that while KU has proposed Phase One and Phase Two rates, the calculation of the total reduction in revenue requirements should be based on the full tax rate reduction to 34 percent. In that manner, KU will be placed on the same basis as other utilities.

Based on the tax rate reduction to 34 percent and other Tax Reform Act adjustments accepted herein, KU's annual tax expense for rate-making purposes will decline by \$12,523,000 calculated as follows:

Taxable Income	\$105,080,000
MULTIPLY BY:	
Change in Tax Rates (49.92% - 38.785%)	X .11135
Subtotal	\$ 11,701,000
Reversing Deferred Taxes	\$ 3,684,000
DIVIDE BY:	
Original Tax Rate	: .4992
Reversing Timing Differences	7,380,000
MULTIPLY BY:	
Change in Tax Rate	X .11135
Subtotal	\$ 822,000
REDUCTION IN TAXES	<u>\$ 12,523,000</u>

In the above calculation the impact of the reversing tax timing differences must be added to the tax reduction to conform to the requirements of the Tax Reform Act that the reversing timing differences be credited to income at the rate determined under the average rate assumption method. KU's witness, Jay

Price, testified that the rate applicable to KU for this proceeding was 46 percent⁶ or a composite rate of 49.92 percent. This adjustment is consistent with the position of KU and of the AG.

To reflect the tax reduction in rates, it is necessary to apply a revenue conversion factor to determine the reduction in revenue requirements caused by the reduction in tax expense. The revenue conversion factor based on KU's "gross up" as shown on Price Exhibit 3, Schedule 3, page 2 of 2, line 26, and based on the 34 percent federal tax rate is 1.633587. The Commission finds this factor, which also reflects state income taxes, to be an accurate and reasonable means of calculating the change in KU's revenue requirements. The reduction in revenue requirements is calculated as follows:

Reduction in Taxes	\$ 12,523,000
LESS:	
Commission 48/46% Reduction Amount Required to Maintain Earnings	<452,000> <235,000>
Subtotal	<u>\$ 11,836,000</u>
MULTIPLY BY:	X <u>1.633587</u>
REVENUE REQUIREMENTS REDUCTION	<u>\$ 19,335,000</u>

In the above calculation, two adjustments have been allowed. The first is the adjustment ordered by the Commission in Case No. 8624⁷ to flow back excess deferred taxes related to the 1979 change in the federal tax rate from 48 percent to 46 percent,

⁶ Hearing Transcript, pages 92-93.

⁷ Case No. 8624, General Adjustment of Electric Rates of Kentucky Utilities Company, Final Order dated March 18, 1983.

which is expiring. The second adjustment is to allow KU to maintain the actual test-year rate of return of 9.98 percent. As discussed in the sections on Rate Base Adjustments, only adjustments not dependent upon future plant additions have been allowed. In this case, those include the effect of Unbilled Revenues and the amortization of Pre-1971 Investment Tax Credit. The amount of additional revenues to maintain the rate of return was computed as follows:

Unbilled Revenues	\$5,583,000
MULTIPLY BY:	
Tax Rate	X .38785
	<u>\$2,165,000</u>
ITC Amortized ⁸	192,000
Subtotal	<u>\$2,357,000</u>
Actual Rate of Return	<u>.0998</u>
ADDITIONAL REVENUES REQUIRED	<u>\$ 235,000</u>

Therefore, based on the tax rate reduction to 34 percent and the other Tax Reform Act-related changes which the Commission has accepted herein, KU's annual revenue requirements decline by \$19,335,000. The reduction should flow the Tax Reform Act tax savings to KU's ratepayers while having a neutral impact on its earnings. Such a result is consistent with the Commission's objectives as set out in its Order of December 11, 1986.

Attached as Appendix B is a calculation of the revenue requirements reduction based on the effective federal tax rate of 40 percent which was the basis for KU's Phase One rates. The

⁸ Per Price Exhibit 3, Schedule 3, page 1, line 6.

Commission is of the opinion that the reduction in revenue requirements proposed by KU for 1987 of \$9,760,000 is reasonable. Further, it is the the opinion of the Commission that the difference between KU's proposed reduction for 1987 and the calculation in Appendix B will be mitigated by the fact that KU's rates were placed in effect for billings on and and after March 1, 1987, 4 months prior to the effective date of reductions for other utilities.

Therefore, the reduction in revenue requirements for the Phase Two rates effective for billings on and after January 1, 1988, should reflect an additional decrease of \$9,575,000 calculated as follows:

Total Reduction at 34%	\$19,335,000
Phase One Reduction	<u>9,760,000</u>
PHASE TWO REDUCTION	<u>\$ 9,575,000</u>

Contributions in Aid of Construction and Customer Advances

The Tax Reform Act requires that any contributions received in aid of construction, or any other contribution by a customer or potential customer, to provide, or encourage the provision of services to or for the benefit of the transferor be included as taxable income.⁹ On December 12, 1986, Kentucky-American Water Company ("Kentucky-American") submitted a letter to the Commission wherein it proposed the following options for treatment of contributions and customer advances for construction:

⁹ Explanation of Tax Reform Act of 1986. Commerce Clearing House, Inc., par. 1,670, page 486.

- a. "No Refund" Option: Under this alternative the contributor would not be entitled to any potential refunds. The total amount contributed would be recorded as ordinary income for tax purposes and the associated tax would be recorded as a payable. Kentucky-American would supply the capital necessary for completion of the construction (construction cost - net contributions).
- b. "Refund" Option: Under this alternative the contributor would be entitled to the potential refund. The contribution would be increased to include federal income taxes and the total amount received would be recorded as ordinary income for tax purposes. The contributor would then be entitled to the potential refund of the entire contribution within the statutory time limit of 10 years.

Further, Kentucky-American proposed that for contributions in aid of construction the no refund option be used for rate-making purposes.

After careful consideration of the information presented by Kentucky-American, the Commission is of the opinion that the refund option as proposed by Kentucky-American appears to be the most equitable method of passing on the taxes related to contributions to both the utility and its general body of ratepayers, in that it will require the customers receiving the service to pay for the total cost of providing that service with the potential for future refunding. Further, the utility and its general body

of ratepayers would be only obligated to contribute capital in the future as customers are added to the system and the benefits from those additions are received. Therefore, the Commission has chosen the refund option for use by Kentucky-American and for general applicability to all utilities.

The Commission recognizes that this policy is being established based solely on the evidence presented by Kentucky-American and is of the opinion that this matter should be investigated further in a separate proceeding. Therefore, the policy is being implemented on a temporary basis subject to the outcome of a formal investigation wherein all parties will be given the opportunity to submit evidence on this issue.

The treatment of contributions established herein will result in no revenue requirement impact on the utilities in these proceedings and, thus, no adjustment has been recognized.

Rate Design

In the order establishing this case, the Commission suggested that the reduction in revenue resulting from the Tax Reform Act could be spread to consumers by a uniform reduction to all KWH charges. Kentucky Utilities spread the reduction based on the percentage of sales for each rate classification to total sales. This method is equitable and achieves the intent of the Commission to conform with the rate design approved in the last rate case.

Statutory Notice

The Commission has determined, as provided in KRS 278.180, that a notice period of less than 30 days is reasonable. The shorter notice period was required because the Tax Reform Act was

passed by Congress in October 1986, with an effective date of January 1, 1987, which provided a relatively short time for the Commission to conduct investigatory proceedings and issue orders implementing rates effective July 2, 1987, to reflect the 40 percent tax rate in utility rates for 1987 under the procedure established herein.

SUMMARY

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that:

1. The Tax Reform Act results in a substantial cost savings to KU and said cost savings should be flowed through to ratepayers in an equitable manner.

2. The unique characteristics and primary considerations of this proceeding that require narrowing its scope are: (1) the cost change generated by the Tax Reform Act was clearly beyond the control of the utility; (2) the cost change generated by the Tax Reform Act affected all major privately owned utilities in a similar manner; (3) the cost change generated by the Tax Reform Act had a major impact on the cost of service of utilities; and, (4) the cost change generated by the Tax Reform Act became effective at a specified date which required expeditious action on the part of the Commission.

3. The implementation procedure detailed herein is an equitable method for determining the adjustment in revenues required to reflect the 40 percent Federal Income Tax Rate in the rates of utilities for the calendar year 1987.

4. The adjustment to rates prescribed herein has no affect on the earnings of KU after recognition of the cost savings resulting from the Tax Reform Act, and consequently said rate adjustment is fair, just, and reasonable.

IT IS THEREFORE ORDERED that:

1. The motion to strike the testimony of Mr. Kinloch is denied.

2. All other motions not specifically addressed are denied.

3. The rates placed into effect for billings on and after March 1, 1987, shall remain in effect through December 31, 1987.

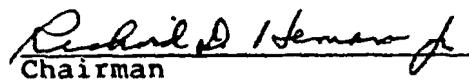
4. The rates in Appendix A are the approved rates for service rendered on and after January 1, 1988.

5. Revised tariffs reflecting the rates set out in Appendix A shall be filed within 30 days from the date of this Order.

6. Revised tariffs reflecting the Commission's policy on the treatment of taxes associated with contributions in aid of construction shall be filed within 30 days from January 1, 1988.

Done at Frankfort, Kentucky, this 11th day of June, 1987.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 9780 DATED June 11, 1987.

The following rates and charges are prescribed for the customers in the area served by Kentucky Utilities Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the date of this Order.

RS
RESIDENTIAL SERVICE

RATE

Customer Charge \$ 2.75 per month

Plus an Energy Charge of:

5.545 cents per KWH for the first 100 KWH used per month.

5.086 cents per KWH for the next 300 KWH used per month.

4.675 cents per KWH for all in excess of 400 KWH used per month.

FERS
Full Electric Residential Service

RATE

Customer Charge \$ 3.75 per month

Plus an Energy Charge of:

4.732 cents per KWH for the first 1,000 KWH used per month.

4.328 cents per KWH for all in excess of 1,000 KWH used per month.

GS
General Service

RATE

Customer Charge: \$4.00 per month

Plus an Energy Charge of:

7.008 cents per KWH for the first 500 KWH used per month.

5.866 cents per KWH for the next 1,500 KWH used per month.

5.389 cents per KWH for all in excess of 2,000 KWH used per month.

CWH
Combination Off Peak Water Heating

RATE

Customer Charge \$1.00 per month
Plus All Energy at 3.146 cents per KWH per month.

O.P.W.H.
Off Peak Water Heating

RATE

Customer Charge \$1.00 per month
Plus All Energy at 3.753 cents per KWH per month.

RATE 33
Electric Space Heating Rider

RATE

For All KWH used under this schedule during each heating season at
4.408 cents per KWH.

A.E.S.
All Electric School

RATE

All KWH at 4.418 cents per KWH.

IS
Interruptible Service

RATE

Plus Energy Charge of 2.104 cents for all KWH used in the billing
month.

LP
Combined Lighting and Power Service

RATE

Plus an Energy Charge of:

- 3.328 cents per KWH for the first 500,000 KWH used per month.
- 3.079 cents per KWH for the next 1,500,000 KWH used per month.
- 2.949 cents per KWH for all in excess of 2,000,000 KWH used per month.

LCI - TOD
Large Commercial/Industrial Time-of-Day Rate

RATE

Energy Charge of 2.646 cents per KWH for all KWH used.

HLF
High Load Factor

RATE

Energy Charge of 2.708 cents per KWH for all KWH used.

MP
Coal Mining Power Service

RATE

Plus an Energy Charge of:

- 3.335 cents per KWH for the first 500,000 used per month.
- 2.985 cents per KWH for all in excess of 500,000 KWH used per month.

LMP - TOD
Large Mine Power Time-of-Day Rate

RATE

Energy Charge of 2.526 cents per KWH for all KWH used.

M
Water Pumping Service

RATE

Plus an Energy Charge of:

- 5.135 cents per KWH for the first 10,000 KWH used per month.
- 4.402 cents per KWH for all in excess of 10,000 KWH used per month.

ST. LT.
Street Lighting Service

RATE

<u>Incandescent System*</u>	<u>Load/Light</u>	<u>Rate Per Standard</u>	<u>Light/Month Ornamental</u>
1,000 Lumens (Approximately)	.102 KW/Light	\$ 2.29	\$ 2.92
2,500 Lumens (Approximately)	.201 KW/Light	2.89	3.66
4,000 Lumens (Approximately)	.327 KW/Light	4.18	5.08
6,000 Lumens (Approximately)	.447 KW/Light	5.58	6.59
10,000 Lumens (Approximately)	.690 KW/Light	7.63	9.15
<u>Mercury Vapor</u>			
3,500 Lumens (Approximately)	.126 KW/Light	\$ 5.66	\$ 7.95
7,000 Lumens (Approximately)	.207 KW/Light	6.62	8.78
10,000 Lumens (Approximately)	.294 KW/Light	7.69	9.60
20,000 Lumens (Approximately)	.453 KW/Light	9.17	10.71
<u>High Pressure Sodium</u>			
4,000 Lumens (Approximately)	.060 KW/Light	\$ 4.87	\$ 7.38
5,800 Lumens (Approximately)	.083 KW/Light	5.30	7.81
9,500 Lumens (Approximately)	.117 KW/Light	6.01	8.69
22,000 Lumens (Approximately)	.242 KW/Light	8.96	11.64
50,000 Lumens (Approximately)	.485 KW/Light	14.57	17.26

*NOTE: Incandescent restricted to those fixtures in service on October 12, 1982 (Except for spot Replacement).

P.O.Lt.
Private Outdoor Lighting

RATE

<u>Monthly Charge</u>	<u>Approximate Lumens</u>	<u>Type Light</u>	<u>KW Rating</u>
\$ 7.56	7,000	Mercury Vapor	.207
9.19	20,000*	Mercury Vapor	.453
14.57	50,000*	High Pressure Sodium	.485

*NOTE: Not available for urban residential home use.

C.O.LT.
Customer Outdoor Lighting

RATE

<u>Monthly Charge</u>	<u>Lumens</u>	<u>Type Light</u>	<u>KW Rating</u>
\$ 5.51*	2,500	Incandescent	.201
6.55**	3,500	Mercury Vapor	.126
7.56**	7,000	Mercury Vapor	.207

*Restricted to those fixtures in service on December 15, 1971.
**Restricted to those fixtures in service on October 12, 1982.

SPECIAL CONTRACT FOR ELECTRIC SERVICE TO
WEST VIRGINIA PULP AND PAPER COMPANY

ENERGY CHARGE

2.585 cents per KWH

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 9780 DATED June 11, 1987.

Calculation of Reduction in Revenue Requirements at the 40
percent Federal Tax Rate:

Calculation of Tax Reduction:

Taxable Income	\$105,080,000
MULTIPLY BY:	
Change in Tax Rates (49.92% - 44.35%)	X .0557
	\$ 5,853,000
Reversing Deferred Taxes	\$ 3,684,000
DIVIDE BY: Original Tax Rate	÷ .4992
Reversing Timing Differences	\$ 7,380,000
MULTIPLY BY: Change in Tax Rate	X .0557
	\$ 411,000
REDUCTION IN TAXES	<u>\$ 6,264,000</u>

Amount Required to Maintain Earnings:

Effect of Unbilled Revenues	\$2,476,000 ¹
ITC Amortized	<u>192,000²</u>
	\$2,668,000
Actual Rate of Return	<u>.0998</u>
ADDITIONAL REVENUES REQUIRED	<u>\$ 266,000</u>

Calculation of Reduction in Revenue Requirements:

Reduction in Taxes	\$6,264,000
LESS: Commission 48/46% Reduction	<452,000>
Amount Required to Maintain Earnings	<u><266,000></u>
Subtotal	\$5,546,000
MULTIPLY BY: (1/(1 - .4435))	X 1.796945
REVENUE REQUIREMENTS REDUCTION	<u>\$9,966,000</u>

¹ Per Price Exhibit 3, Schedule 3, page 1, line 13.

² Ibid., line 6.