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 LOUISVILLE GAS AND ELECTRIC COMPANY	)))	CASE NO. 9781

O R D E R

On July 1, 1987, Louisville Gas and Electric Company ("LG&E") filed a Petition for reconsideration in this case. LG&E was seeking reconsideration on the grounds that the Commission's decision to exclude certain adjustments from the calculation of revenue requirements was arbitrary and inconsistent with the effects of the Tax Reform Act of 1986 ("Tax Reform Act").

On July 21, 1987, the Commission granted LG&E's petition. A rehearing was held at the Commission's offices in Frankfort, Kentucky, on August 18, 1987. LG&E and the Utility and Rate Intervention Division on behalf of the Attorney General have filed rehearing briefs in this case.

ISSUES ON REHEARING

In its petition, LG&E cited five proposed adjustments to cash flow which were excluded by the Commission in the Final Order of June 11, 1987. However, at the rehearing, LG&E stated that the proposed adjustment relating to customer contributions in aid of construction would have no revenue requirement impact under the method adopted by the Commission. The remaining adjustments and the related cash flow loss are as follows:

1. Interest Capitalized	
Federal	$1,261,000
State	290,000
2. Pension Expense Capitalized	
Federal	401,000
State	92,000
3. Decreased Depreciation	
Federal	545,000
4. Deferred Federal Income Taxes Rate Reduction	
Federal	4,607,000

The total cash flow loss related to these adjustments is $7,196,000 and the related increase in interest expense above the sum calculated by the Commission is $591,000 based on LG&E's embedded cost of debt of 8.22 percent.

Interest, Pension Expense and Depreciation

In its petition, LG&E states that the Commission's generic rule that "only adjustments not dependent upon future plant additions have been allowed"[1] has been erroneously applied to the proposed adjustments for Interest Capitalized, Pension Expense Capitalized and Decreased Depreciation. In support of this position, LG&E stated that the adjustments for the effects of the Tax Reform Act were made to the test year and although other utilities may have calculated the loss of cash flow based on future plant additions, LG&E's adjustments were based on actual plant additions.

The Commission recognizes that LG&E's proposed adjustments were not calculated on the basis of future plant additions but on the basis of test-year plant additions. However, since test-year

[1] Case No. 9781, Final Order dated June 11, 1987, page 17.

plant additions are not within the scope of the capitalization and depreciation rules changes in the Tax Reform Act, such plant additions do not trigger any post-test year changes in expenses. Only future additions to plant will create post-test-year Tax Reform Act-related changes in expenses.

LG&E witness, Lee Fowler, acknowledged at the May 8, 1987, hearing that the Tax Reform Act depreciation rules will have no effect on test-year plant in service. Mr. Fowler then explained that, "...we had to use something and we had understood that you could not use a forward method. So, we used - a forward addition."[2] Recognizing that its proposed adjustments could not be calculated on the basis of future plant additions, since such additions are neither known nor measurable, LG&E based its calculation on a proxy - its test-year plant additions.

The Tax Reform Act changed the capitalization and depreciation rules for plant constructed and placed in service <u>after</u> January 1, 1987. As a result of these tax rule changes, utilities, in general, will experience lower interest, pension, and depreciation expenses as new plant is constructed and placed in service. However, the Tax Reform Act has no impact on expenses associated with plant in service at December 31, 1986. In this proceeding, LG&E's test year was the 12-month period ending November 30, 1986. Consequently, the above referenced tax changes will be applicable <u>not</u> to plant in service at the end of test year, but to future plant additions.

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2 Hearing Transcript, May 8, 1987, page 70.

The Commission has allowed known and measurable adjustments to LG&E's test year-end level of plant and expenses to reflect the impacts of the Tax Reform Act. However, the Commission has disallowed any adjustment to the test year that is based on future changes in plant or expenses related to serving additional customers or system growth. This disallowance is based on the fundamental regulatory principle that these post-test year expense adjustments, without offsetting revenue adjustments and corresponding capitalization adjustments, would create a mismatch between revenue, capitalization, and rate base.

Additionally, LG&E argues that the Tax Reform Act did not take effect until 1987 and the effects of the Tax Reform Act could not be measured in LG&E's historical test year ending November 30, 1986. LG&E states that the Commission must either recognize that none of the effects of the Tax Reform Act occurred during LG&E's test year or recognize all of the cash flow adjustments proposed by LG&E.

The Commission realizes that LG&E's future cash flow will be reduced as a result of the Tax Reform Act. However, any reduction resulting from the changes in capitalization and depreciation rules will occur subsequent to the test year as additional plant is constructed and placed into service. Therefore, the above adjustments proposed by LG&E are dependent upon future plant additions, speculative in nature, and should be disallowed upon rehearing.

Deferred Federal Income Taxes

LG&E is also requesting that the cash flow loss of $4,607,000 resulting from the reduction in deferred federal income taxes be included in determining the amount of additional revenues required to maintain cash flow. LG&E argues that the loss of cash flow from applying the lower federal income tax rates to actual deferred income taxes for the test year clearly represents a cash flow loss to LG&E that should be included in the determination of the amount to maintain cash flow.

However, the reduction in taxes of $4,607,000 is solely the result of a reduction in the tax rate and the reduction in cash flow is offset by a decrease in cost of service. For rate-making purposes, deferred taxes are included in rates as a part of LG&E's total book tax expense. The Commission has included in rates an amount for taxes based upon a utility's book tax expense. As such, a reduction in revenue requirements resulting from lower tax rates should appropriately reflect lower deferred taxes.

Therefore, LG&E's request that the cash flow loss resulting from reduced deferred federal income taxes be included in the determination of the amount required to maintain cash flow is denied.

SUMMARY

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

1. The adjustments proposed by LG&E for interest capitalized, pension expense capitalized, decreased depreciation, and deferred federal income taxes should be denied.

2. The adjustment for contributions in aid of construction will have no revenue requirement impact under the method adopted by the Commission and LG&E has withdrawn this adjustment for reconsideration.

IT IS THEREFORE ORDERED that:

1. The adjustments proposed by LG&E for interest capitalized, pension expense capitalized, decreased depreciation, and deferred federal income taxes be and hereby are denied.

2. All provisions of the Commission's June 11, 1987, Order are affirmed.

Done at Frankfort, Kentucky, this 4th day of December, 1987.

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.
Chairman

Vice Chairman

Commissioner

ATTEST:

Forest M. Skaggs
Executive Director