

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES)	
COMPANY FOR AN ORDER AUTHORIZING)	
INCLUSION OF INVESTMENT TAX CREDITS IN)	CASE NO.
CALCULATION OF ENVIRONMENTAL)	2007-00178
SURCHARGE AND DECLARING APPROPRIATE)	
RATEMAKING METHODS FOR BASE RATES)	

O R D E R

On May 4, 2007, Kentucky Utilities Company (“KU”) filed an application seeking authorization to include certain investment tax credits in its environmental surcharge calculations, approval of revisions to monthly environmental surcharge reporting formats, and a declaration that its proposed rate base and capitalization treatments of the investment tax credits and proposed allocation of its Kentucky jurisdictional rate base is the appropriate rate-making method for the determination of base rates. The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention (“AG”), and Kentucky Industrial Utility Customers, Inc. (“KIUC”) sought and were granted intervention.

The Commission’s May 29, 2007 Order established a procedural schedule that provided for discovery, the opportunity to request a public hearing, and the filing of comments. On July 10, 2007, KU filed a statement indicating it believed this case could be submitted for decision without a hearing and, on July 17, 2007, KU filed comments on the case. KIUC did not indicate whether the case could be submitted for decision

without a hearing, but did file comments on July 13, 2007. The AG did not request a hearing and did not file comments on the application.

BACKGROUND

The Energy Policy Act of 2005 became law on August 8, 2005. This legislation created several investment tax credits designed to encourage the development and construction of certain kinds of generation facilities. One of the tax credits is the Qualifying Advanced Coal Project Credit, which provides tax credits for integrated gasification combined-cycle projects and projects using other advanced coal-based generation technologies.¹ To be eligible for the advanced coal-based generation technology tax credit (“ACGT Tax Credit”), the project must meet specific criteria for high efficiency and low emissions.² The ACGT Tax Credit is 15 percent of all qualifying investments, with a maximum credit allocated to any one project of \$125 million.³

KU and Louisville Gas and Electric Company (“LG&E”) currently are constructing Trimble County Unit No. 2 (“Trimble 2”).⁴ Trimble 2 will be a state-of-the-art, super-

¹ Up to \$800 million in tax credits can be granted for integrated gasification combined-cycle projects and up to \$500 million in tax credits can be granted for projects using other advanced coal-based generation technologies.

² The specific requirements are listed in the Application at 3 and 26 U.S.C. § 48A.

³ The ACGT Tax Credit could be forfeited or reduced if the utility fails to secure required certifications, does not complete the project within a specified time frame, or the project does not produce the total nameplate generating capacity. See Application, Exhibit 5, Department of Treasury – Internal Revenue Service Closing Agreement, at 2.

⁴ KU and LG&E were granted a Certificate of Public Convenience and Necessity to construct Trimble 2 in Case No. 2004-00507, Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for a Certificate of Public Convenience and Necessity, and a Site Compatibility Certificate, for the Expansion of the Trimble County Generating Station, final Order dated November 1, 2005.

critical, pulverized coal-fired generating unit that will employ the latest technology to achieve efficiency and low environmental impact. Trimble 2 will be owned by KU, LG&E, the Illinois Municipal Electric Agency (“IMEA”),⁵ and the Indiana Municipal Power Agency (“IMPA”).⁶

Trimble 2 meets the requirements for the ACGT Tax Credit. KU and LG&E have submitted applications to the U. S. Department of Energy (“DOE”) and the Internal Revenue Service (“IRS”) seeking the ACGT Tax Credit. Trimble 2 has received DOE certification. The IRS has accepted the Trimble 2 application, allocated a total ACGT Tax Credit of \$125 million, and approved a Closing Agreement required in connection with claiming the tax credit.⁷ Because IMEA and IMPA are exempt from federal income taxation, neither will receive a portion of the ACGT Tax Credit. KU and LG&E will share the tax credit in proportion to their respective ownership interests in Trimble 2.

KU's share of the ACGT Tax Credit will be 81 percent of \$125 million, or \$101.25 million. The ACGT Tax Credit can be recognized by KU on its books in the same manner as qualifying investments are booked. KU made initial entries in December 2006 to record its respective share of the progress expenditure credits claimed in 2006. KU will continue to record the progress expenditure credits until the projected in-service date for Trimble 2, which is currently expected to be 2010. At that time, KU will have recorded the entire \$101.25 million ACGT Tax Credit on its books. Amortization entries

⁵ IMEA is a not-for-profit municipal corporation and a unit of local government in Illinois.

⁶ IMPA is a not-for-profit corporation and political subdivision of Indiana.

⁷ Application at 4-5 and Exhibits 2 through 6.

for the ACGT Tax Credit will begin when Trimble 2 goes into service for tax purposes in 2010 and will continue over the regulatory life of the unit. The air quality control system currently has an estimated regulatory life of 28.8 years and the remainder of the plant has an estimated regulatory life of 41.5 years.⁸

KU has determined that it must use the same rate treatment for the ACGT Tax Credit as it utilized for all post-1971 investment tax credits. In 1972, KU elected a rate treatment under the tax code⁹ wherein KU would reduce its rate base by the amount of investment tax credit it received. This rate treatment is referred to as the “ratable restoration” method.¹⁰ While the original tax code section has been repealed, current provisions in the tax code¹¹ have retained the same tax treatment. KU stated that if it failed to normalize the tax credit utilizing the ratable restoration method, it would result in KU having to forfeit the credit along with other negative consequences. KU noted that in previous rate cases the Commission has consistently applied the ratable restoration method as the appropriate rate-making treatment for investment tax credits.¹²

⁸ Application at 7.

⁹ 26 U.S.C. § 46(f)1.

¹⁰ Under the ratable restoration method, the utility's rate base is reduced by the amount of the tax credit and as the tax credit is amortized over the life of the asset the rate base is restored. See Blake Direct Testimony at 3-4.

¹¹ 26 U.S.C. § 50. See Response to the Commission Staff's First Data Request dated June 12, 2007, Item 2(b), page 4 of 4. In addition, IRS Notice 2006-24 states that 26 U.S.C. § 50 applies to the ACGT Tax Credit. See Application at 6 and Exhibit 5.

¹² Application at 6.

ANALYSIS OF PROPOSALS

In its application,¹³ KU has requested the Commission issue an Order that:

- Authorizes the inclusion in the calculation of KU's environmental surcharge of that portion of KU's ACGT Tax Credit that is related to projects approved for recovery through the environmental surcharge;
- Approves revisions to the monthly environmental surcharge formats ES Forms 2.00 and 2.10 to reflect the ACGT Tax Credit; and
- Declares the proposed rate base and capitalization treatments of the ACGT Tax Credit and the proposed allocation of Kentucky jurisdictional rate base to be the appropriate rate-making methods for the determination of base rates.

Inclusion in Environmental Surcharge Calculations

The air quality control system for Trimble 2 was included as a project in the environmental compliance plan amendment approved by the Commission in Case No. 2006-00206.¹⁴ The air quality control system for Trimble 2 represents approximately 23 percent of the qualified investment in Trimble 2.

Because the ratable restoration method reduces KU's rate base by the amount of the investment tax credit it receives, KU has proposed to include in the calculation of its monthly environmental surcharge a pro rata amount of the ACGT Tax Credit associated with the air quality control system for Trimble 2. KU would begin to include the ACGT Tax Credit on ES Forms 2.00 and 2.10 for the first expense month filing following the issuance of a final Order in this case. KU also has proposed to recalculate its

¹³ Id. at 10.

¹⁴ Case No. 2006-00206, The Application of Kentucky Utilities Company for a Certificate of Public Convenience and Necessity to Construct a Selective Catalytic Reduction System and Approval of Its 2006 Compliance Plan for Recovery by Environmental Surcharge, final Order dated December 22, 2006.

environmental surcharge revenue requirements beginning with the December 2006 expense month to reflect the benefit to customers of the ACGT Tax Credit and include that amount as an adjustment to the current expense month. KU stated this approach would allow its customers to receive the full benefit of the environmental portion of the ACGT Tax Credit through the monthly environmental surcharge filings.¹⁵

In its comments, KIUC stated that KU's proposal on the environmental surcharge treatment of the ACGT Tax Credit was appropriate and it had no objection.¹⁶

The Commission has reviewed the information concerning the rate-making treatment for the ACGT Tax Credit and agrees that KU is required to follow the ratable restoration method. The Commission has reviewed KU's proposal to begin reflecting that portion of the ACGT Tax Credit associated with the Trimble 2 air quality control system in the determination of its monthly environmental surcharge revenue requirements and finds the proposal is reasonable and consistent with the application of the ratable restoration method. The Commission has also reviewed KU's proposal to recalculate its previous environmental surcharge revenue requirements to reflect the recognition of the ACGT Tax Credit and to provide the cumulative benefit to ratepayers as an adjustment to a current monthly surcharge filing and finds the proposal is reasonable and should be approved. KU should include this adjustment as part of the first monthly environmental surcharge filing submitted after the date of this Order. KU

¹⁵ Response to the Commission Staff's First Data Request dated June 12, 2007, Item 7.

¹⁶ KIUC Comments at 1.

should include all calculations and workpapers that support the adjustment with the monthly filing.

Revisions to Monthly Surcharge Reporting Formats

In conjunction with the recognition of the ACGT Tax Credit in the determination of the monthly environmental surcharge revenue requirement, KU proposed that ES Forms 2.00 and 2.10 be revised. On ES Form 2.00, a line item titled "Pollution Control Deferred Investment Tax Credit" would be included in the section of the form labeled "Determination of Environmental Compliance Rate Base." On ES Form 2.10, a column labeled "Unamortized ITC" would be included.¹⁷ KIUC did not comment on KU's proposed revision of the surcharge reporting formats.

The Commission has reviewed the proposed revisions to ES Forms 2.00 and 2.10 and finds the revisions are reasonable and should be approved.

Rate-Making Treatment for Future Base Rate Case

In addition to including the effect of the ACGT Tax Credits in its monthly environmental surcharge calculations, KU requested that the Commission declare in this case that its proposed rate base and capitalization treatments of the ACGT Tax Credit and the proposed allocation of the rate base to be the appropriate rate-making treatment for the determination of base rates. KU proposed to exclude the environmental surcharge rate base from the Kentucky jurisdictional rate base. The percentage of this reduced Kentucky jurisdictional rate base compared to the total company rate base would be utilized to allocate capitalization in KU's next base rate

¹⁷ Blake Direct Testimony, Exhibit KWB-4.

case. KU provided sample calculations reflecting its proposal for rate base and capitalization calculations.¹⁸

KU argued that its proposed treatment was necessary to ensure that no double-counting of the ACGT Tax Credit resulted from the recognition of the tax credit in both the environmental surcharge and base rates.¹⁹ KU expressed its belief that proper rate-making treatment for issues that impact both the environmental surcharge and base rates should be determined concurrently to ensure consistent rate-making treatment across both mechanisms. KU also stated deciding this issue in this case provided important certainty about the rate-making implementation of the ratable restoration method and reduced the risk that KU could lose the tax credit due to inconsistent rate-making treatment.²⁰

KIUC opposed determining the appropriate rate-making treatment in this case, arguing it would be better to defer this issue to the next base rate case when a full record would exist. KIUC contended that KU has proposed to change the methodology for all environmental surcharge costs, not just the ACGT Tax Credit. KIUC compared KU's proposal with the Commission's previous approach to allocating capitalization. KIUC argued that the KU proposal would result in a different outcome than the present Commission methodology, but acknowledged it was difficult to estimate the effect.²¹

¹⁸ Id., Exhibit KWB-5.

¹⁹ The ACGT Tax Credit associated with the balance of the investment in Trimble 2, exclusive of the air quality control systems, would be recognized in KU's base rates.

²⁰ Response to the Commission Staff's First Data Request dated June 12, 2007, Item 6.

²¹ KIUC Comments at 1-2.

The Commission has compared the rate-making treatment KU proposed in this case with the approach utilized in two previous KU cases where the environmental surcharge was excluded in the determination of base rates.²² KU's proposal does not appear to be consistent with the Commission's treatment of the environmental surcharge and the allocation of capitalization presented in Case Nos. 1998-00474 and 2003-00434. The Commission notes that in discussing its proposal on rate base and capitalization, KU did not refer to these previous decisions or explain why the current proposal was more reasonable than the rate-making treatment in previous cases.

Based on its review and the arguments of KU and KIUC, the Commission finds that it is not reasonable in this case to establish the appropriate base rate case rate-making treatment for the environmental surcharge and ACGT Tax Credit. Therefore, the Commission finds that KU's proposal should be denied. The Commission notes that the avoidance of double-counting any component of the environmental surcharge in the determination of base rates has been an issue in every base rate case since the inception of the environmental surcharge statute. While KU has proposed what it believes to be consistent rate-making treatment between the environmental surcharge and base rates, it has failed to explain why the approach utilized by the Commission in previous KU cases is no longer reasonable. Lastly, as noted by KU in its application, the Commission has long recognized that the appropriate rate-making treatment for tax credits is affected by the tax normalization requirements of the tax code.

²² Case No. 1998-00474, The Application of Kentucky Utilities Company for Approval of an Alternative Method of Regulation of Its Rates and Service, final Order dated January 7, 2000 and Case No. 2003-00434, An Adjustment of the Electric Rates, Terms, and Conditions of Kentucky Utilities Company, final Order dated June 30, 2004.

IT IS THEREFORE ORDERED that:

1. KU's request for authorization to include in the calculation of its environmental surcharge the portion of the ACGT Tax Credit related to the air quality control system at Trimble 2 being recovered through the environmental surcharge is approved.

2. KU's proposed revisions to ES Forms 2.00 and 2.10 are approved. KU shall use the revised formats beginning with the first monthly environmental surcharge report filed after the date of this Order.

3. KU's proposal to recalculate previously filed environmental surcharge revenue requirements to reflect the effect of the ACGT Tax Credit and provide the cumulative benefit to ratepayers through the environmental surcharge, as discussed in its application and this Order, is approved. KU shall make this adjustment in the first monthly environmental surcharge report filed after the date of this Order.

4. KU's request to declare the proposed rate base and capitalization treatments of the ACGT Tax Credit and the proposed allocation of Kentucky jurisdictional rate base to be the appropriate rate-making methods for the determination of base rates is denied.

5. In the event that the ACGT Tax Credit is reduced or forfeited, KU shall notify the Commission in writing within 10 days of KU receiving the notice of reduction or forfeiture.

Done at Frankfort, Kentucky, this 7th day of September, 2007.

By the Commission

ATTEST:


Executive Director

Case No. 2007-00178