COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

Electronic Application Of Kentucky Power Company For (1) A General Adjustment Of Its Rates For Electric Service; (2) An Order Approving Its 2017 Environmental Compliance Plan; (3) An Order Approving Its Tariffs And Riders; (4) An Order Approving Accounting Practices To Establish Regulatory Assets Or Liabilities; And (5) An Order Granting All Other Required Approvals And Relief	)	Case No. 2017-00179

KENTUCKY POWER COMPANY'S RESPONSE IN OPPOSITION TO KIUC'S PETITION FOR REHEARING

Kentucky Power Company states for its response in opposition to Kentucky Industrial Utility Customers, Inc.'s ("KIUC") February 7, 2018 Petition for Rehearing:

INTRODUCTION

KIUC seeks through its Petition for Rehearing to have the Commission further adjust the Company's revenue requirement to account for the impact of the Tax Cuts and Jobs Act on the income tax expense of a third-party supplier. The Commission should reject KIUC's attempt to reopen the already adjudicated revenue requirement and expand the scope of the Commission's tax review beyond the Company's federal corporate income tax expense. Far from reducing the Company's revenue requirement, granting KIUC's motion, as discussed below, also would require a $4,670,302 increase in the revenue requirement, or a $3,360,907 revenue requirement increase after netting the KIUC request. The better course is to address the Rate Case Order as outlined by the Company in its Motion for Rehearing and deny KIUC's request. Doing so maintains the balance of the Commission Order and allows the main elements of the bargain in Settlement Agreement, including the three-year stay out, to remain in place.

A. <u>The Commission Should Reject KIUC's Attempt to Expand Its Consideration of the Impact of the Tax Cuts and Jobs Act Beyond the Impact on Kentucky Power's Own Federal Income Tax Expense.</u>

The Settlement Agreement reached in this case among Kentucky Power and the Settling Intervenors delicately balanced the Company's reduced revenue requirement with its agreement not to file another rate case for three years. KIUC's request to amend the Company's test-year Rockport UPA expense to account for a post-test year change in the federal income tax expense paid by the UPA counterparty upsets that balance and calls into question the Company's ability to agree to the stay out. In the Rate Case Order, the Commission reduced the Company's revenue requirement to reflect the effect the reduction in the federal corporate tax rate had on <u>Kentucky Power's own income tax expense</u> by reducing both the adjusted test year amount of federal income tax expense and the amount of federal income tax expense related to incremental revenue. While the Company disagrees with the calculation used by the Commission to derive the amount of the reduction and has sought rehearing on the same, it agrees that the actual reduction in Kentucky Power's own federal income tax expense arising from the Tax Cuts and Jobs Act should flow through to its customers as promptly as possible.

KIUC seeks something different in kind and scope. KIUC now asks the Commission to further adjust the Company's revenue requirement based on the changes in the income tax expense of a single, third-party supplier. In particular, KIUC invites the Commission to reduce the Company's revenue requirement to reflect the change in federal income tax that its counterparty to the Rockport UPA will pay. The Commission should decline KIUC's invitation.

Instead of adhering to ratemaking principles as asserted in its Petition,[1] KIUC's request ignores the nature of a historic test year. The historic test year is not intended to serve as an

[1] KIUC Petition at 2.

exact accounting of each dollar that will be spent in future years. It is a snap shot in time of the test year levels of the individual costs comprising the Company's expenses. The fact that the individual costs comprising the Company's expenses will continue to change when the new rates are in effect does not render the snapshot inaccurate, or the use of a historic test year no longer useful, so long as the overall balance among the individual costs (and between test year costs and test year revenues) is maintained. Indeed, implicit in the use of a historical test year to establish the Company's rates for the future is that Kentucky Power retains the ability to manage its future expenses when the new rates are in effect so that it can employ a post-test year decrease in one type of expense to offset a post-test year increase in a different expense. When that is no longer possible, or costs cannot be reduced through further efficiencies, the Company normally has the option of seeking a rate adjustment.

The typical rough balance among the test year levels of the Company's expenses was rendered much more precise, and thus more difficult to maintain, by the important concessions agreed to by Kentucky Power as part of the Settlement Agreement. These concessions provided multiple benefits not otherwise available to the Company's customers, including the Rockport Deferral and the rate case stay out. The one-sided, single item nature of KIUC's proposal upsets that already precise balance by adjusting a single cost to reflect reduced tax expense without adjusting for post-test year increases in the Company's other expenses or known and measureable post-test year decreases in the Company's revenues.

A prime example of this is the increase in the ROE component of the Company's Rockport UPA expense as a result of the operating ratio increase associated with the Rockport Unit 1 SCR being placed in service in August 2017. As Company Witness Satterwhite testified, the 12.16 percent ROE specified by the Rockport UPA is a nominal amount that is adjusted based on the operating ratio for purposes of computing the Company's actual payment.[2] The operating ratio reflects the amount of Rockport investment in service. During the test year the average ROE paid by Kentucky Power was 8.18 percent and not the nominal 12.16 percent provided for by the Rockport UPA[3]. Thus, the amount of Rockport UPA expense included in the Company's base rates reflects this average rate and not the nominal 12.16 percent provided for by the Rockport UPA. Since the Rockport Unit 1 SCR was placed into service in August 2017, the increase in plant investment in service has led to a corresponding increase in operating ratio and ROE paid by Kentucky Power under the Rockport UPA. The ROE on the January 2018 invoice was 11.19 percent. The increase in Rockport UPA expense from the change in operating ratio is the sort of increase contemplated by the Company in agreeing to the three-year rate case stay out in the Settlement Agreement; KIUC's further proposal to adjust the Company's revenue requirement to reflect the impact of the tax rate change on a single supplier is not.

The Commission should reject KIUC's suggestion to adjust Kentucky Power's rates based on a decrease in a single component of the test year level of expense from a single third-party. Doing so is not only arbitrary, and will result unjust and unreasonable rates, but by abandoning the test year concept and tipping the balance struck in the Settlement Agreement it will imperil Kentucky Power's ability to adhere to the three-year stay out and the other concessions requiring the Company's consent that are contained in the Settlement Agreement.

Moreover, just the act of starting to probe beyond the Company's direct income tax changes and extending that evaluation into supplier income tax issues could send a negative signal to investors creating uncertainty, placing downward pressure on credit metrics, and potentially increasing the cost of debt for the Company as it tries to honor a three-year stay out.

[2] Satterwhite Hearing Testimony at 448-49.

[3] *Id.*

The Commission should reject KIUC's request for rehearing.

B. <u>If the Commission Accounts for the Reduction in Rockport UPA Tax Expense It Must Similarly Account for the Reduction in the PJM Transmission Owner Revenue Credit in Base Rates.</u>

To the extent the Commission grants KIUC's motion for rehearing to reduce the Company's revenue requirement to reflect the reduction in the UPA counterparty's federal income tax expense, **which it should not**, it must also look at all measurable impacts of the Tax Cuts and Jobs Act on Kentucky Power's cost of service. As an example, the Commission must reopen the Company's PJM Transmission Owner Revenue credit included in the Company's base rates. It would be patently unjust for the Commission to reduce the Company's revenue requirement based on the impact of the Tax Cuts and Jobs Act on the Company's Rockport UPA expense without also increasing the revenue requirement to address the reduction in the Company's PJM Transmission Owner Revenues. If the Commission proceeds down the path proposed by KIUC, it must look at both sides of the coin. If it were to do so, the net change in the Company's revenue requirement for just KIUC's proposal and the required reduction in PJM Transmission Owner Revenue credit included in the Company's base rates would be an <u>increase</u> of $3,360,907 in the Company's revenue requirement.

As a transmission owner in PJM, Kentucky Power receives revenues from other PJM participants that utilize the Company's transmission assets. The transmission revenues the Company receives are derived using a PJM formula rate approved by FERC. Based on test year Transmission Owner Revenues, Kentucky Power embedded a credit of $59,518,865 to the benefit of customers in the Company's base rates.[4]

[4] Application, Section V, Schedule 4, Line 279.

The PJM formula rate that determines Kentucky Power's Transmission Owner Revenues incorporates the then-effective corporate tax rate.[5] The Tax Cuts and Jobs Act's reduction in corporate tax rate will flow through the PJM formula rate and result in a reduction in the transmission revenues. Because the Company's transmission owner revenue credit is based on the test year amount of transmission owner revenues, which were based on the prior tax rate, the change in tax rate will produce lower revenues resulting in a mismatch between the amount of Transmission Owner Revenues received by the Company and the Transmission Owner Revenue credit included in base rates of $4,670,302.[6]

To the extent the Commission grants rehearing to address the tax-rate-change-driven mismatch between test-year Rockport UPA expense and the going forward Rockport UPA expense, it must also account for the tax-rate-change-driven mismatch between the test-year PJM Transmission Owner Revenue credit and the credit going forward. The net change to the revenue requirement is an increase of $3,360,907. Failing to address both sides of the coin is arbitrary, unjust, and unreasonable, and threatens the Company's ability to continue to agree to the stay out. Importantly, if the regulatory relationship were to devolve to the point where the Commission were only to consider the downward impacts of a change in law on the Company's revenue requirement, the Company's credit rating could be threatened.

For the reasons set forth above, the Commission should reject KIUC's petition for rehearing. Reopening specific third-party expenses to address the impact of the Tax Cuts and Jobs Act is inconsistent with the use of a historic test year and upsets the delicate balance in the

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[5] The formula rate calculation used in establishing the Company's Transmission Owner revenues can be found at http://www.aep.com/about/codeofconduct/OASIS/TariffFilings/ as described in Exhibit 1 to the Company's Response.

[6] *See* Exhibit 1 to the Company's Response. The tax rate reductions in the Tax Cuts and Jobs Act will also reduce the Company's PJM OATT LSE Charges. However, unlike the Transmission Owner Revenues which are embedded in base rates and not tracked for over or recovery, the difference between test year and actual PJM OATT LSE Charges will flow back to customers through Tariff P.P.A.

Settlement Agreement that allowed the Company to agree to a three-year stay out. If, however, the Commission grants KIUC's petition, it must also at least account for the effect of the tax rate change on the Company's Transmission Owner Revenues. Doing so results in a net increase to the Company's revenue requirement of $3,360,907.

Respectfully submitted,

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EXHIBIT 1

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Test Year PJM OATT TO Revenue Change Due to TCJA

KPCo PJM Transmission Owner Annual Revenue Requirement - 2015 Update as Filed [1]	$59,909,597	Applied to 4 months of test year (March 2016 - June 2016)
KPCo PJM Transmission Owner Annual Revenue Requirement - 2016 Update as Filed [2]	$60,418,707	Applied to 8 months of test year (July 2016 - February 2017)
KPCo PJM Transmission Owner Annual Revenue Requirement - 2015 Update Adjusted to 21% FIT [3]	$55,126,004	
KPCo PJM Transmission Owner Annual Revenue Requirement - 2016 Update Adjusted to 21% FIT [4]	$55,962,728	

Test year month		
March - 2016	$ 4,593,834	
April	$ 4,593,834	
May	$ 4,593,834	
June	$ 4,593,834	
July	$ 4,663,561	
August	$ 4,663,561	
September	$ 4,663,561	
October	$ 4,663,561	
November	$ 4,663,561	
December	$ 4,663,561	
January	$ 4,663,561	
February 2017	$ 4,663,561	
Test Year TO Rev Credit @21% Tax Rate	$ 55,683,820	
KY Retail Jurisdictional Amount @21% Tax	$ 54,848,563	= $55,683,820*.985
Test Year TO Rev Credit in Rates	$ 59,518,865	Section V, Schedule 4, line number 279
Difference (revenue reduction)	**$ (4,670,302)**	

Notes/Sources

1 Source: http://www.aep.com/about/codeofconduct/OASIS/TariffFilings/ Located under the Annual Update 2015 Section/Kentucky Power Spreadsheet/KPCo Projected TCOS tab/cell L15

2 Source: http://www.aep.com/about/codeofconduct/OASIS/TariffFilings/ Located under the Annual Update 2016 Section/Kentucky Power Spreadsheet/KPCo Projected TCOS tab/cell L15

3 Source: http://www.aep.com/about/codeofconduct/OASIS/TariffFilings/ Located under the Annual Update 2015 Section/Kentucky Power Spreadsheet/KPCo Projected TCOS tab/cell L15 - Change cell F337 on the KPCo Historic TCOS tab to 21% from 35%

4 Source: http://www.aep.com/about/codeofconduct/OASIS/TariffFilings/ Located under the Annual Update 2016 Section/Kentucky Power Spreadsheet/KPCo Projected TCOS tab/cell L15 - Change cell F337 on the KPCo Historic TCOS tab to 21% from 35%