COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.	)	
	)	
COMPLAINANT	)	
V.	)	**Case No. 2018-00036**
	)	
DUKE ENERGY KENTUCKY, INC.	)	
	)	
DEFENDANT	)	

DUKE ENERGY KENTUCKY, INC.'S COMMENTS

Comes now Duke Energy Kentucky, Inc. (Duke Energy Kentucky or Company), by counsel, and tenders its comments submitted in conformity with the April 5, 2018 Order of the Kentucky Public Service Commission (Commission).

I. Background

On December 20, 2017, the United States Congress passed legislation known as the Tax Cuts and Jobs Act (Tax Act). The legislation, signed into law by President Donald Trump, is the most significant revision to the federal tax code in 30 years. The Tax Act has several unique implications for regulated utilities such as Duke Energy Kentucky. On the one hand, the legislation is beneficial to the Company's ratepayers as a result of a 40 percent reduction in the federal income tax (FIT) rate that lowers the cost of service and, therefore, customers' rates. On the other hand, the Tax Act will impose new tax liability upon Duke Energy Kentucky - and, by extension, its customers - through the elimination of bonus depreciation and the manufacturing deduction. These changes manifest themselves in several ways on Duke Energy Kentucky's income statement and balance sheet; one of the most notable effects of the Tax Act is the need to dispose of protected and unprotected excess Accumulated Deferred Income Taxes (ADITs).

Following the enactment of the Tax Act, but prior to President Trump signing the legislation, Kentucky Industrial Utility Customers, Inc. (KIUC) filed a complaint against the Company and other investor-owned electric utilities in Kentucky seeking an immediate return of the estimated benefits of the Tax Act to customers. On December 27, 2017, the Commission entered an Order directing Duke Energy Kentucky to establish a regulatory liability to "reflect the reduction in the federal corporate tax rate to 21 percent and the associated savings in excess deferred taxes on an interim basis until utility rates are adjusted to reflect the federal tax savings." The Commission subsequently entered another Order on January 25, 2018, establishing separate dockets to determine the effect of the Tax Act upon each utility's rates.

The Company filed testimony and an offer of settlement on January 26, 2018. Following an informal conference held on February 7, 2018, Duke Energy Kentucky and KIUC entered into a Stipulation and Settlement Agreement (Stipulation) designed to resolve the impact of the Tax Act upon the Company's natural gas operations in this docket and provide for the impact of the Tax Act upon the Company's electric operations to be resolved in the course of the Company's then-pending electric base rate case, Case No. 2017-00321.[1] The Attorney General (AG) chose not to become a signatory to the Stipulation and filed comments in opposition. By Order entered on April 5, 2018, the Commission determined that additional process would be necessary. Duke

[1] *See In the Matter of the Application of Duke Energy Kentucky, Inc. for 1) An Adjustment of the Electric Rates; 2) Approval of an Environmental Compliance Plan and Surcharge Mechanism; 3) Approval of New Tariffs; 4) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; and 5) All Other Required Approval and Relief*, Application, Case No. 2017-00321 (Ky. P.S.C. Sep. 1, 2017). The effect of the Tax Act upon the Company's electric operations has in fact been considered and determined in the electric rate case. Thus, these comments are limited to the Tax Act's effects on Duke Energy Kentucky's natural gas operations. By limiting its comments as such, the Company is not waiving any available rights or remedies with regard to its electric rates, as determined in Case No. 2017-00321.

Energy Kentucky filed responses to data requests on April 19, 2018, and, with the filing of these comments, submits the case for a judgment by the Commission.

II. Overview of the Tax Act

FIT Rate Reduction

The new statutory income tax rate of 21 percent represents a 40 percent reduction from the previous rate of 35 percent. This will lower a key component of Duke Energy Kentucky's cost of service, *i.e.*, income taxes. In combination with the elimination of bonus depreciation (see below), a lower corporate tax rate will slow the accumulation of deferred income taxes and have an increasing effect on rate base, thereby causing an effect that is expected to increase the cost of service over the long-term.

Interest Expense Deductibility

The Tax Act generally provides that net interest expense is deductible only to the extent it does not exceed a stated percentage of an adjusted taxable income calculation, which calculation becomes increasingly restrictive over the next four years. However, regulated utilities are exempt from this limitation provision and may deduct their interest expense without limitation. Duke Energy Corporation advocated strongly on behalf of its customers to achieve this important exemption, and the Company's customers will retain the significant benefits that flow from it.

Depreciation and Expensing of Capital

The Tax Act generally provides that corporations may immediately expense capital as it is placed in service, akin to 100 percent bonus depreciation. However, the Tax Act specifically includes an exemption/exception for the immediate expensing of capital by regulated utilities. Instead, utilities are directed to use modified accelerated cost recovery system (MACRS) depreciation for capital investment placed in service. Though no longer accompanied by "bonus" depreciation, MACRS still represents a significantly accelerated rate of depreciation compared to book depreciation. As a result, deferred taxes will continue to accrue under MACRS, but will do so at a slower rate compared to bonus depreciation and at a much slower rate under the lower 21 percent corporate tax rate, which will cause a more rapid increase to rate base relative to the period prior to passage of the Tax Act.

Bonus depreciation has the effect, generally, of reducing taxable income in the early years of an asset's life, and therefore deferring associated cash taxes. However, given their capital-intensive nature, utilities were often put into tax loss positions (net operating losses, or NOLs) from an abundance of bonus depreciation and therefore were limited in their ability to incrementally delay cash taxes. The benefit of accelerated depreciation, however, is that it defers cash taxes. Because the deferred income taxes will be paid in some future period, however, a deferred tax liability was established. The cash collected from customers, but deferred from the taxing authorities, is used to fund the operations and investments of the utility and avoid a commensurate level of third-party financings that would otherwise have been necessary but for the additional deferred income taxes.

Manufacturing Deduction Elimination

Prior to the Tax Act, domestic manufacturers were granted a tax deduction based on a certain percentage of qualifying manufacturing income, and the production of electricity qualified for this tax benefit. In order to avail itself of this deduction, a corporation had to be in a taxable income position, however, this was often not the case recently for most regulated utilities because of the impact of bonus depreciation. Unfortunately, the elimination of bonus depreciation for utilities in the Tax Act coincided with the elimination of this tax deduction for all manufacturers, which is detrimental to customer rates over the long-term.

Excess ADITs

At the end of 2017, Duke Energy Kentucky had a net deferred tax liability, booked at a 35 percent corporate tax rate and driven overwhelmingly by accelerated and bonus depreciation of fixed assets for tax purposes. Because a deferred tax liability represents taxes collected from customers but not yet paid to taxing authorities, and because the ultimate payment of these taxes will now occur at a 21 percent corporate tax rate (down from 35 percent), the balance of deferred tax liability must be remeasured. The resulting "excess" deferred tax balance becomes a regulatory liability. The Tax Act requires that excess deferred taxes generally associated with property, and specifically connected to the accelerated depreciation of property, must be normalized into customers rates in a highly prescribed manner that mirrors the remaining life of the underlying assets. These are known as "protected" excess deferred taxes. All other excess deferred taxes may be treated by the Commission like any other regulatory liability in the rate-setting process. If all excess deferred tax liability balances are normalized for rate-setting purposes, the impact to the Company would be neutral to pre-Tax Act cash flow even as customers will realize a rate benefit over time. Under the Tax Act, the protected excess ADIT reserve may be reduced with a corresponding reduction in the revenue that the utility collects from ratepayers no more rapidly than the reserve would be reduced under the Average Rate Assumption Method (ARAM).

III. Proposed Resolution

Duke Energy Kentucky is uniquely situated. Of all the large investor-owned utilities in Kentucky, it has gone the longest without having a base rate increase for either its electric or natural gas operations. Prior to the Order entered on April 13, 2018, in Case No. 2017-00321, Duke Energy Kentucky's last electric base rate increase was approved on December 21, 2006.[2]

[2] *See In the Matter of the Application of the Union Light, Heat and Power Company D/B/A/ Duke Energy Kentucky for an Adjustment of Electric Rates,* Case No. 2006-00172 (Ky. P.S.C. December 21, 2006).

Similarly, the Company's last natural gas base rate increase was approved on December 29, 2009.[3] The financial situation of Duke Energy Kentucky is different from other investor-owned utilities as a result of its ability to avoid base rate increases for over a decade. The Company's rate base and capitalization that existed at the time of its late rate cases have increased significantly as more and more investment has been made in both the Company's natural gas and electric systems. However, with respect to its natural gas operations, the Company's rates charged and collected continue to reflect what was approved by the Commission in late 2009.

While the impact of the Tax Act upon Duke Energy Kentucky's electric rates has been addressed in Case No. 2017-00321, the Commission should understand that the length of time in which the Company's customers have enjoyed no base rate increase could lead to a different outcome now than what would be expected in cases where a natural gas utility has had frequent base rate increases over the same period. Duke Energy Kentucky believes that a "one-size-fits-all" approach to implementing the Tax Act in this context would be arbitrary unreasonable and would not recognize the benefit to customers from Duke Energy by not seeking rate relief since 2009. Instead, each utility's unique situation should be examined and taken into account when crafting the appropriate balance between returning the Tax Act's benefits to customers and not harming the utility's financial condition.

Even with the Tax Act in place, Duke Energy Kentucky cannot be said to have unreasonable rates unless its earnings are significantly in excess of its authorized return. As set forth in the testimony of Mr. William Don Wathen and elsewhere, the record demonstrates the opposite is true. Duke Energy Kentucky's existing natural gas rates – even with the lower FIT and refund of excess ADITs factored in – are not excessive, but rather, to the extent one argues they

[3] *See In the Matter of the Application of Duke Energy Kentucky, Inc. for an Adjustment of Rates,* Order, Case No. 2009-00202 (Ky. P.S.C. December 29, 2009).

are unfair, unjust or unreasonable, it is because such rates are producing earnings that are far *below* what could be considered reasonable. Nevertheless, the Company has endeavored to negotiate a resolution that fairly returns the benefits of the Tax Act to its customers without producing an unreasonable financial burden to the Company and adversely impacting its credit quality. The Stipulation previously entered into by Duke Energy Kentucky and KIUC strikes an appropriate balance and should be approved.

Reduced Natural Gas Rates Due to a Lower FIT

As set forth in the Company's responses to data requests, the Company's total net investment natural gas rate base was $295,171,642 as of December 31, 2017[4]. For the year, the Company achieved a 6.76 percent return on equity (which is far below any authorized return for any utility in Kentucky) for its gas operations and had an overall corporate long-term debt rate of 4.011 percent,[5] and a short-term debt rate of 1.711 percent.[6] This results in a 5.35 percent average weighted cost of capital.[7] Based upon a request by the Commission, Duke Energy Kentucky calculated that its gross revenue conversion factor (GRCF) fell from 1.6285899, based upon a 35 percent FIT,[8] to a 1.3399789 GRCF based upon a 21 percent FIT.[9]

The Commission's data requests asked Duke Energy Kentucky to use its rate base and capitalization as of December 31, 2017, in the preparation of an illustrative calculation of how the Tax Act benefits might be returned to customers. It must be emphasized that the Company's present natural gas rates have been in effect for over eight years and that the rate base and

[4] See Staff-DR-01-002.

[5] See Staff-DR-01-003.

[6] *See id.*

[7] See Staff-DR-01-004.

[8] See Staff-DR-01-005.

[9] See Staff-DR-01-006.

capitalization underlying the Company's current base rates is based upon the test year from its 2009 natural gas rate case, a position that is very different from the rate base as of December 31, 2017. As set forth in the testimony of Mr. Wathen in support of the Stipulation, the Company's revenue requirement in Case No. 2009-00202 was based upon the thirteen-month average capitalization allocated to gas service. That number was then used as the basis for estimating the Company's capitalization for a forecasted period, using the pre-tax return on the new 21 percent FIT and the currently approved return on equity. Moreover, because the ratio used to allocate capital between electric and natural gas in Case No. 2017-00321 was not challenged by any party and was expressly approved by the Commission, the fact that Duke Energy Kentucky's electric capitalization has been established allows for the simple computation of the Company's current natural gas capitalization. The net result of this, of course, is that the Company's significant investment in its system over the past decade, coupled with its allowed rate of return, indicate that the Company is currently under-recovering its costs and invested capital through current rates, even in light of the reduced FIT liability.

Rather than seeking to recover this under-earning via a surcharge, KIUC and Duke Energy Kentucky agreed in the Stipulation to leave the refund component of the refund obligation at $0. While this would be an acknowledgement that the Company's rates are currently insufficient to allow it to recover its authorized return even with a lower FIT, it also assures that the value of excess ADITs to be returned to customers will not be diminished.

Protected Excess ADIT Amortization

The Company calculates a balance of $31,411,000 in protected excess ADITs as of December 31, 2017. Consistent with the Stipulation, the Company recommends that the Commission amortize the refund of the protected ADITs as required by the ARAM method specified in federal law, which will result in an annual amortization of $772,711 to be refunded in 2018. Under the ARAM methodology, the amortization for these protected excess ADITs will change annually. The Stipulation accounts for this dynamic through a rider mechanism that will allow the annual rate to be refunded to adjust as necessary to ensure that customers are receiving the appropriate amount of credit for this portion of the excess ADIT in the appropriate manner under the law. Neither KIUC nor the Attorney General object to this component of the Stipulation, which should therefore be approved.

Unprotected Excess ADIT Amortization

The Company calculates a balance of $304,364 in unprotected excess ADITs as of December 31, 2017. Consistent with the Stipulation, the Company recommends that the Commission amortize the refund of the unprotected ADITs over a fifteen-year period, which is five years less than what the Commission's December 27, 2017 Order originally suggested and three years less than the amortization proposed recently by Kentucky Power Company and KIUC in Case No. 2018-00035.[10] A fifteen-year amortization would equal an annual $25,364 refund to customers. Duke Energy Kentucky acknowledges that the Commission recently directed the Company to amortize the unprotected excess ADITs for its electric operations through rates over a ten-year period. The Company continues to believe that the fifteen-year period as was negotiated as part of this settlement is reasonable.

Tax Refund Rider

As part of the Stipulation, the Company proposed to create a new Tax Refund Rider that would be calculated by computing the amount of the refund to residential and non-residential customers based on their relative shares of overall revenue from the most recent base rate case.

[10] *See In the Matter of Kentucky Industrial Utility Customers, Inc. v. Kentucky Power Company*, Settlement Agreement, Case No. 2018-00035 (Ky. P.S.C. Apr. 27, 2018).

The amount of the refund allocated to each class is then divided by the usage for each class that was used in the last base rate case for establishing base rates in order to calculate the Tax Refund Rider rates for residential and non-residential customers. Duke Energy Kentucky now estimates that the total amount refunded between May 1, 2018, and March 31, 2019, would be $1,070,207, which is the sum of $456,553 for non-residential customers and $613,654 for residential customers.[11]

Commitment to file a Natural Gas Base Rate Case

With this Stipulation, the Company agreed that it would file a natural gas base rate case to assure the Commission and customers that the full impact of the TCJA will ultimately be reflected in the Company's natural gas base rates. This will also enable the Company an opportunity to earn a fair, just, and reasonable return on its invested capital since the time of its last natural gas rate proceeding. With the approval of the aforementioned adjustable Tax Refund Rider, the need for a base rate case solely to implement the TCJA is mitigated. Nonetheless, this commitment was one that was considered important to the Company. To the extent the Commission is concerned with any "requirement" that the Company must file a base rate case within a specified period of time, Duke Energy Kentucky is willing to agree to extending the filing deadline further out. While the Company reserves the right to file a base rate case at any time, as is within its rights under the law, the Company is willing to remove the absolute commitment to do so within a specified time as a condition to resolution of this matter.

Rider ASRP Adjustment

The Stipulation also provides that Duke Energy Kentucky will pass along the income tax-related savings from the Tax Act in its Accelerated Service-Line Replacement Program (Rider

[11] *See* Staff DR-01-013.

ASRP). Upon approval of the Stipulation, the Company will reduce the FIT variable to arrive at a correctly adjusted tax gross-up factor. The AG does not object to this adjustment and it should be approved. Duke Energy Kentucky will make this adjustment in its next annual Rider ASRP filing with rates effective January 1, 2019.

Summary

Duke Energy Kentucky's proposal, embodied in the Stipulation, is the product of negotiation between it and KIUC, with input, although not agreement, from the AG. The proposal seeks to fairly and reasonably balance the interests of Duke Energy Kentucky's customers to have the benefits of the Tax Act reflected in rates against the Company's interest in not creating an artificial and unnecessary financial challenge. For instance, a 15-year amortization period for the unprotected excess ADIT will balance providing customers with the full benefit of the reduction in the federal income tax in a timely manner with the importance of maintaining a strong balance sheet – and cash flows – to enable the Company to finance important investments.

This balance is in the best interest of customers and the Company. The implementation of the Tax Act has the potential to adversely affect the Company's cash flow needed to fund ongoing operations and new infrastructure investments. An unmitigated cash flow shortfall could force the Company to rely excessively on third-party capital to fund itself, to the detriment of its financial condition, credit quality and, ultimately, its customers. Moreover, as the balance of the excess ADIT liability declines, the Company's rate base and, consequently, its capitalization, will increase. The potential impact from a credit downgrade due to increased borrowings as a result of an unreasonable cash flow constraint would ultimately harm customers. While the Company agrees that customers should receive the appropriate level of excess deferred taxes, it must be done over a reasonable period so as to not unfairly harm the Company. An appropriate balance must be struck between reversing these excess balances and returning them to customers and maintaining the Company's credit quality. In closing, Duke Energy Kentucky appreciates the Commission's diligence in managing the docket in this case and respectfully requests the Commission approve the Stipulation as filed.

This 4th day of May, 2018.

Respectfully submitted,

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CERTIFICATE OF SERVICE

This is to certify that the foregoing electronic filing is a true and accurate copy of the document being filed in paper medium; that the electronic filing was transmitted to the Commission on May 4, 2018; that there are currently no parties that the Commission has excused from participation by electronic means in this proceeding; and that a copy of the filing in paper medium is being hand-delivered to the Commission on the 4th day of May 2018 and a copy of the filing is also being emailed to the following:

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