

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) Approval Of Tariffs And Riders;)
(3) Approval Of Certain Regulatory And Accounting)
Treatments; and (4) All Other Required Approvals)
And Relief)

Case No. 2025-00257

TESTIMONY OF DAVID HODGSON
ON BEHALF OF KENTUCKY POWER COMPANY
IN SUPPORT OF THE SETTLEMENT AGREEMENT

**SETTLEMENT TESTIMONY OF
DAVID HODGSON ON BEHALF OF
KENTUCKY POWER COMPANY
BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY**

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I. INTRODUCTION

1 **Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS.**

2 A. My name is David Hodgson. I am the Managing Director Tax Accounting & Regulatory
3 for American Electric Power Service Corporation (“AEPSC”).

4 **Q. ARE YOU THE SAME DAVID HODGSON WHO OFFERED DIRECT AND**
5 **REBUTTAL TESTIMONY IN THIS PROCEEDING?**

6 A. Yes, I am.

7 **Q. DID YOU PARTICIPATE IN THE NEGOTIATIONS WHICH LED TO THE**
8 **SETTLEMENT AGREEMENT BEING SUBMITTED FOR CONSIDERATION**
9 **AND APPROVAL BY THE COMMISSION?**

10 A. Yes, I reviewed and provided technical support to help develop some of the concepts in the
11 Settlement Agreement including, in particular, the creation of customer rate relief concepts
12 set forth in the “4. Customer Rate Relief” section of the Settlement Agreement.

13 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

14 A. My testimony supports the formation of the new Deferred Tax Liability Rider and the
15 associated modification of the timing of realizing unprotected deferred income tax expense,
16 including the necessary accounting treatment, to help effectuate the customer rate relief set
17 forth in the Settlement Agreement.

II. DEFERRED TAX LIABILITY BACKGROUND

Q. WHAT IS A DEFERRED TAX LIABILITY.

A. A deferred tax liability is a future tax obligation that is recorded on the balance sheet that arises from temporary differences between the income recorded for financial reporting (book) purposes and income determined for income tax reporting (tax) purposes. A deferred tax liability represents the taxes that will be payable in future periods when those differences reverse.

Q. PLEASE PROVIDE AN EXAMPLE OF THE CONCEPT OF A DEFERRED TAX LIABILITY.

A. To demonstrate the concept, I will provide two examples one in which the utility has no temporary differences between book and taxable income and one in which a temporary difference exists. In both examples the federal income tax rate is 21%.

In the first example, the utility has book income of \$1,000 in Year 1 and in Year 2 and no temporary differences in the recognition of income for book and tax purposes. Because there are no differences in the recognition of income between book and tax, the utility also has income of \$1,000 each year for tax purposes. In this example, in Year 1 the utility records \$210 of current federal income tax expense and has a liability for income taxes payable to the Internal Revenue Service ("IRS") of \$210. Because the utility has no temporary differences between book and taxable income, it has not deferred payment of tax on any of its book income and therefore does not record a deferred tax liability. In Year 2, the utility records another \$210 of current federal income tax expense and has an additional liability for income taxes payable to the IRS of \$210. As was the case in Year

1 1, because no temporary differences existed, no payment of tax was deferred, and no
2 deferred tax liability is recorded.

3 Now suppose the same set of facts, wherein the utility has book income of \$1,000
4 in Year 1 and in Year 2 but for tax purposes the utility can accelerate a repair expense of
5 \$1,000 to Year 1 that is recognized for book purposes in Year 2. For tax purposes, because
6 the utility can accelerate a repair expense to Year 1, it has \$0 taxable income in Year 1.
7 Because the utility now has no taxable income in Year 1, it has no tax liability that is
8 currently payable to the IRS. However, the recognition of the repair expense is a temporary
9 difference between book and taxable income, therefore the utility has not reduced its tax
10 liability over time, it has just pushed that liability into later years. As such, in Year 1 the
11 utility records deferred tax expense of \$210 and establishes a deferred tax liability of \$210.
12 For tax purposes in Year 2 the utility cannot recognize the repair expense that is recognized
13 in its book income because it was already recognized for tax purposes in Year 1. This
14 results in taxable income in Year 2 of \$2,000 and a payment due to the IRS of \$420. As a
15 result, the utility records current tax expense of \$420 and a liability for taxes payable of
16 \$420. Because the timing difference in the recognition of the repair expense was reversed
17 in Year 2, the utility no longer has deferred the payment of tax on its book income. As
18 such, the utility reverses its deferred tax liability and records a negative deferred tax
19 expense (i.e., deferred tax benefit). Therefore, in Year 2 the utility has a total tax expense
20 of \$210 (\$420 current tax expense plus \$210 deferred tax benefit).

21 In both examples the utility has income taxes payable to the IRS for a total of \$420
22 over the two years, the only difference is the timing at which the taxes are payable. In the
23 first example, the utility has taxes payable in Year 1 of \$210 and in Year 2 of \$210 and in

1 the second example the utility has no income taxes payable in Year 1 and taxes payable of
2 \$420 in Year 2. The acceleration of the repair expense for tax purposes did not reduce the
3 tax liability, it just deferred the time at which the tax liability is payable. The acceleration
4 of the repair expense for tax purposes provides the utility with an interest-free loan from
5 the federal government of \$210 in Year 1 that is payable in Year 2.

6 **Q. PLEASE EXPLAIN THE RATEMAKING IMPACT OF DEFERRED INCOME**
7 **TAXES?**

8 A. Typically, the temporary differences in book and taxable income are normalized for
9 ratemaking, meaning that rates reflect the income tax expense both currently due and the
10 income tax expense that has been deferred due to the temporary difference. This results in
11 a more stable rate of federal income taxes in rates. In the second example provided earlier
12 in my testimony, under a normalized method, the utility's rates include income tax expense
13 of \$210 in its rates in both Year 1 and Year 2 based on the book income of \$1,000 each
14 year. If deferred income tax expense is not included in ratemaking, the utility's rates
15 fluctuate from including income tax expense of \$0 in Year 1 to \$420 in Year 2 despite the
16 fact that the utility's book income is stable year-over-year. Additionally, when deferred
17 income tax expense is included in a utility's rates, the deferred tax liability may be provided
18 as a benefit to customers. Typically, a deferred tax liability is included as a reduction to the
19 rate base on which a utility earns a return because the deferred tax liability represents an
20 interest-free loan from the government as described earlier in my testimony.

21 **Q. DOES THE COMPANY HAVE DEFERRED TAX LIABILITIES?**

22 A. Yes. For the purpose of providing the revenue credit in the Deferred Tax Liability Rider,
23 the Company has identified a deferred tax liability related to a difference in the book and

1 tax classification of certain expenditures. These expenditures are capitalized and
2 depreciated for book purposes but can be immediately expensed as a repair expense for tax
3 purposes. As such, the deferred tax liability is recorded in the year the expenditure is made
4 and recognized as an expense for tax purposes and reverses as book depreciation is
5 recorded related to that capitalized expenditure.

III. DEFERRED TAX LIABILITY RIDER IN SETTLEMENT

6 **Q. HOW DO THE SIGNATORY PARTIES PROPOSE TO TREAT DEFERRED TAX**
7 **LIABILITIES TO DECREASE THE BILL IMPACTS OF THE REVENUE**
8 **REQUIREMENT ASSOCIATED WITH THE RATE CASE?**

9 A. The Signatory Parties propose to defer and later amortize the deferred tax expense that the
10 Company has incurred and has been recognized in its financial statements. In doing so, the
11 Signatory Parties propose to change the timing at which deferred tax expense is recognized
12 in the Company's financial statements and ratemaking. The proposal changes the manner
13 and timing in which customers are provided with the benefit of the interest-free loan from
14 the federal government that is discussed in the example above. The deferred tax liabilities
15 on the Company's books will remain unchanged because the amount of taxes that the
16 Company has deferred and will be payable to the IRS in the future is unchanged.

17 **Q. CAN YOU DESCRIBE THE RATE CREDITS THAT WILL BE IMPLEMENTED**
18 **THROUGH THE NEW DEFERRED TAX LIABILITY RIDER?**

19 A. Yes, the Deferred Tax Liability Rider is designed to provide revenue credits to customers
20 over the course of two years starting March 1, 2026 through February 29, 2028 by
21 modifying the timing over which income tax expense associated with unprotected income
22 tax timing differences is incorporated into ratemaking. In the first year, running from
23 March 1, 2026 through February 28, 2027 ("2026 Rate Case Year"), the Deferred Tax

1 Liability Rider is designed to provide a revenue credit of \$25 million. In the second year,
2 running from March 1, 2027 through February 29, 2028 ("2027 Rate Case Year"), the
3 Deferred Tax Liability Rider is designed to provide a revenue credit of \$15 million.

4 **Q. PLEASE DESCRIBE THE ACCOUNTING NECESSARY TO ACCOMPLISH THE**
5 **DEFERRED TAX LIABILITY RIDER CREDIT FOR THE 2026 AND 2027 RATE**
6 **CASE YEARS?**

7 A. To accomplish the Deferred Tax Liability Rider revenue credits, the Company will credit
8 operating deferred income tax expense and debit a new regulatory asset ("DTL Regulatory
9 Asset"). The Company will record these entries in the amount of approximately \$20.2
10 million and during 2026 Rate Case Year and approximately \$13.7 million during 2027 Rate
11 Case Year.

12 **Q. WHY IS THE COMPANY CREATING THE DTL REGULATORY ASSET?**

13 A. The Signatory Parties' proposal does not change the amount of deferred tax expense that
14 is incorporated into ratemaking, it only changes the timing over which it occurs. Because
15 the Company is deferring income tax expense to provide the revenue credit to customers
16 for the 2026 and 2027 Rate Case Years, it must collect that income tax expense at a later
17 time to recover the tax expense that it incurs to provide service to its customers.

18 **Q. DESCRIBE THE DEFERRED TAX LIABILITY RIDER REVENUE**
19 **REQUIREMENT DISCUSSED IN SECTION 4.B. OF THE STIPULATION?**

20 A. The Deferred Tax Liability revenue requirement is comprised of several components. The
21 first component is the credit to deferred income tax expense for the deferral of expense
22 discussed earlier in my testimony that will occur during 2026 Rate Case Year and 2027
23 Rate Case Year. The second component is the return on the DTL Regulatory Asset. The

1 third component is the amortization of the DTL Regulatory Asset. The Settlement
2 Agreement also provides for an annual true-up of the Deferred Tax Liability revenue
3 requirement which makes up the fourth component. Finally, all of those components are
4 multiplied by the gross revenue conversion factor to arrive at the Deferred Tax Liability
5 revenue requirement.

6 **Q. WHY DOES THE DEFERRED TAX LIABILITY RIDER REVENUE**
7 **REQUIREMENT INCLUDE A RETURN ON THE DTL REGULATORY ASSET?**

8 A. The Deferred Tax Liability Rider revenue requirement includes a return on the DTL
9 Regulatory Asset to recognize that because the Company used its deferred tax liability to
10 provide revenue credits to customers, it no longer has the benefit of the interest-free loan
11 from the federal government. The Company's deferred tax liabilities are incorporated into
12 its ratemaking as a reduction to rate base because they represent an interest-free loan from
13 the federal government. The return on the DTL Regulatory Asset offsets the return that is
14 provided to customers by the deferred tax liability being a reduction to rate base.

15 **Q. DO THE TAX LAWS OR RULES PROHIBIT THE COMPANY FROM**
16 **TREATING THE DEFERRED TAX LIABILITIES AS PROPOSED IN THE**
17 **SETTLEMENT AGREEMENT?**

18 A. No. As discussed earlier in my testimony, the Company identified a deferred tax liability
19 related to a difference in the book and tax classification of certain expenditures. This
20 deferred tax liability is unprotected and not subject to IRS normalization rules. Therefore,
21 there is flexibility in the timing at which the tax benefits may be provided to customers.

22 **Q. HOW WILL THE DEFERRED TAX LIABILITY RIDER REVENUE**
23 **REDUCTION IMPACT FUTURE RATES?**

1 A. As discussed earlier in my testimony, one component of the Deferred Tax Liability Rider
2 revenue requirement is the amortization of the DTL Regulatory Asset. The Deferred Tax
3 Liability Rider is designed to modify the timing of the over which deferred income tax
4 expense is incorporated into ratemaking. Therefore, while in the 2026 and 2027 Rate Case
5 Years the Deferred Tax Liability Rider provides a revenue credit, in the time after those
6 rate years, the Rider will result in a revenue charge.

7 **Q. OVER WHAT PERIOD WILL THE DTL REGULATORY ASSET BE**
8 **AMORTIZED?**

9 A. The DTL Regulatory Asset will be amortized over the life of the underlying plant for which
10 the deferred tax liability was established – 26 years. As discussed earlier in my testimony,
11 the deferred tax liability that is being deferred into the DTL Regulatory Asset is related to
12 expenditures that were immediately expensed as repair expenses for tax purposes but
13 capitalized for book purposes. Therefore, the timing difference will reverse as the book
14 capital assets are depreciated. It is necessary for the amortization of the DTL Regulatory
15 Asset to be tied to the reversal of the underlying timing difference in order for the Company
16 to recover its tax expense to align with when the taxes will be payable to the IRS in the
17 future.

IV. CONCLUSION

18 **Q. OVERALL, WHAT ARE THE BENEFITS TO CUSTOMERS ASSOCIATED**
19 **WITH THE COMPANY'S PROPOSED TAX TREATMENTS DESCRIBED IN**
20 **YOUR DIRECT TESTIMONY?**

1 A. The Company's proposed tax treatments ensure that the Company properly recovers tax
2 expenses through rates that are equivalent to those incurred while providing customers with
3 an advance credit to offset the revenue requirement increase associated with this rate case.

4 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

5 A. Yes, it does.

VERIFICATION

The undersigned, David A. Hodgson, being duly sworn, deposes and says he is the Managing Director, Tax Accounting and Regulatory for American Electric Power Service Corporation, that he has personal knowledge of the matters set forth in the foregoing testimony and the information contained therein is true and correct to the best of his information, knowledge, and belief after reasonable inquiry.

David A. Hodgson
David A. Hodgson

State of Ohio)
) Case No. 2025-00257
County of Franklin)

Subscribed and sworn to before me, a Notary Public in and before said County and State, by David A. Hodgson, on 1/9/2026.

[Signature]
Notary Public

My Commission Expires Never

Notary ID Number NO ID



Paul D. Flory
Attorney At Law
Notary Public, State of Ohio
My commission has no expiration date
Sec. 147.03 R.C.