COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF THE GAS AND ELECTRIC RATES, TERMS, AND CONDITIONS OF LOUISVILLE GAS AND ELECTRIC COMPANY	)))	CASE NO. 2003-00433

and

AN ADJUSTMENT OF THE ELECTRIC RATES, TERMS, AND CONDITIONS OF KENTUCKY UTILITIES COMPANY	)))	CASE NO. 2003-00434

O R D E R

On July 23, 2004, the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), filed a petition for rehearing on four issues arising from the Commission's June 30, 2004 Orders granting increases in the revenues for the electric operations of Louisville Gas and Electric Company ("LG&E") and the jurisdictional operations of Kentucky Utilities Company ("KU"). On August 2, 2004, pursuant to the Commission's July 23, 2004 Order, LG&E and KU filed a joint response in opposition to the AG's petition for rehearing. No other party to the rate cases filed comments on the AG's petition for rehearing. In addition, LG&E, KU and the AG have filed responses to the Commission's July 26, 2004 Order which requested additional information to assist in the review of the merits of the AG's petition.

Based on the petition, the joint response, and the data responses, the Commission makes the following findings:

Kentucky Income Tax Rate

The June 30, 2004 Orders found that the Kentucky statutory income tax rate should be used in determining the revenue requirements for LG&E and KU. In rejecting the AG's proposal to use the effective Kentucky income tax rate, the Commission noted that use of the Kentucky statutory income tax rate was consistent with its decisions in previous LG&E and KU cases. The Commission also stated its concerns about appropriately reflecting the payment of taxes in Indiana and Virginia when determining the adjustment to the test-year-actual income tax expense if the effective tax rate were utilized. However, LG&E and KU were directed to address in detail the use of the effective tax rate in their next rate cases.[1]

In his petition for rehearing, the AG dismisses arguments from LG&E and KU that the use of the statutory tax rate was consistent with previous rate case decisions, noting that in those previous cases LG&E and KU were not able to avail themselves of a lower effective tax rate. The AG notes that even with a recognition of the Indiana or Virginia tax impacts, the effective tax rate determined by LG&E and KU would still be lower than the statutory tax rate. The AG argues that there is nothing in the record to support the continued use of the statutory tax rate in the face of LG&E's and KU's actual tax experience. However, in response to the Commission's July 26, 2004 data request, the AG indicated he was not aware of any other state regulatory commission using an effective state income tax rate for rate-making purposes.[2]

[1] See June 30, 2004 Order in Case No. 2003-00433 at 52-55 and June 30, 2004 Order in Case No. 2003-00434 at 45-47.

[2] Response of the AG to the Commission's July 26, 2004 Order, Item 1.

In their August 2, 2004 joint response to the petition for rehearing, LG&E and KU contend that the use of the effective Kentucky income tax rate is more uncertain and complicated than the use of the statutory tax rate because of fluctuations in credits and apportionment adjustments from out-of-state activities over time. LG&E and KU reason that the statutory tax rate is not distorted by these items and is objective, known and measurable, and easily understood and verifiable. LG&E and KU submitted calculations in their data responses to show the impact that the effective Kentucky income tax rate, modified to reflect the impact of Indiana or Virginia taxes, would have had on the revenue requirements as determined in the June 30, 2004 Orders. LG&E determined that its electric revenue increase would be $504,596[3] lower and KU determined that its jurisdictional revenue increase would be $416,109[4] lower. LG&E and KU note that even with the use of the effective Kentucky income tax rate, the resulting revised revenue increases would still be higher than the revenue increases that were agreed to by LG&E and KU and accepted by the June 30, 2004 Orders.

The Commission continues to have concerns about LG&E's and KU's approach to recognizing the impact of the Indiana or Virginia taxes when considering the use of the effective Kentucky income tax rate. Specifically, we are concerned that the modified effective tax rates submitted by LG&E and KU to reflect the Indiana or Virginia taxes do not accurately reflect the impact of those taxes. The Commission has reviewed LG&E's and KU's calculations showing the impact of the modified effective Kentucky income tax rate, but we cannot replicate the results they submitted. Our inability to replicate those

[3] LG&E's Response to the Commission's July 26, 2004 Order, Item 2.

[4] KU's Response to the Commission's July 26, 2004 Order, Item 2.

results may be due to LG&E and KU not reflecting the use of a lower state income tax rate in their determination of federal income taxes.

Based on a review of the arguments presented, the Commission finds good cause to rehear this issue to determine whether it is appropriate to use the effective Kentucky income tax rates, what those tax rates are, and whether their use would have impacted the revenue increases granted.

Continued Use of 2001 Depreciation Rates

In his petition for rehearing, the AG argues that the Commission should have approved new depreciation rates associated with plant accounts where the AG's witness and LG&E's and KU's depreciation witness agreed on the service lives. The AG contends his witness's service life analysis was not arbitrary and did not always select a service life that produced the lowest depreciation rates. The AG urges the Commission to modify the findings in the June 30, 2004 Orders to reflect that he did not always propose the longest possible service lives or adopt a "results-oriented" approach to his depreciation recommendations. The AG also claims that the current depreciation rates that were approved in 2001 contain the "double counted inflation" that the Commission cited as the reason for rejecting LG&E's and KU's depreciation studies filed in these cases.

In their joint response, LG&E and KU commented that the AG has offered no valid reason to grant rehearing on any of the three depreciation issues he raises. Concerning the continued use of the 2001 depreciation rates, LG&E and KU observe that under the terms of the Partial Settlement Agreement, Stipulation and Recommendation ("Partial Settlement and Stipulation") all the parties in the two rate

cases, except for the AG, agreed that the 2001 depreciation rates should remain in effect. LG&E and KU state that the 2001 depreciation rates were established as part of the "Global Settlement" approved by the Commission in December 2001. LG&E and KU note that the AG was a party to and supported the depreciation rates established in the Global Settlement.

The Commission has reviewed the AG's arguments on this issue and finds that continuing to use the 2001 depreciation rates is reasonable under the circumstances here. The new depreciation studies filed by LG&E and KU were rejected based on our findings that they were flawed and they did not produce reasonable depreciation rates. Similarly, the AG's depreciation studies were found to be flawed and they too were rejected as not producing reasonable depreciation rates. Since LG&E and KU clearly have a right to recover depreciation expenses through their rates, the only alternative available in these cases was to continue using the 2001 depreciation rates which had previously been agreed to by all parties including the AG.

The June 30, 2004 Orders did not state that all the service lives proposed by the AG were arbitrary, only the extension of those service lives proposed for a specific group of transmission and distribution assets. While the June 30, 2004 Orders noted LG&E's and KU's belief that the AG's use of the longest available service lives for this specific group of transmission and distribution assets reflected a "results-oriented" approach to determining depreciation rates, the Commission did not state that the AG's recommendations were "results-oriented." Rather, the Commission stated that in reference to certain transmission and distribution assets, it was not reasonable to always select the service life that produced the lowest depreciation rates.

Finally, the AG now claims for the first time that the current depreciation rates, which were approved as part of the Global Settlement in 2001, include double counted inflation. He cites his witness's testimony at the public hearing to support this claim. However, a review of the transcripts in these cases discloses that at no time did the AG witness claim that the current depreciation rates include double counted inflation. The AG's transcript citation relates to an explanation of how a utility would have no obligation to incur removal costs for an asset, not a claim that the current depreciation rates of LG&E and KU contain double counted inflation.[5]

A final argument raised by the AG is that the Commission should have adopted the AG's service lives for those accounts on which both the AG and LG&E and KU were in agreement. However, this argument overlooks the fact that depreciation rates as approved by the Commission reflect both the service lives of the assets and a net cost of removal component. An agreement to modify the service lives cannot be used to revise depreciation rates when the existing component of net removal cost cannot be identified. LG&E's and KU's existing depreciation rates were the result of a settlement, and neither the settlement nor the agreed upon rates separately identify the components of service life and net removal cost. Therefore, even if the Commission accepted the proposed service lives as agreed to by the AG, LG&E, and KU, it would not be possible to calculate new depreciation rates because the components of net removal costs cannot be identified.

Based on these findings, the Commission will deny rehearing on this issue.

[5] Transcript of Evidence, Volume III, May 6, 2004, at 146-148.

Treatment of Net Salvage

The AG argues that the Commission should reconsider its rejection of his proposal to incorporate a 5-year average of experienced salvage expense as part of depreciation expense. The AG claims the Commission rejected this approach by accepting the claims of LG&E and KU that the 5-year average wasn't appropriate because of inter-company asset transfers between the companies. The AG states that the information necessary to eliminate the inter-company transfer effects was in the record and that this information should have been utilized to develop a 5-year average of experienced salvage expense. The AG also requests the Commission, at a minimum, clarify what net salvage is being charged as the amount contributing to what the AG believes is an excessive depreciation reserve, an excess he contends is many times greater than LG&E's and KU's actual salvage expense.

In their joint response, LG&E and KU contend that the AG has misinterpreted the June 30, 2004 Orders. LG&E and KU note one of the reasons the Commission rejected the 5-year actual expense approach was the fact the 5-year approach contained unrepresentative data. LG&E and KU also quote the June 30, 2004 Orders' statement that capitalizing the cost of removal in order to recover those costs over the life of the investment is a common practice and has been accepted by the Commission for a number of years. LG&E and KU argue that the AG has offered nothing new, and has no evidence to support his claim that LG&E and KU will never spend the amounts included in accumulated depreciation as the net salvage reserve. In response to the AG's request that the amount of net salvage be identified, LG&E and KU contend that on a going forward basis they will be able to identify the actual costs incurred for salvage

when assets are retired and that this information should address the AG's concerns in the future.

As the Commission stated in the June 30, 2004 Orders, the issue here is whether it is reasonable to recover the cost of removal over the life of the investment by including the cost of removal as a component of depreciation rates. The AG opposes this methodology based, at least in part, on his definition of depreciation expense as a charge to operating expense to reflect the recovery of a company's previously expended capital.[6] Under this definition, the AG argues that the cost of removal, net of any salvage, should not be included in the depreciation rates, as the net cost of removal is not part of the capital expended to secure an asset. Under the AG's proposed methodology, any net cost of removal is recognized when the asset is retired, and the net cost of removal is then treated as a current expense in the period retired. Under this methodology, ratepayers are required to pay 100 percent of the net cost of removal in the year the asset is retired, even if they were not ratepayers during the prior years when the asset was used to provide utility service. Requiring ratepayers to pay for costs of an asset when they received no benefit from that asset creates intergenerational inequities. Under the AG's proposed methodology, today's ratepayers who are receiving the benefits from a long lived asset may not be ratepayers in the future when the asset is retired and, thus, would not pay for the net cost of removal.

The AG's definition of depreciation is not consistent with the definition prescribed in the Federal Energy Regulatory Commission's Uniform System of Accounts ("USoA") and adopted by this Commission pursuant to KRS 278.220. The USoA defines

[6] Majoros Depreciation Direct Testimony at 7 of 51.

depreciation as "the loss in service value not restored by current maintenance, incurred in connection with the consumption or <u>prospective retirement of electric plant</u> in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance."[7] (emphasis added) The Commission believes that this definition, coupled with a desire to match an asset's cost with the ratepayers who receive its benefit (and thereby avoiding intergenerational inequities), supports capitalizing the net cost of removal by including it in depreciation rates, rather than expensing the total net cost of removal when the asset is retired. As noted in the June 30, 2004 Orders, capitalizing the cost of removal is a common practice and it has been accepted by this Commission for a number of years. Thus, the Commission will deny rehearing on this issue.

<u>Return of Depreciation Over-Collections</u>

The AG contends that because previously approved depreciation rates included costs of removal and salvage expenses that he believes will never be incurred by LG&E and KU, the accumulated depreciation balances are inflated with excess costs that should be returned to ratepayers over a 10-year period. The AG argues that these over-inflated costs of removal and salvage expenses will not be returned to ratepayers through the normal comparison of the theoretical and actual depreciation reserves because the theoretical depreciation reserve will have had these over-inflated costs included initially. The AG acknowledges that he had not previously provided the calculation of his proposed 10-year amortization amounts, and now files his proposed calculations as an attachment to his petition for rehearing.

[7] 18 CFR 1.101 at 281.

LG&E and KU contend that the AG is doing nothing more than re-arguing the position that the Commission rejected in the June 30, 2004 Orders. In addition, LG&E and KU argue that the AG's calculations now filed to support rehearing should be rejected, under KRS 278.400, as being evidence that the AG could have or should have, with the exercise of reasonable diligence, offered during the prior hearing. LG&E and KU note that the AG's position on this issue and his methodology for recognizing net salvage result in the total elimination of any net cost of removal from both the depreciation rates and the accumulated depreciation balance. LG&E and KU state that there is no evidence in the record to support the AG's claims that the net cost of removal contained in the accumulated depreciation balances are "phantom" expenses, i.e., they will never be incurred, or they are "over-inflated." LG&E and KU further state that the questionable attachments document the AG's assertion that every single dollar in the cost of removal depreciation reserve was improperly collected and that net salvage should be collected as part of operating expenses. LG&E and KU contend that the Commission acted properly in rejecting the AG's proposed methodology and continuing the approach of capitalizing the cost of removal by including it as a component of depreciation rates.

The Commission finds that the $456 million figure set forth in the AG's petition reflects the total cost of removal balances contained in the accumulated depreciation balances for the total company operations of LG&E and the total company operations of KU. Consequently, this includes the net cost of removal associated with LG&E's gas operations and KU's Virginia and other jurisdictional operations. The total net cost of removal included in LG&E's accumulated depreciation balance for electric operations is

$171 million,[8] and the amount included in KU's accumulated depreciation balance for Kentucky jurisdictional operations is $235.1 million.[9] Thus, the total amount for both utilities' electric operations, and the total amount at issue here, is $406.1 million.

The cost of removal that is included in the depreciation rates and that has been accrued in the accumulated depreciation balances reflects the utilities' best estimate of what the net cost of removal will be for their current utility plant in service. These estimates are based on the actual retirement, cost of removal, and salvage value experience of the utilities, as well as information from other utilities with similar assets.

The AG has argued that the total net costs of removal incorporated in the accumulated depreciation balances are excessive, reflect inaccurate estimates of the costs of removal and salvage, and are over-inflated expenses that will never be incurred by LG&E and KU. These arguments reflect the AG's position that the net cost of removal should be treated as an operating expense in the year incurred and not a capitalized cost included in depreciation rates. The AG has presented no evidence to persuade us that the costs of removal are excessive, or that they will never be incurred.

In both his testimony and post-hearing brief, the AG discussed his proposal to amortize the costs of removal contained in the accumulated depreciation balances. However, the AG did not propose an adjustment to reflect the 10-year amortization of

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[8] See June 30, 2004 Order in Case No. 2003-00433 at 33.

[9] See June 30, 2004 Order in Case No. 2003-00434 at 28.

the cost of removal in his recommended revenue requirements,[10] and his post-hearing brief did not amend his proposed revenue requirements to include the 10-year amortization expense. Now, on rehearing, the AG has modified his depreciation expense proposals for LG&E and KU to reflect the 10-year amortization, but he has not proposed any revisions to his recommended revenue requirements for either utility.

The Commission finds that rehearing on this issue should be denied. The AG's arguments are based upon his proposed methodology that treats the cost of removal and salvage expenses as costs to be recovered as operating expenses in the year incurred. As discussed previously in this Order, this treatment of net cost of removal is contrary to the definition of depreciation in the USoA and is inconsistent with the Commission's prior treatment of these costs. The AG has submitted no evidence to demonstrate that the costs of removal included in the accumulated depreciation balance are the result of inaccurate estimates and are over-inflated expenses that will never be incurred by LG&E and KU. Thus, the Commission will deny the AG's request for rehearing on this issue. Consequently, the challenge by LG&E and KU to the AG's submission of an amortization adjustment to support his request for rehearing is moot.

In a separate Order issued today, the Commission decided to hold these cases in abeyance pending the receipt of an investigative report from the AG on other issues more fully discussed in that Order. Once this stay is lifted, a procedural Order will be established for rehearing the issue of using the effective Kentucky income tax rates.

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[10] See Case No. 2003-00433, Henkes Electric Direct Testimony, Schedules RJH-1, RJH-3, RJH-4, and RJH-8 and Majoros Depreciation Direct Testimony, Exhibit MJM-3; Case No. 2003-00434, Majoros Revenue Requirements Direct Testimony, Exhibit MJM-1, MJM-2, and MJM-7 and Majoros Depreciation Direct Testimony, Exhibit MJM-4.

IT IS THEREFORE ORDERED that:

1. Rehearing is granted to determine whether it is appropriate to use the effective Kentucky income tax rates, what those tax rates are, and whether the use of the effective Kentucky income tax rates would have impacted the revenue increases granted.

2. Rehearing on all other issues raised in the AG's petition for rehearing is denied.

Done at Frankfort, Kentucky, this 12th day of August, 2004.

By the Commission

ATTEST:

Executive Director