The Impact of Federal and International Policy on Kentucky's Energy Future

A Review Conducted Pursuant to Executive Order 2005-120

by the Kentucky Public Service Commission

August 22, 2005

Kentucky
UNBRIDLED SPIRIT™

INTRODUCTION

Executive Order 2005-120, issued by Governor Ernie Fletcher on February 7, 2005, directed the Kentucky Public Service Commission ("Commission") to "consider, investigate, and issue a report related to the role of the federal government and international institutions as they might bear on an energy policy for the Commonwealth of Kentucky." Further, the Executive Order stated that "The Report shall identify federal and international policies or actions that affect the ability of the PSC to establish in Kentucky electric and natural gas rates that are fair, just and reasonable. The report shall also identify how such policies or actions affect the ability of Kentucky based energy producers to export energy supplies in interstate and international markets."

In accordance with the Executive Order, the Commission conducted a comprehensive review of relevant statutes, treaties, and other source materials. This report summarizes the jurisdiction of federal government agencies and the Commission with respect to electricity and natural gas utilities and services, and the effect of recent federal statutory and regulatory changes on Kentucky's energy policy and the ability of the Commission to ensure fair, just, and reasonable utility rates for Kentuckians. The findings and conclusions of this report are based upon years of Commission expertise in regulating utilities within its jurisdiction and participating on behalf of the Commonwealth in federal regulatory proceedings, particularly at the Federal Energy Regulatory Commission ("FERC"). The statements contained in this report are intended as general observations, and are not binding on the Commission in any pending or future proceeding.

Lastly, the role of the federal government and relevant international institutions is a fluid one. Consequently, this report reflects the status quo. Many relevant issues are presently before the courts, at the FERC and other federal agencies, and part of the World Trade Organization's ("WTO") ongoing negotiations regarding the General Agreement in Trade and Services ("GATS"). Moreover, the provisions of the Barton-Domenici Energy Policy Act of 2005, enacted on August 8, 2005, will be implemented over the coming years and will undoubtedly affect energy prices and utility rates in Kentucky. Where possible, this report attempts to summarize the potential effects of this legislation.

EXECUTIVE SUMMARY

Kentucky enjoys abundant supplies of affordable energy in the form of electricity and natural gas. Kentucky consumers, on average, pay the lowest electricity rates in the nation, while our natural gas rates are slightly below the national average. The wholesale price of natural gas is established by mature, interstate commodities markets regulated by the federal government and is passed through to consumers in the rates of distribution utilities. Interstate electricity markets and electric utility service are undergoing a period of rapid change and subject to both federal and state regulation.

The price Kentuckians pay for natural gas is largely determined by federal policies affecting supply, demand, and deliverability. Initiatives to increase the availability of natural gas, in the form of new production and infrastructure, will benefit Kentucky ratepayers. As for electricity, Kentucky (unlike some states) closely regulates all aspects of electricity price and service to customers, whereas the federal government regulates the price and terms of service for bulk power sales to other utilities. Kentucky's extremely low electricity rates are the result of historic investments by Kentucky's utilities in large, coal-fired generating units, along with an abundant local fuel supply, sound utility management, and careful regulation. Federal policies regarding interstate wholesale power markets and environmental regulations will affect the price of electricity in Kentucky. Kentucky should consider appropriate policies to mitigate these risks.

On August 8, 2005, the President signed into law H.R. 6, the Barton-Domenici Energy Policy Act of 2005. In the Comprehensive Energy Bill just passed by Congress, contained in the voluminous Act are noteworthy changes to federal electricity and natural gas laws. The provisions of the Act, which include clarification of FERC jurisdiction with regard to interstate markets and RTOs along with economic incentives and tax reforms, are designed to improve electric reliability and spur investment in electricity and natural gas infrastructure. The new law also contains a number of tax reforms that may affect electricity and natural gas prices. Specifically, the Act amends the Internal Revenue Code to assign a seven-year depreciation recovery period to natural gas gathering lines; assigns a fifteen-years depreciation recovery period to natural gas distribution lines and certain electric transmission properties; expands the amortization period for certain pollution control facilities; and exempts certain prepayments of natural gas from arbitrage bond rules. Lastly, the new Act contains a number of provisions designed to improve our Nation's energy efficiency, which will help reduce future prices for electricity and natural gas. Among the provisions are efficiency standards for new products and appliances, new energy efficiency requirements for the Federal government, and a tax credit up to $2000 per year for 20% of expenditures for energy efficiency improvements made to existing residences before 2008.

Recent developments in international trade law do not appear to pose a threat to Kentucky energy prices and supplies. However, treaties potentially affecting international energy markets should be monitored carefully.