COMMONWEALTH OF KENTUCKY

BEFORE THE ENERGY REGULATORY COMMISSION

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In the Matter of

GENERAL ADJUSTMENT IN ELECTRIC RATES OF KENTUCKY POWER COMPANY	)))	CASE NO. 7900

<u>ORDER</u> <u>DENYING</u> <u>REHEARING</u>

On December 17, 1980, the Energy Regulatory Commission entered an order granting the Kentucky Power Company $11,535,000 in increased operating revenue by approving increased rates to the Company's customers. On January 8, 1981, Kentucky Power Company filed an application for rehearing of the Commission's December 17, 1980 Order in which it alleged six (6) "errors" had been committted in the Commission's original Order. For purposes of clarity, the Commission will address each of Kentucky Power's contentions individually.

(1) Kentucky Power's first assertion of error in the Commission's Order is that the record of this proceeding will not justify the Commission's action in raising Kentucky Power's rate of return on common equity from 12.75 to 13.25%. Instead, the Company argues that a return nearer the higher end of the range found just and reasonable for this particular utility 1/ was more in order.

As is virtually always the case in an adversary rate proceeding, the evidence on rate of return on equity was exextremely conflicting and the conclusions of the expert witnesses on this were quite divergent, although each of them had impressive qualifications. The Attorney General's witness, Mr. Johnson, testified that his estimate of the Company's cost of equity was 13.25%, and that this figure fully reflected recent trends in economic and security market conditions. He then concluded that a range of returns on

1/At page 7 of its December 17, 1980 Order the Commission stated that "a range of returns [illegible]
to 14.6% [illegible]

common equity of 12.5% to 14.6% to be fair for Kentucky Power. [2/] Likewise, Kentucky Power's witness presented testimony in support of a return on equity of approximately 14.5%. [3/] Accordingly, it was and it remains the Commission's opinion that the most reasonable conclusion which may be drawn from the testimony and exhibits offered is that the appropriate decision on this point lies somewhere between the extreme limits of the expert testimony.

The determination of a fair rate of return for a public utility requires the exercise of a fair and informed judgement having regard for all of the relevant facts. The range of returns must not only allow the utility to attract capital at reasonable costs to insure continued reliable service and provide for necesary expansion to meet future requirements, but it must also provide for the lowest possible rate to the consumer. The Commission has determined that a range of returns on equity of 12.5% to 14.6% would meet these criteria for Kentucky Power Company. This finding of a "zone of reasonableness" for Kentucky Power's return on equity is fully consistent with the precepts established by the United States Supreme Court in FPC v. Natural Gas Pipeline Company, 315 U.S. 574, 586 (1942).

After careful consideration of Kentucky Power's original cost, its entire capital structure, its historical debt cost and equity requirements and, finally, its inability to earn the return on equity found reasonable by this Commission in the past, the Commission has found that a rate of return on common equity of 13.25% is both necessary and adequate to provide a fair return on the combined operations of the utility. For all of these reasons, the Commission, after additional consideration, hereby affirms its - decision with regard to the returns found just and reasonable in its Order of December 17, 1980.

2/Johnson prefiled testimony, p. 53.

3/Hanley prefiled testimony, p. 33.

As further "support" for its contention that the rate of return granted to the Company is inadequate, Kentucky Power cites the higher returns found reasonable by this Commission for the Louisville Gas & Electric Company and Kentucky Utilities in their most recent rate cases. Kentucky Power argues that since its own bond rating is <u>lower</u> than either of these other utilities, it should have received a <u>higher</u> rate of return, presumably on the ground that it is a "riskier" company for investors. (Application for Rehearing, pp. 5-6).

The fallacy of Kentucky Power's argument on this point is clear. A company's <u>bond</u> rating is not indicative of the investment quality or riskiness of its <u>common stock</u> issues. As Moody's Public Utility Manual states "ratings are designed exclusively for the purpose of grading <u>bonds</u> according to their investment qualities." 4/ Moreover, the evidence in the record of this case does not contain any comparison of the relative equity risks of Kenucky Utilities, Louisville Gas and Electric, and Kentucky Power.

The record in this case does, however, support the conclusion that Kentucky Power's equity is less risky than that of the average electric utility. Mr. Johnson (witness for the Attorney General) notes that Kentucky Power is part of the integrated AEP system (which reduces risks associated with building and operating generating plants), that Kentucky Power is 100% coal fired, and has a relatively high common equity ratio. He then concluded that the risks associated with the equity capital of Kentucky Power is less than that facing stockholders of the average electric utility. 5/

4/Moody's Public Utility Manual, 1980, Vol. I., p. vii, emphasis added.

5/Johnson prefiled testimony page 20.

Moreover, in his own testimony, Mr. Hanley showed that Kentucky Power has a higher common equity ratio and a better quality of earnings than the average electric utility in his comparison groups. 6/

Since Kentucky Power relied on these comparisons, the Commission will point out herein that Kentucky Power's common equity ratio of 42.7% is significantly higher than either Kentucky Utilities's ratio of 34.4% or Louisville Gas & Electric's ratio of 36.4%. Partially as a result of this high common equity ratio, Kentucky Power's overall cost of capital of 10.82% is higher than Kentucky Utilites' cost of capital of 10.28%, and Louisville Gas and Electric's cost of capital of 10.4%. 8/ In both the Kentucky Utilities and Louisville Gas and Electric cases, the Commission stated the opinion that the companies would not be able to earn the return authorized. The record in this case supports the conclusion that Kentucky Power in fact achieved a higher return allowed in both 1978 and 1979. 9/ Clearly, the rate of return on equity of 13.25% established in this case as just and reasonable for Kentucky Power reflects recent trends in capital market conditions and is consistent with recent commission decisions.

(2) Kentucky Power's second allegation of error is the Commission's acceptance and use of 11% as the cost for short-term debt to the Company during the test year. Kentucky Power argues that the Commission should have, instead, used the current prime rate at the time the December 17, 1980, Order was issued. While in past years, the Commission has accepted this "most recent" cost of short-term debt for rate-setting purposes, we believe that the extreme fluctuations in the prime rate during the past year makes the "current" prime no longer appropriate as a true measure of short-term

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6/Hanley exhibit accompanying prefiled testimony, Schedules 3, 6, 8 & 11.

7/Order in Case #7799 p. 5, and Order in case #7804, p. 5.

8/Order in Case #7799 p. 10, and Order in Case #7804 p. 10.

9/Transcript of hearing, Vol. 2, p. 36-37, Applicant Cross Exhibit #1, Johnson Exhibit schedule 39.

debt cost. Indeed, Kentucky Power's own witness (Mr. Hanley) testified in August of 1980 that his estimate of the cost of short-term debt to the Company was 10.95%. [10/] Moreover, at the next hearing in November of 1980 (when the prime rate was approaching 16%), Mr. Hanley did not change his original estimate of 11%. No other evidence was presented on prospective short-term debt costs by the Company. For these reasons, the Commission affirms its original finding that Kentucky Power's average cost of short-term debt during the test year was approximately 11%.

(3) Kentucky Power also disagrees with the Commission's method of treating a portion of the accumulated job development investment tax credits (J.D.I.C.) as debt when determining debt charges and related federal and state income taxes. The Company's position is that these credits do not in <u>actuality</u> generate interest deductible for tax purposes and that the Commission's treatment therefore understates the adjusted test year tax expenses.

The Company posed this same argument in its Case No. 7489 and the Commission's refutation of that point in its Order on Rehearing dated June 27, 1980, therein applies equally to the same issue in the present case: "Since this capital (J.D.I.C.) is obtained from the ratepayer at zero cost to the company, if <u>actual</u> costs were the issue the Commission would not allow any return on J.D.I.C."

This Commission has complied with the provisions of Section 46(f) of the Internal Revenue Code as it relates to the election made by Kentucky Power in that the Commission's treatment assigns the overall cost of capital to the unamortized portion of the credit. As the IRS Regulation requires that the credit be treated as capital (which in Kentucky Power's case is composed of common equity <u>and</u> debt),

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10/ Hanley testimony, Schedule 5, p. 1, f.m.3.

the Commission's computation of the interest synchronization adjustment (which reflects the tax deductibility of interest on the debt portion of the capital structure) is fully consistent with the intent and purpose of the I.R.S. Code.

The Commission therefore finds that the Company's request for a rehearing with respect to the interest synchronization adjustment should be denied.

(4) As its fourth assignment of "error", Kentucky Power argues that the Commission erred in rejecting the adjustment concerning the relocation costs of its parent company, American Electric Power, from New York City to Columbus, Ohio. Here the Company argues that any cost not yet incurred must by definition be estimated, and that such an "estimation" did not invalidate the adjustment or violate the "measurability" requirement for such adjustments. The Commission finds no fault with this logic. The Commission does, however, find that the Company did not in any manner prove or substantiate its basis for a reasonable estimation or measurability of the adjustment or any of the component costs involved in the relocation.

The responsibility to prove the validity of a rate adjustment clearly lies with the Applicant before the rate-setting body. Yet in the instant case, this Commission afforded Kentucky Power two separate opportunities to supply information in support of these "estimated" costs. In its Order dated July 17, 1980, the Commission in Item No. 10 requested that the Company supply "a complete description of the basis of the estimate and any reference necessary to support this basis, "for <u>all</u> pro forma adjustments introduced by the Company." The Company's response to this request was that such information was provided in its original Notice and the testimony of its witness, J. H. Via, Jr.. Examination of these documents shows unquestionably that no analysis of the derivation or methods used to calculate this adjustment was provided.

Moreover, unlike other "unknown" costs such as a rate case expense, the Commission had no past experience or historical costs to rely on to make its own estimate in the absence of the requested evidence from the Company itself. Thus the Commission was left with an undocumented figure that could in no way meet the test of "measurability" required for adjustments outside the test year, and such an adjustment must be denied.

(5). Kentucky Power's fifth point in its request for rehearing is that the Commission erred in its calculation of test year depreciation expense for the Company. The Commission finds that a mathematical error on this point was in fact made, and will now correct this through a revision in the rates found just and reasonable for the Company. 11/ However, the Commission finds that no rehearing is necessary on this point, and that the Company is authorized to place into effect the revised rates under Tariff L.G.S. (Large General Service) set out in Appendix "A" of this Order which supersedes the L.G.S. rates set out on page 3 of Appendix "A" of the Commission's original Order dated December 17, 1980.

(6). As its final assignment of "error" on the part of the Commission, Kentucky Power argues that the Commission should not have allocated the $11.5 M in additional revenue granted the Company in this case to each of the utility's customer classes in the same proportion that each such class of customers is currently contributing to the Company's revenues. Under Kentucky Power's revenue allocation

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11/The effect of this revision in Kenucky Power's depreciation rates will increase annual revenues to the Company by approximately $154,000.

proposal about 50% of the revenue requirement would have to be born by the utility's residential consumers with a major portion of the remaining revenue coming from its commercial and industrial customers. Kentucky Power's residential customers are already bearing 38% of the Company's revenue requirements and the Commission has found that in view of present economic conditions there is no justification at this time for further increasing the rate burden on the utility's residential consumers, many of whom are on low and fixed incomes. For this reason, we are affirming the original revenue allocation as set forth in our Order of December 17, 1980.

The Commission does wish to point out, however, that it recognizes the importance of a fully allocated cost of service study as one tool to be used in setting rates that are just and reasonable. It is an accepted fact that such a study will reflect to some degree the cost of providing service to a utility's particular class of service. However, there is a wide divergence of views as to the proper method (or methods) to be used in such a fully allocated cost of service study. Until such time as this Commission has had the opportunity to set its own standards for performing such cost of service studies, it will give lesser importance to those studies submitted in individual rate proceedings by the utilities themselves. However, this should not be interpreted to mean that the Commission will give no consideration to a well-designed cost-of-service study submitted in a general rate case.

For all of the reasons set forth above, and being advised, the Energy Regulatory Commission hereby ORDERS that the Application for Rehearing filed by Kentucky Power Company on January 8, 1981, in this matter, be, and it hereby is, denied.

IT IS FURTHER ORDERED, that the rates under Tariff L.G.S. (Large General Service) set out on Page 3 of Appendix "A" to the Commission's Order of December 17, 1980, are hereby set aside.

IT IS FURTHER ORDERED, that the rates under Tariff L.G.S. (Large General Service) set out in Appendix "A" attached hereto and made a part hereof are approved for service rendered on and after the date of this Order.

IT IS FURTHER ORDERED, that Kentucky Power shall file within thirty (30) days of the date of this Order its revised tariff sheets setting out the rates and charges approved therein.

Except as modified herein, the Order dated December 17, 1980, shall remain in full force and effect.

Done at Frankfort, Kentucky, this 28th day of January, 1981.

ENERGY REGULATORY COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary

AMENDMENT TO

PAGE NO. 3

APPENDIX "A"
CASE NO. 7900 ORDER DATED 12/17/80

APPENDIX TO AN ORDER OF THE KENTUCKY ENERGY REGULATORY COMMISSION IN CASE NO. 7900 DATED JANUARY 28, 1981

The following rates and charges are prescribed for the customers in the area served by Kentucky Power Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the date of this Order.

TARIFF L.G.S.
(Large General Service)

AVAILABILITY OF SERVICE:

Replaces service formerly offered under Tariffs LP and CPO.

Available for general service. Customers shall contract for a definite amount of electrical capacity in kilovolt-amperes, which shall be sufficient to meet normal maximum requirements but in no case shall the capacity contracted for be less than 50 kva. The Company may not be required to supply capacity in excess of that contracted for except by mutual agreement. Contracts will be made in multiples of 25 kva.

RATE:

Service Charge	\$56.00 per month
Energy Charge	
Kwhrs equal to the first 30 times the kva of monthly billing demand	6.653¢ per kwhr
Kwhrs equal to the next 170 times the kva of monthly demand	3.426¢ per kwhr
Kwhrs in excess of 200 times the kva of monthly billing demand	2.239¢ per kwhr