COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE ENVIRONMENTAL SURCHARGE MECHANISM OF KENTUCKY POWER COMPANY D/B/A AMERICAN ELECTRIC POWER FOR THE SIX-MONTH BILLING PERIODS ENDING DECEMBER 31, 1998 AND DECEMBER 31, 1999, AND FOR THE TWO-YEAR BILLING PERIOD ENDING JUNE 30, 1999	))))))))	CASE NO. 2000-107

O R D E R

On March 14, 2000, the Commission initiated two 6-month reviews and one 2-year review of Kentucky Power Company d/b/a American Electric Power's ("Kentucky Power") environmental surcharge as billed to customers for the following periods: the 6-month periods (a) July 1, 1998 to December 31, 1998; (b) July 1, 1999 to December 31, 1999; and (c) the 2-year period July 1, 1997 to June 30, 1999.[1] Pursuant to KRS 278.183(3), the Commission must review, at 6-month intervals, the past operations of the surcharge and, after hearing, disallow any surcharge amounts that are not just and reasonable and reconcile past surcharge collections with actual costs recoverable. At 2-year intervals, the Commission must review and evaluate the past operations of the environmental surcharge and, after hearing, disallow improper

[1] Since Kentucky Power's surcharge is billed on a 2-month lag, the amounts billed from July 1998 through December 1998 are based on costs incurred from May 1998 through October 1998; amounts billed from July 1999 through December 1999 are based on costs incurred from May 1999 through October 1999; and amounts billed from July 1997 through June 1999 are based on costs incurred from May 1997 through April 1999.

expenses and, to the extent appropriate, incorporate surcharge amounts found just and reasonable into the existing base rates of the utility.

Kentucky Power generates, transmits, and distributes electric power to over 170,000 customers in 20 counties in eastern Kentucky. Kentucky Power is a wholly owned subsidiary of the American Electric Power Company ("AEP"), a registered public utility holding company. Kentucky Power, along with its four affiliates that operate in other states, are all members of an interstate power pool, commonly known as the AEP Power Pool. Transactions among the members are governed by the AEP Pool Agreement, which allocates certain revenues and expenses associated with wholesale sales of power. This Agreement is subject to the exclusive regulatory jurisdiction of the Federal Energy Regulatory Commission ("FERC").

In anticipation that those parties to Kentucky Power's last 6-month review would desire to participate in this proceeding, the Attorney General's office ("AG") and the Kentucky Industrial Utility Customers, Inc. ("KIUC") were deemed parties to this proceeding. A public hearing was held on July 18, 2000, and all information requested during the hearing has been filed. Briefs were filed on August 22, 2000.

JURISDICTIONAL ALLOCATION

Kentucky Power contends that its experience in implementing the surcharge demonstrates that using the approved revenue-based allocation methodology ("revenue method") does not permit it to recover all of its environmental costs and does not properly allocate its environmental costs to the appropriate cost-causers. Kentucky Power believes that a more appropriate methodology would allocate fixed environmental costs on a demand basis and variable environmental costs on an energy

basis ("demand and energy method"), consistent with Kentucky Power's retail System Sales Clause ("Sales Clause"). Kentucky Power notes that while the revenue method may have originally appeared reasonable, due to circumstances unique to Kentucky Power, that methodology has not produced the desired or required results.[2]

Kentucky Power lists three of these circumstances. First, Kentucky Power notes it has many wholesale sales that do not use AEP facilities and these sales produce what Kentucky Power identifies as "non-physical" revenues. These non-physical revenues were originally included in the calculation of the jurisdictional allocations under the revenue method, but after several months, they were eliminated from the calculation by agreement of the parties and Commission Staff. Second, Kentucky Power believes that the revenue method is an imprecise measure for environmental cost allocation purposes. Kentucky Power states that for the 12-month period ending June 2000, retail customers paid for 75.5 percent of its environmental costs while no recovery was received for the remaining 24.5 percent. Finally, Kentucky Power argues that the environmental facilities were constructed and costs incurred to meet its retail customers' demand, thus its retail customers should bear the costs as directed under KRS 278.183.[3]

Kentucky Power extensively argues against the use of the revenue method by contrasting it with its Sales Clause. The Sales Clause, approved by the Commission in 1988, was designed to share profits from Kentucky Power's off-system sales with retail ratepayers. Kentucky Power states that the rationale behind the Sales Clause is that

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[2] Kentucky Power Brief at 2, 3, and 9.

[3] Id. at 3-4.

since the ratepayers are paying for the fixed costs of the units generating sales off-system, ratepayers should share in the profits received from those sales. Kentucky Power's base rates recognize a historic level of profit from off-system sales. Periodically, Kentucky Power's non-base rates increase or decrease to reflect one-half of the difference between the current level of profit and the historic level of profit. Kentucky Power claims that the revenue method used in the environmental surcharge does not recognize the effect of the Sales Clause on it or its ratepayers. Kentucky Power believes that environmental costs assigned by the revenue method to off-system sales customers are not totally recovered from those customers because the system sales profits used to calculate the Sales Clause are based on "out-of-pocket" costs.[4] Kentucky Power argues that while the environmental surcharge costs allocated under the revenue method to off-system sales customers are composed of fixed and variable costs, in essence only the variable costs can be recognized in the Sales Clause calculations. Therefore, Kentucky Power claims the remaining fixed environmental costs are unrecovered.[5]

Kentucky Power further argues that the revenue method creates an inconsistency by accepting costs from the AEP Power Pool based on the Pool Agreement, while deviating from the Pool Agreement for the surcharge by allocating costs back to the AEP Power Pool on a percentage of revenue basis. Kentucky Power

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[4] Out-of-pocket costs include all operating, maintenance, tax, transmission losses, losses that would not have been incurred if the power and energy had not been supplied for such deliveries, including demand and energy charges for power and energy supplied by third parties. See Kentucky Power Brief at 10, footnote 6.

[5] Kentucky Power Brief at 9-10.

contends that consistency and equity require that costs to and from Kentucky Power should be on a fully-distributed basis, rather than on an average embedded basis that is lower. Kentucky Power believes that the environmental surcharge, the Sales Clause, and the Pool Agreement should all follow the same cost allocation methodology. Kentucky Power further believes that equity requires that the other AEP operating companies should not be allocated any of its fixed environmental costs since Kentucky Power is not a capacity surplus company. Kentucky Power claims that it and its ratepayers do not pay any fixed environmental investment cost on purchases from non-surplus AEP companies.[6]

KIUC opposes Kentucky Power's proposal to use a demand and energy method and supports the continued use of the revenue method for allocating the environmental costs between retail customers subject to this Commission's jurisdiction and wholesale customers who are non-jurisdictional. KIUC notes that Kentucky Power neither filed testimony on this issue nor produced a current cost-of-service study in support of its position. KIUC argues that a total revenue allocation factor recognizes that environmental compliance costs include both fixed and variable costs and that some pollution is caused through the generation of electricity regardless of who the ultimate customer is. KIUC states that Kentucky Power seeks to completely disregard the Commission's decision to adopt the revenue method in Case No. 96-489[7] and the

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[6] Id. at 9, footnote 5.

[7] Case No. 96-489, Application of Kentucky Power Company d/b/a American Electric Power to Assess a Surcharge Under KRS 278.183 to Recover Costs of Compliance with the Clean Air Act and Those Environmental Requirements Which Apply to Coal Combustion Waste and By-Products, final Order dated May 27, 1997; rehearing Order dated July 8, 1997.

April 30, 1998 Opinion and Order of the Franklin Circuit Court affirming that decision.[8] KIUC contends that the Franklin Circuit Court previously rejected the same arguments that Kentucky Power has raised in this proceeding. KIUC states Kentucky Power's argument that the majority of its environmental costs are fixed, or demand, related and should be assigned to Kentucky ratepayers is erroneous. KIUC points to data responses from Kentucky Power that indicate approximately 73.13 percent of its environmental costs are variable, or energy, related. KIUC also points to financial data that shows Kentucky Power's off-system sales account for approximately 40 percent of its total sales. KIUC concludes that these facts support the continued use of the revenue method, which helps to ensure that Kentucky ratepayers do not subsidize the cost of Kentucky Power's off-system sales.[9]

In his brief, the AG contends that Kentucky Power has presented exactly the same arguments that were advanced and rejected in Case No. 96-489. The AG notes that the Commission carefully considered and addressed each argument in that case, and concluded that the revenue method was the most appropriate allocation approach. The AG further notes that the Franklin Circuit Court affirmed the Commission's decision to adopt a revenue allocation rather than a demand and energy allocation. The AG concludes that the record now before the Commission contains nothing that warrants the change proposed by Kentucky Power.[10]

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[8] Commonwealth of Kentucky v. Kentucky Public Service Commission, Franklin Circuit Court, Consolidated Case Nos. 97-CI-114, 97-CI-01138, and 97-CI-01319, April 30, 1998.

[9] KIUC Brief at 1-4 and 6-8.

[10] AG Post-Hearing Brief at 4-5.

When the Commission opened this environmental surcharge review, the procedural schedule directed Kentucky Power to file by April 13, 2000 any prepared direct testimony in support of the reasonableness of the application of its environmental surcharge mechanism during the three periods under review.[11] Kentucky Power chose not to file any prepared direct testimony concerning its surcharge. While Kentucky Power has responded to information requests[12] and answered questions at the public hearing concerning the jurisdictional allocation issue, it waited to provide its most extensive and thorough explanations and arguments in its post-hearing brief. The Commission recognizes that this tactic may have short-circuited the discovery and cross-examination which was contemplated by the procedural schedule. However, since Kentucky Power presented no argument that was not presented and rejected in Case No. 96-489, we do not believe any party suffered any prejudice.

The Commission fully recognizes Kentucky Power's membership in a multistate holding company and the impacts of the AEP Pool Agreement. While the allocation methodologies under the AEP Pool Agreement are subject to FERC's exclusive jurisdiction, the environmental surcharge is under our exclusive jurisdiction. Under KRS Chapter 278, and specifically KRS 278.183, this Commission is obligated to establish reasonable jurisdictional allocation methods that minimize the risk of Kentucky ratepayers subsidizing the costs of power sold to wholesale customers.

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[11] March 14, 2000 Order, ordering paragraph number 4.

[12] See Response to the Commission's March 14, 2000 Order, Item 24 and Response to the Commission's May 1, 2000 Order, Item 9.

Kentucky Power's membership in the AEP system provides no valid basis to change from the revenue method established to allocate Kentucky Power's environmental costs under the surcharge. Kentucky Power's non-physical revenues are no longer an issue in the surcharge calculation and, thus, do not justify abandoning the revenue method. Kentucky Power began receiving non-physical revenues in July 1997 and became aware of the impact those revenues were having on the jurisdictional allocations in April 1998.[13] Kentucky Power contacted Commission Staff about this situation, and after a September 1998 informal conference with the parties, Kentucky Power was permitted to exclude non-physical revenues from the revenue method calculations.[14] This exclusion began with the October 1998 billing month[15] and has continued to date. Thus, the exclusion of Kentucky Power's non-physical revenues from the revenue method calculations eliminates those revenues as a reason to change allocation approaches.

This exclusion of non-physical revenues was not addressed in the Commission's July 15, 1999 Order in Case No. 98-624, because the exclusion was implicitly recognized in the settlement agreement approved by the Commission in Case

[13] See Case No. 98-624, An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of Kentucky Power Company d/b/a American Electric Power as Billed from January 1, 1998 to June 30, 1998, Response to the Commission's December 21, 1998 Order, Item 9, pages 1 through 6 of 7.

[14] See Kentucky Power Monthly Environmental Surcharge Report, transmittal letter dated September 18, 1998.

[15] The surcharge amounts billed in October 1998 were based on expenses for the month of August 1998.

No. 99-149.[16] The Commission has reviewed the record in Case No. 98-624, as well as the information contained in the periods under review in this proceeding, and finds that the implicit exclusion of non-physical revenues from the determination of the jurisdictional allocation factor should be recognized explicitly in this case.

The Commission is not persuaded by Kentucky Power's claim that it has not recovered its environmental costs allocated to off-system sales under the revenue method. Kentucky Power contends that for the 12-months ending June 2000 it received no recovery for 24.5 percent of its fixed environmental costs. Kentucky Power assumes that because the fixed component of environmental costs allocated to off-system sales is not recognized in its Sales Clause calculation, the fixed cost component must not have been recovered. Kentucky Power provided no analysis of its gross and net margins from off-system sales to demonstrate that these allocated environmental costs have not been recovered. Absent evidence to support this position, such as an analysis of the margins achieved from off-system sales, the Commission cannot accept Kentucky Power's unsupported assumption. However, assuming that Kentucky Power is not recovering its fixed environmental costs on its wholesale sales, one obvious reason would be because its wholesale sales are priced below cost. The remedy for this problem is not to pass the wholesale costs to retail ratepayers through the environmental surcharge. Thus, this circumstance does not warrant a change from the

[16] Case No. 99-149, Joint Application of Kentucky Power Company, American Electric Power Company, Inc. and Central and South West Corporation Regarding a Proposed Merger, final Order dated June 14, 1999. Under the terms of the settlement agreement, the parties agreed there would be no adjustment to the environmental surcharge for the period under review in Case No. 98-624.

use of the revenue method to determine the jurisdictional allocation of environmental costs.

In Case No. 96-489, the Commission was presented with Kentucky Power's proposal to allocate 98.6 percent of fixed environmental costs to retail ratepayers on the basis of peak demand, and KIUC's proposal to allocate 83 percent to retail ratepayers based on total revenues. The evidence in that case showed that only 64 percent of the energy produced by Kentucky Power was sold to retail customers, while 36 percent was sold to wholesale customers. Finding that the environmental costs should be assigned to the cost-causer, the Commission followed its established precedent in adopting a revenue-based allocation. On appeal, the Franklin Circuit Court affirmed the Commission's allocation of 83 percent of environmental costs to retail ratepayers based on a revenue allocation.[17] The Court specifically ruled that, "Because Kentucky Power's system is currently operated to supply wholesale sales for resale, a representative cost allocation must be made to these sales."[18]

Now, Kentucky Power proposes to allocate 99.6 percent of fixed environmental costs to retail ratepayers based on the same peak demand allocation previously rejected. In support of its proposal, Kentucky Power argues that neither the prior decisions of the Commission nor the Franklin Circuit Court are binding precedent because there has been a change in circumstances since those prior decisions were issued. The change in circumstances, according to Kentucky Power, is that it now has actual experience under the revenue allocation. That experience allegedly shows retail

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[17] Commonwealth of Kentucky v. Public Service Commission at 19.

[18] Id.

ratepayers paying for 75.5 percent of environmental costs, while the remaining 24.5 percent are unrecovered.

An analysis of the evidence in this case indicates stark similarities to that in Case No. 96-489. Here, for the 12 months ending June 2000, over 42 percent of the energy produced by Kentucky Power was sold to wholesale customers, while over 25 percent of its revenues from physical sales came from wholesale customers.[19] This clearly demonstrates that Kentucky Power is continuing to produce substantial quantities of power for wholesale customers. While Kentucky Power accurately notes that based on revenues, retail ratepayers are only paying for 75 percent of environmental costs, it provided no analysis to demonstrate that the remaining 25 percent of environmental costs were not being recovered. Further, even assuming that 25 percent of the costs are not being recovered, the issue previously decided was that retail ratepayers should not pay for all environmental costs incurred to make wholesale sales. Thus, the Commission adopted, and the Circuit Court affirmed, the use of a revenue allocation. Costs properly allocable to wholesale customers cannot, and must not, be reallocated to retail customers merely because such costs are not being recovered from wholesale customers. Reallocating such costs to retail customers violates the principle that costs be allocated to the cost-causer.

As for Kentucky Power's last claim, the Commission has previously rejected the argument by Kentucky Power that its environmental facilities and associated costs were constructed and incurred to meet the demands of its Kentucky ratepayers only, and those ratepayers should bear virtually all the costs. In fact, Kentucky Power constructed

[19] Kentucky Power Information Response, Item 5, filed August 22, 2000.

its environmental facilities and incurs environmental costs in order for it to comply with the environmental laws and regulations applicable to the generation of electricity. These compliance actions must take place regardless of whether the electricity generated is sold to Kentucky ratepayers, to the AEP Power Pool, or to make other wholesale sales. The Commission is not persuaded by Kentucky Power's argument that its Kentucky jurisdictional customers are the only environmental cost-causers. The sales of its generation properly identify the cost-causers of Kentucky Power's environmental costs. In this proceeding, Kentucky Power has offered no compelling evidence to change the Commission's prior decision.

The existence and operation of Kentucky Power's Sales Clause also does not justify changing the jurisdictional allocation approach from the revenue method. As discussed previously in this Order, Kentucky Power has provided no analysis of its gross and net margins on off-system sales to demonstrate its claimed lack of recovery of environmental costs allocated to off-system sales. Further, Kentucky Power has provided no analysis showing the impact on the Sales Clause if the fixed environmental costs allocated to off-system sales were recognized in the Sales Clause calculations. Kentucky Power's Sales Clause was the result of a 1988 settlement agreement resolving litigation related to an earlier Kentucky Power general rate case. If the off-system sales profits are misstated because the current Sales Clause does not provide for the recognition of fixed environmental costs, then it is the Sales Clause which needs modification, and not the jurisdictional allocation approach used to assign environmental costs.

The Commission is not persuaded by Kentucky Power's arguments that the use of the revenue method creates an inconsistency with the costing provisions of the AEP Pool Agreement. Because of the requirements of the AEP Pool Agreement, the environmental surcharge mechanism does include costs associated with AEP's Rockport, Indiana and Gavin, Ohio generating units. However, the AEP Pool Agreement does not dictate how the Commission allocates the environmental costs to retail ratepayers under the surcharge mechanism.

Kentucky Power's contention that no other AEP operating company should be allocated any of its fixed environmental costs because Kentucky Power is not a capacity surplus company is irrelevant. This Commission has exclusive jurisdiction over Kentucky Power's retail rates, including its environmental surcharge. Kentucky Power's fixed and variable environmental costs must be allocated to the appropriate cost-causer. To the extent that Kentucky Power makes sales to other AEP affiliates, it is clearly inappropriate for the environmental costs associated with those sales to be recovered through a surcharge on Kentucky retail ratepayers, regardless of whether Kentucky Power is a surplus member of the AEP power pool. While Kentucky Power claims that it pays no fixed environmental costs on purchases from AEP non-surplus members, Kentucky Power has provided no analysis of the costs incorporated in the price it pays for purchases from any other AEP operating company, whether surplus or non-surplus.

The Commission finds that none of the arguments offered by Kentucky Power support a change in the jurisdictional allocation approach and, therefore, the revenue method should continue to be utilized. We agree with the AG that Kentucky Power's arguments concerning the appropriate cost-causer are essentially the same as it

presented, and the Commission considered and rejected, in Case No. 96-489. Kentucky Power's concerns over the interaction of the environmental surcharge mechanism with its Sales Clause indicate that if there is a problem, it lies within the Sales Clause and does not constitute justification for a change in the allocation approach. We further agree with the arguments of KIUC, which notes that significant levels of Kentucky Power's sales are made to off-system customers. Under these conditions, it is neither appropriate nor reasonable to allocate a greater share of Kentucky Power's environmental costs to its jurisdictional ratepayers, and in effect subsidize off-system sales customers.

SURCHARGE ROLL-IN

In response to a data request, Kentucky Power calculates that an increase of $7,707,584 should be incorporated into its existing base rates pursuant to KRS 278.183(3).[20] This amount reflects Kentucky Power's annualization of its February 2000 expense month filing. Kentucky Power determines the amounts that specifically would be incorporated into its existing base rates by utilizing the same methodology as used in its last general rate case. This includes allocating the environmental surcharge roll-in to Kentucky jurisdictional ratepayers on the basis of the demand and energy method, rather than the revenue method.[21]

Kentucky Power justifies the annualization of the February 2000 information by stating that it was the only monthly filing which included all of the environmental costs

[20] Response to the Commission's March 14, 2000 Order, Item 23. The incorporation of a portion of the environmental surcharge into existing base rates has also been referred to in this record as a "roll-in."

[21] Id. and Response to the Commission's May 1, 2000 Order, Item 10.

which it anticipates will continue for the foreseeable future.[22] In response to hearing data requests, Kentucky Power prepared four alternative scenarios that produced roll-in amounts ranging from an increase in base rates of $1,764,701 to a reduction in base rates of $59,260.[23] All of the scenarios are based on the expense months for the 12-month period ending April 1999. The differences in the roll-in amounts are related to the jurisdictional allocation approach utilized, the inclusion of Kentucky Power's low NOx burners, the treatment of non-physical revenues, and the inclusion of eligible environmental expenses not recognized in the initial monthly surcharge filings.[24] In its brief, Kentucky Power states that it is not requesting a roll-in at this time, but rather is requesting the Commission change the jurisdictional allocation methodology.[25]

KIUC contends the environmental surcharge roll-in is discretionary, unnecessary, and that there is no compelling reason to implement a roll-in at this time. Concerning Kentucky Power's calculation of a roll-in reflecting the annualization of the February 2000 expense month, KIUC argues the approach is inappropriate because the February 2000 expenses are beyond the scope of this review and would provide for recovery of projected rather than actual environmental costs. In addition, KIUC states that there is

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[22] Response to the Commission's May 1, 2000 Order, Item 11 and Transcript of Evidence ("T. E."), July 18, 2000, at 22-23. The February 2000 expense month was the first monthly filing that reflected the costs associated with Kentucky Power's low NOx burners and the utilization of emission allowances.

[23] Hearing Information Request, filed August 8 and 22, 2000, Item 3, pages 8, 15, and 22 of 22; and Item 4, pages 2 and 8 of 8.

[24] The scenario resulting in a reduction to base rates of $59,260 was the only scenario that did not include the low NOx burners.

[25] Kentucky Power Brief at 2, footnote 1.

no evidence that the February 2000 expenses are just and reasonable or that annualizing one month of expenses results in a representative level of ongoing costs. KIUC also objects to the change in the jurisdictional allocation approach and the use of Kentucky Power's 1990 billing determinants to design the actual amount to be rolled into existing base rates.[26] KIUC contends that the terms of the settlement agreement in Case No. 99-149 prohibit Kentucky Power from directly or indirectly changing its base rates.[27]

KIUC argues that any roll-in of the environmental surcharge must follow a principle of "revenue neutrality." This concept provides that neither the utility nor the ratepayers should be enriched or harmed simply by shifting the recovery of incremental environmental costs from the surcharge mechanism to base rates. KIUC contends that this principle is reflected in the Commission's fuel adjustment clause ("FAC") methodology. KIUC notes that the FAC methodology requires the quantification of the current recoverable fuel costs on a per KWH basis, with a comparison to the recoverable fuel costs included in the utility's base rates, also stated on a per KWH basis. Through this comparison, the total dollar amount actually recovered by the utility for fuel costs in base rates based upon current period sales is captured, and revenue neutrality is achieved.[28] To maintain revenue neutrality for an environmental surcharge roll-in, KIUC proposes that the base revenue requirement surcharge component each

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[26] Kollen Direct Testimony at 6 and 9-12.

[27] KIUC Brief at 5-6.

[28] Kollen Direct Testimony at 7-8.

month be set at the actual level of recovery in base rates, rather than a fixed amount.[29] KIUC concludes that the most reasonable amount eligible for roll-in is the credit to base rates of $59,260, based on its objections to the use of the February 2000 annualized expense month data and the principle of revenue neutrality. However, KIUC also observes that a “base rate roll-in for such a small amount is not worth the trouble.”[30]

In his brief, the AG argues that the Commission can roll surcharge amounts found just and reasonable into existing base rates, but only to the extent appropriate. The AG notes that KRS 278.183 is a cost recovery statute, not a general rate-making statute. The AG contends that KRS 278.183(2) requires the continued tracking of any surcharge amounts rolled into base rates so that amounts already recovered through base rates and amounts recovered through the operation of the surcharge total 100 percent of the approved compliance costs. The AG agrees with the position of KIUC on revenue neutrality and supports KIUC’s proposal that the base revenue requirement component be set each month to reflect the actual recovery of environmental costs through existing rates.[31]

The Commission considered all the alternative surcharge roll-in amounts calculated by Kentucky Power. The Commission believes that any surcharge amount rolled into base rates should account for the month-to-month fluctuation of the surcharge revenue requirement. The Commission further believes that the 12-month period should reflect months that are included in the 2-year review pursuant to

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[29] Id. at 13-14.

[30] KIUC Brief at 13.

[31] AG Post-Hearing Brief at 1-4.

KRS 278.183(3). Finally, the jurisdictional allocation of the surcharge should be consistent with the approach used to determine the monthly allocations. The only alternative calculated by Kentucky Power that conforms to these conclusions was the scenario that produced the credit of $59,260. The other calculations prepared by Kentucky Power either reflected the use of Kentucky Power's demand and energy method to determine jurisdictional allocations; annualized the February 2000 expense month, which has not undergone review by the Commission; or included the impact of Kentucky Power's low NOx burners, which were not part of the surcharge mechanism during the period of the 2-year review in this case.

As noted previously in this Order, KRS 278.183(3) provides that the Commission must, to the extent appropriate, incorporate surcharge amounts found just and reasonable into the existing rates of the utility. Based upon a review of the information presented in this case, the Commission concludes that the level of surcharge that is just and reasonable to be incorporated into Kentucky Power's base rates is the credit of $59,260. However, because of the insignificant nature of this amount, compared to Kentucky Power's total revenues ($347 million in 1999), the Commission finds that it is not appropriate as a result of this 2-year review to incorporate any surcharge amount into the existing base rates of Kentucky Power.

The Commission notes the general agreement of Kentucky Power, the AG, and KIUC on the principle of revenue neutrality. The Commission shares the same concerns and agrees that in circumstances where a roll-in is appropriate, this principle should be taken into consideration. However, we will not express an opinion on the proposal by KIUC requiring the base revenue requirement surcharge component each

month to be set at the actual level of recovery in base rates. KIUC was unable to provide a calculation of the base rate roll-in reflecting this approach, citing the absence of a current cost-of-service study or billing determinant data consistent with the review period.[32] KIUC's proposal, while addressing the concern about revenue neutrality, appears to make the monthly surcharge calculations more complicated. And while KIUC has correctly described the workings of the Commission's FAC mechanism,[33] it did not propose an approach similar to that mechanism to address its revenue neutrality concerns.

The Commission does not agree with KIUC's contention that a roll-in is in violation of the terms of the settlement agreement in Case No. 99-149. In the same section of the agreement quoted in KIUC's brief concerning the base rate moratorium is the following statement: "During this period, the fuel adjustment clause, the environmental surcharge, the demand side management adjustment and the system sales tracker shall continue in force and shall not be subject to any freeze."[34] The roll-in of the surcharge into base rates, to the extent appropriate, is part of the environmental surcharge operation under KRS 278.183.

RATE OF RETURN

In Case No. 96-489, Kentucky Power proposed that the debt portion of its weighted average cost of capital be recalculated monthly to more closely reflect the cost

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[32] Response to the First Data Request of Commission Staff to KIUC, dated June 14, 2000, Item 7.

[33] Kollen Direct Testimony at 7, line 16, through 8, line 9.

[34] KIUC Brief, Appendix B, at 3.

actually incurred. The rate of return on common equity would remain fixed and subject to review during the 2-year environmental surcharge reviews. The Commission accepted Kentucky Power's proposal concerning the rate of return on common equity, but found that the debt portion of the weighted average cost of capital should remain fixed during the 6-month period, and be reviewed and re-established during each 6-month review case.[35] This proceeding represents the first opportunity to review the common equity portion of the weighted average cost of capital.

Kentucky Power provided the outstanding balances for its long-term debt, short-term debt, and common equity as of December 31, 1999, the last billing month of the review periods. It also provided the blended interest rates of the long-term and short-term debt.[36] Kentucky Power proposes that the rate of return on common equity should remain at 11.50 percent, as established in Case No. 96-489.[37] Based on this information, Kentucky Power's weighted average cost of capital, before income tax gross-up, is as follows:

	Capital Structure	Cost	Weighted Cost
Long-Term Debt	53.65%	7.748%	4.157%
Short-Term Debt	5.82%	6.192%	.360%
Common Equity	40.53%	11.500%	4.661%
Weighted Average Cost of Capital			9.178%

[35] Case No. 96-489, final Order dated May 27, 1997, at 32 and 35. The weighted cost of capital currently in effect was established at 9.203 percent. See Case No. 98-106, An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of Kentucky Power Company d/b/a American Electric Power as Billed from July 1, 1997 to December 31, 1997, final Order dated August 4, 1998, at 4-5.

[36] Response to the Commission's March 14, 2000 Order, Item 13.

[37] Id., Item 22.

Neither the AG nor KIUC expressed an opinion on the cost of debt and equity proposed by Kentucky Power.

The Commission has reviewed Kentucky Power's calculations and finds them to be reasonable and consistent with the Commission's decisions in Case No. 96-489. Therefore, Kentucky Power should use a weighted average cost of capital of 9.178 percent in all monthly environmental surcharge filings subsequent to the date of this Order.

SURCHARGE ADJUSTMENT

In its March 14, 2000 Order, the Commission indicated that since each of the three periods under review in this proceeding may have resulted in over- or under-recoveries, the Commission would entertain proposals to adopt one adjustment factor to net all over- or under-recoveries. Up through the hearing, Kentucky Power maintained that for the two 6-month review periods and the last quarter of the 2-year review period, it under-recovered its environmental costs by a cumulative $63,305.[38] Kentucky Power proposed that the cumulative under-recovery be collected from customers by increasing the environmental surcharge revenue requirement by $21,102 in each of the first three billing months following the Commission's decision in this proceeding.[39] However, in its brief, Kentucky Power notified the Commission that it had determined the cumulative under-recovery was $213,033. The revised amount is composed of the original under-

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[38] Id., Item 15, page 3 of 3.

[39] Response to the Commission's May 1, 2000 Order, Item 6. Due to a typographical error, Kentucky Power had calculated the monthly amount based on $63,605, which resulted in a monthly increase of $21,202 for 3 months. Using the correct under-recovery of $63,305 and dividing by 3 months results in a monthly adjustment of $21,102.

recovery of $63,305 plus an additional under-recovery of $149,728. This additional amount reflects Kentucky Power's claim that it is entitled to recover costs originally excluded from its surcharge in the expense months of May, June, and July of 1998. This exclusion was the result of non-physical revenues being included in the determination of the jurisdictional allocation factor for those expense months.[40] Kentucky Power proposes that the revised under-recovery could be recognized in either three or six equal adjustments to future monthly filings.[41] Kentucky Power offered no reason or explanation for neither including this adjustment in its initial determination of its under-recovery nor proposing the adjustment at the hearing.

The AG and KIUC expressed no opinion on the original under-recovery of $63,305. With it being presented only in Kentucky Power's brief, they have likewise expressed no opinion on the additional adjustment for an under-recovery of $149,728.

The Commission has reviewed Kentucky Power's calculations and finds reasonable the original determination of a cumulative under-recovery of $63,305 for the two 6-month review periods and the last quarter of the 2-year review period. The Commission also finds reasonable Kentucky Power's original proposal to increase the environmental surcharge revenue requirement calculated in each of the first three billing months following the date of this Order by $21,102.

The Commission further finds that Kentucky Power's adjustment for an additional $149,728 relating to the inclusion of non-physical revenues for the expense months of

[40] As noted previously in this Order, beginning with the August 1998 expense month, non-physical revenues were excluded when applying the revenue method to determine the jurisdictional allocation factor.

[41] Kentucky Power Brief at 2.

May, June, and July of 1998 is unreasonable and should be rejected. An identical adjustment for these same months was proposed in Case No. 98-624 and that case was resolved when Kentucky Power agreed that no adjustments should be made to the environmental surcharge. To now propose this adjustment a second time would violate the Stipulation and Settlement Agreement, signed by Kentucky Power in Case No. 99-149, which provides that, "The parties further agree that there shall be no adjustment to the environmental surcharge as a result of the six-month review in PSC Case No. 98-624."[42]

Based on a September 1998 informal conference requested by Kentucky Power with the AG, KIUC, and Commission Staff, it was agreed that Kentucky Power could begin excluding non-physical revenues from the allocation formula on a prospective basis beginning with the August 1998 expense month. Kentucky Power indicated that it understood that any corrections for past billings to reflect this change would be considered, as appropriate, in the 6-month review of the surcharge.[43] The 6-month review of the surcharge for that period was conducted in Case No. 98-624. As part of its determination of a net under-recovery of its surcharge in that review, Kentucky Power proposed to restate the jurisdictional allocation factors for the 6 months under review as well as all prior and subsequent months containing non-physical revenues. Thus, Kentucky Power proposed to restate the expense months of July 1997 through

[42] Case No. 99-149, Stipulation and Settlement Agreement, p. 3, a copy of which is attached to KIUC's Brief as Appendix B.

[43] See Kentucky Power Monthly Environmental Surcharge Report, transmittal letter dated September 18, 1998, attached hereto as Appendix A.

July 1998 as if the non-physical revenues had been excluded from the calculations.[44] Kentucky Power provided the following explanation for its proposed adjustment in Case No. 98-624:

> Page 5 of 7 shows the monthly effect power brokering transactions have had on the surcharge mechanism during the review period. Monthly variances have been calculated and are included in Item No. 1, Line 16. Pages 4 and 6 of 7 are similar schedules covering months outside the review period. Monthly variances have been calculated and the total included in Item No. 1 in the column headed 'Out of Period Adjustment', Line 16. The Company proposes to net this adjustment with any others during the review period in order to remove it from future review periods.[45] (emphasis added).

The "Out of Period Adjustment" referred to by Kentucky Power in Case No. 98-624 included the under-recovery for expense months May through July 1998 due to the non-physical revenues. In the settlement reached in Case No. 99-149, Kentucky Power agreed that no adjustment would be made to the environmental surcharge in Case No. 98-624, which included Kentucky Power's out of period adjustment for expense months May through July 1998 due to non-physical revenues. Thus, Kentucky Power's acceptance of the settlement agreement in Case No. 99-149 completely resolved any under-recovery for this issue.

IT IS THEREFORE ORDERED that:

1. Kentucky Power shall continue to calculate its environmental surcharge using the revenue method as previously ordered by this Commission.

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[44] Case No. 98-624, Response to the Commission's December 21, 1998 Order, Item 1, page 2 of 2, and Item 9, pages 4 through 6 of 7, attached hereto as Appendix B.

[45] Id., Item 9(d), page 2 of 7. Kentucky Power used the terms "power brokering" and "non-physical sales" interchangeably in this data response.

2. The environmental surcharge for the 2-year period as billed from July 1, 1997 to June 30, 1999 shall not be incorporated into Kentucky Power's existing base rates.

3. For purposes of calculating Kentucky Power's environmental surcharge, total company revenues shall exclude non-physical revenues, as Kentucky Power has been doing since the expense month of August 1998. Kentucky Power shall continue to disclose the monthly level of non-physical revenues in its monthly environmental surcharge report as it has done since the expense month of August 1998.

4. Kentucky Power shall use a weighted average cost of capital of 9.178 percent in all monthly environmental surcharge filings subsequent to the date of this Order.

5. Kentucky Power shall include a $21,102 increase its environmental surcharge revenue requirement determined in its next three monthly surcharge reports.

Done at Frankfort, Kentucky, this 8th day of February, 2001.

By the Commission

ATTEST:

Executive Director