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 JUNE 30, 2000, DECEMBER 31, 2000, DECEMBER 31, 2001, AND JUNE 30, 2002 AND FOR THE TWO-YEAR BILLING PERIOD ENDING JUNE 30, 2001	)	CASE NO. 2002-00393

O R D E R

On November 21, 2002, the Commission initiated four 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) January 1, 2000 to June 30, 2000; (b) July 1, 2000 to December 31, 2000; (c) July 1, 2001 to December 31, 2001; (d) January 1, 2002 to June 30, 2002; and (e) the 2-year period July 1, 1999 to June 30, 2001.[1] Pursuant to KRS 278.183(3), the Commission must review, at 6-month intervals, the past operations

[1] Since Kentucky Power s surcharge is billed on a 2-month lag, the amounts billed from January 2000 through June 2000 are based on costs incurred from November 1999 through April 2000; amounts billed from July 2000 through December 2000 are based on costs incurred from May 2000 through October 2000; amounts billed from July 2001 through December 2001 are based on costs incurred from May 2001 through October 2001; amounts billed from January 2002 through June 2002 are based on costs incurred through November 2001 through April 2002; and amounts billed from July 1999 through June 2001 are based on costs incurred from May 1999 through April 2001.

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

The following parties requested and were granted full intervention: the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention (AG), and the Kentucky Industrial Utility Customers, Inc. (KIUC).

The Commission issued a procedural schedule on November 21, 2002 that provided for an informal conference and a public hearing on May 1, 2003. The informal conference was held on January 22, 2003. Kentucky Power filed prepared direct testimony and responded to requests for information. The AG and KIUC did not submit requests for information or file testimony. On April 22, 2003, Kentucky Power filed a motion requesting that the May 1, 2003 hearing be cancelled and that this case be submitted for adjudication based on the existing record. Kentucky Power indicated in its motion that it had contacted the AG and KIUC and the parties were in agreement with its motion. The Commission granted the motion on April 24, 2003.

SURCHARGE ADJUSTMENT

The November 21, 2002 Order initiating this case indicated that since each of the five 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. Kentucky Power determined that it had a net under-recovery of its environmental costs of $6,632.[2] Kentucky Power proposed that the net under-recovery be collected from customers by a one-time adjustment of $6,632 to be incorporated into the first monthly environmental surcharge filing after the Commission s final Order in this proceeding.

The Commission has reviewed Kentucky Power s calculations and finds reasonable the determination of a net under-recovery of $6,632 for the periods covered in this proceeding. The Commission also finds reasonable Kentucky Power s proposal to increase the environmental surcharge revenue requirement calculated in the first billing month following the date of this Order by $6,632.

SURCHARGE ROLL-IN

Kentucky Power was requested to provide the surcharge amount that it believed should be incorporated into its existing base rates as part of the 2-year surcharge review. Kentucky Power did not submit an amount and proposed that none of its environmental surcharge be rolled into existing base rates at this time.[3] Kentucky Power argued that no surcharge amount be rolled into base rates until a full cost-of-service study is performed and filed with its next base rate case. Kentucky Power noted that in its current base rates, fixed costs are allocated using a demand allocation methodology and variable costs are allocated using an energy allocation methodology.

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[2] Wagner Direct Testimony at 3. Kentucky Power indicated that the total net under-recovery of $6,632 reflected errors in the amount reported for the Kentucky Air Emission Fee for the 12 months ending June 2001 and June 2002. See Response to the Commission Staff s First Data Request dated November 21, 2002, Items 31 and 42 and Wagner Direct Testimony at 3.

[3] Response to the Commission Staff s First Data Request dated November 21, 2002, Item 50.

Kentucky Power further noted that, in the environmental surcharge, fixed and variable costs are both allocated using the revenue allocation methodology. Kentucky Power believes the two different allocation methods yield materially different results, and, if the two methods were to be merged as part of a roll-in, the resulting base rates would not reflect costs allocated on a consistent basis.

The Commission agrees with Kentucky Power to the extent that a roll-in of the environmental surcharge utilizing a current, full cost-of-service study is optimal. However, Kentucky Power has presented no support for its claim that using the revenue allocation methodology to roll the surcharge into base rates would produce a materially different result than using a cost-of-service study. The revenue allocation methodology increases (or decreases) each rate by the identical percentage, thereby maintaining the existing ratio of revenue among all rates and all rate classes. Thus, this allocation methodology reasonably approximates the utility s existing cost-of-service rate design. The Commission has for many years used the revenue allocation methodology in rate cases when either no cost-of-service study was filed or the one filed was flawed and unreliable.

Further, the Commission notes that in Kentucky Power s last 2-year environmental surcharge review, Case No. 2000-00107,[4] Kentucky Power determined and recommended an amount to be rolled into base rates, despite the absence of a cost-of-service study. Due to the roll-in amount in that case being *de minimis*, the

[4] Case No. 2000-00107, 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.

Commission ultimately determined that none should be required. The record before us now includes no proposed roll-in, along with an agreement by all parties to waive a hearing. The Commission also recognizes that Kentucky Power s next 2-year surcharge review, covering the billing period July 2001 through June 2003, should be initiated later this year. Under these circumstances, it is reasonable to conclude this pending 2-year surcharge review with no base rate roll-in. Kentucky Power will be required to propose a base rate roll-in in its next 2-year surcharge review case, in accordance with KRS 278.183(3).

RATE OF RETURN

In Case No. 1996-00489,[5] the Commission found that Kentucky Power s debt portion of its weighted average cost of capital should remain fixed during the 6-month surcharge period, and be reviewed and re-established during each 6-month review case. The rate of return on common equity would remain fixed and subject to review during the 2-year environmental surcharge reviews. The weighted average cost of capital constitutes the rate of return for Kentucky Power s environmental compliance rate base.

Kentucky Power provided the outstanding balances for its long-term debt, short-term debt, and common equity as of June 30, 2002, the last billing month of the review periods. It also provided the blended interest rates for the long-term and short-term

[5] Case No. 1996-00489, 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.

debt.[6] Kentucky Power proposed to incorporate the 12.75 percent rate of return on common equity as requested in Case No. 2002-00169.[7] Kentucky Power noted that its weighted average cost of capital was an issue in Case No. 2002-00169, and that the weighted average cost of capital authorized in Case No. 2002-00169 could reflect a time period more current than the June 30, 2002 information provided in this case. In response to a data request, Kentucky Power indicated that it could agree to the utilization of a more current time period than June 30, 2002 in determining the going forward weighted average cost of capital used for the surcharge calculations.[8]

In the Commission s March 31, 2003 Order in Case No. 2002-00169, the Commission found it reasonable that the weighted average cost of capital should reflect the cost rates and capital structure of Kentucky Power as of December 31, 2002. The Commission also found that Kentucky Power s accounts receivable financing should be included as a component of the weighted average cost of capital which is the rate of return for Kentucky Power s environmental surcharge rate base. The weighted average cost of capital found reasonable in Case No. 2002-00169, before income tax gross-up,

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[6] Response to the Commission Staff s Second Data Request dated February 4, 2003, Item 3.

[7] Case No. 2002-00169, The Application of Kentucky Power Company d/b/a American Electric Power for Approval of an Amended Compliance Plan for Purposes of Recovering the Costs of New and Additional Pollution Control Facilities and to Amend Its Environmental Surcharge Cost Recovery Surcharge Tariff. In that case, Kentucky Power sought Commission approval of an amended environmental compliance plan consisting of new and additional pollution control facilities and to amend its environmental surcharge tariff. Also See Response to the Commission Staff s First Data Request dated November 21, 2002, Item 49. The case record of Case No. 2002-00169 is incorporated by reference into the record of this proceeding.

[8] Response to the Commission Staff s Second Data Request dated February 4, 2003, Item 4.

was 7.46 percent.[9] Since Kentucky Power now relies upon its cost of capital evidence as presented in Case No. 2002-00169, the Commission will adopt its findings in that case on this issue.

The December 31, 2002 capital structure and cost rates reflect a more current period than the June 30, 2002 information provided in this case. The weighted average cost of capital determined reasonable in Case No. 2002-00169 also reflects the Commission s decision to include Kentucky Power s accounts receivable financing. It would not be reasonable to authorize a weighted average cost of capital in this case that reflects older financial information and that does not recognize the inclusion of accounts receivable financing. Therefore, the Commission finds that the weighted average cost of capital of 7.46 percent should be used in all monthly environmental surcharge filings subsequent to the date of this Order.

JURISDICTIONAL ALLOCATION

In its direct testimony, Kentucky Power renewed its argument that it is inappropriate to use a revenue allocation methodology to allocate the costs incurred to comply with the Clean Air Act. Kentucky Power cited arguments previously presented in its environmental surcharge cases.[10] Kentucky Power offered no new arguments in opposition to the revenue allocation methodology and neither proposed nor made any

[9] Case No. 2002-00169, final Order dated March 31, 2003 at 33. The overall rate of return of 7.46 percent will be grossed up to reflect the income tax effect resulting from the return on common equity. Applying a gross-up factor of 40.48 percent to the common equity component results in a grossed-up rate of return of 10.20 percent.

[10] Wagner Direct Testimony at 3-4.

revisions to its environmental surcharge mechanism to reflect the use of a different allocation methodology.

In Case No. 2002-00169, the Commission conducted an extensive review of Kentucky Power s arguments in opposition to the revenue allocation methodology and the previous decisions by the Commission and the Franklin Circuit Court affirming and upholding the appropriateness and use of the revenue allocation methodology. After considering all the arguments raised by Kentucky Power and the intervenors in Case No. 2002-00169, the Commission found that Kentucky Power s environmental costs should continue to be allocated on the basis of total revenue.[11]

Kentucky Power has not demonstrated any change of circumstances since that decision was issued. Therefore, the Commission finds that the revenue allocation methodology, which has been in use since the establishment of Kentucky Power s environmental surcharge, remains reasonable and appropriate for allocating Kentucky Power s environmental compliance costs. Kentucky Power has presented no new argument or basis to justify a change in that methodology. Therefore, the existing revenue allocation methodology should continue to be used to allocate Kentucky Power s environmental compliance costs.

IT IS THEREFORE ORDERED that:

1. Kentucky Power shall include a $6,632 increase in its environmental surcharge revenue requirement determined in its next monthly surcharge report.

[11] Case No. 2002-00169, March 31, 2003 Order at 46. However, as discussed in that Order, Kentucky Power s Non-Physical Revenues are excluded from the revenue allocation methodology.

2. Kentucky Power shall file in its next 2-year environmental surcharge review case a proposed amount to roll into base rates.

3. Kentucky Power shall use a weighted average cost of capital of 7.46 percent in all monthly environmental surcharge filings subsequent to the date of this Order.

4. Kentucky Power shall continue to calculate its environmental surcharge using the revenue allocation methodology as previously ordered by this Commission.

Done at Frankfort, Kentucky, this 20th day of June, 2003.

By the Commission

ATTEST:

Thomas M. Dorman

Executive Director