

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 FOR THE SIX-MONTH)	CASE NO.
BILLING PERIODS ENDING DECEMBER 31, 2002,)	2006-00128
DECEMBER 31, 2003, JUNE 30, 2004,)	
DECEMBER 31, 2004, AND DECEMBER 31, 2005,)	
AND FOR THE TWO-YEAR BILLING PERIODS)	
ENDING JUNE 30, 2003 AND JUNE 30, 2005)	

O R D E R

On April 25, 2006, the Commission initiated five 6-month reviews and two 2-year reviews of Kentucky Power Company's ("Kentucky Power") environmental surcharge as billed to customers for the following periods: the 6-month periods July 1, 2002 to December 31, 2002; July 1, 2003 to December 31, 2003; January 1, 2004 to June 30, 2004; July 1, 2004 to December 31, 2004; July 1, 2005 to December 31, 2005; and the 2-year periods July 1, 2001 to June 30, 2003 and July 1, 2003 to June 30, 2005.¹ Pursuant to KRS 278.183(3), the Commission must review, at 6-month intervals, the past operations of the environmental surcharge; 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, disallow improper expenses and, to the

¹ Kentucky Power's surcharge is billed on a 2-month lag. Thus surcharge billings for July 2002 recover costs incurred in May 2002, and every subsequent monthly surcharge billing under review recovers costs incurred 2 months prior to billing.

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

The Attorney General, by and through his Office of Rate Intervention (“AG”), and the Kentucky Industrial Utility Customers, Inc. (“KIUC”) sought and were granted intervention in this proceeding. The Commission issued a procedural schedule on April 25, 2006 that provided for discovery, the filing of prepared testimony, an informal conference, and a public hearing. Kentucky Power filed prepared direct testimony, supplemental testimony,² and responded to requests for information. Neither intervenor filed requests for information or testimony. The AG and KIUC filed notices stating they did not object to the submission of the case for decision on the current record, subject to reserving their objections to the inclusion of environmental costs associated with out-of-state generating facilities approved in Case No. 2005-00068.³ The Commission notes that the AG and KIUC appealed that issue to the Franklin Circuit Court and Kentucky Court of Appeals. On July 27, 2006, Kentucky Power filed its response to the

² In its September 8, 2006 Order, the Commission required Kentucky Power to file supplemental testimony addressing the discovery of errors it had found in a previous data response. The supplemental testimony was filed on September 19, 2006.

³ Case No. 2005-00068, Application of Kentucky Power Company for Approval of an Amended Compliance Plan for Purposes of Recovering Additional Costs of Pollution Control Facilities and to Amend Its Environmental Cost Recovery Surcharge Tariff.

Commission's July 24, 2006 Order stating its position that the case should be submitted for adjudication based on the existing record.⁴

SURCHARGE ADJUSTMENT

The April 25, 2006 Order initiating this case indicated that since each of the seven 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 \$225,538.⁵ Kentucky Power proposed that the net under-recovery be collected from customers by increasing the total jurisdictional environmental surcharge revenue requirement by \$37,590 a month for 6 months beginning in the first billing month following the Commission's decision in this proceeding.⁶

⁴ The Commission's September 8, 2006 Order provided that after the parties considered Kentucky Power's supplemental testimony and responses to any data requests, the parties were to either file no later than October 10, 2006 a statement that the case could be submitted for adjudication based on the existing record or request a hearing. Kentucky Power filed a statement on October 10, 2006 indicating that it believed the case could be submitted for adjudication based on the existing record. The AG and KIUC did not file a statement.

⁵ Wagner Supplemental Testimony at 6. Kentucky Power had originally determined that it had a net under-recovery of \$110,756. See Response to the Commission Staff's First Data Request dated April 25, 2006 Order, Item 1, page 10 of 10. On September 1, 2006, Kentucky Power filed a motion requesting that it be allowed to file a revised response to Item 1, due to the discovery of several errors in the calculations. The Commission's September 8, 2006 Order granted Kentucky Power's request and required the filing of supplemental testimony to address how the revised amount was determined and to indicate how many billing periods it proposed to spread the revised net under-recovery over to recover the amount from ratepayers.

⁶ Id.

In their July 6 and 10, 2006 notices agreeing to the submission of this case for decision on the current record, the AG and KIUC reserved their objections to the inclusion of any costs relating to out-of-state generating facilities not qualifying for environmental surcharge recovery pursuant to KRS 278.183, an issue on appeal before the Franklin Circuit Court. On October 30, 2006, the Franklin Circuit Court upheld the Commission's decision that the costs relating to the out-of-state generating facilities did qualify for environmental surcharge recovery.⁷ The AG and KIUC have appealed the Franklin Circuit Court decision to the Kentucky Court of Appeals.

The Commission has reviewed and finds reasonable Kentucky Power's calculation of a net under-recovery of \$225,538 for the seven periods covered in this proceeding. The Commission also finds reasonable Kentucky Power's proposal to increase by \$37,590 the total jurisdictional environmental surcharge revenue requirement in each of the first 6 billing months following the date of this Order.

In addition, Kentucky Power identified errors in the calculation of its monthly surcharge factor in the seven expense months immediately following the end of the last review period included in this proceeding. Kentucky Power determined that these errors had resulted in a net under-recovery of its environmental costs of \$347,425.⁸ Kentucky Power proposed that this net under-recovery be collected from customers by an

⁷ *Commonwealth of Kentucky ex rel. Stumbo v. Kentucky Public Service Commission*, Nos. 05-CI-1534, 05-CI-1543, 05-CI-1544 (Ky. Franklin Cir. Ct. October 30, 2006).

⁸ *Id.* at 8. Kentucky Power identified the errors resulting in the net under-recovery of environmental costs as being the failure to include approved expenses for low nitrogen oxide burners at the Rockport generating units, the utilization of an incorrect surplus weighting factor for costs associated with the Ohio Power Company, and the inappropriate inclusion of sulfur trioxide mitigation costs.

additional increase to the total jurisdictional environmental surcharge revenue requirement of \$57,904 in each of the first 6 billing months following the date of this Order.⁹ Neither the AG nor KIUC has expressed an opinion on Kentucky Power's proposal.

The Commission has reviewed the calculation of this post-review period net under-recovery and examined the reasons why this under-recovery has occurred. We note that Kentucky Power has taken steps to correct the identified errors in the collection and reporting of data for its surcharge mechanism. The Commission believes it is reasonable to address this net under-recovery now rather than wait until subsequent 6-month surcharge reviews. The Commission further believes there is no benefit to either Kentucky Power or its ratepayers to delay the collection of this additional net under-recovery of appropriate environmental costs.

The Commission finds that Kentucky Power's calculation of the post-review period net under-recovery of \$347,425 is reasonable. The Commission also finds reasonable the proposal to increase by \$57,904 the total jurisdictional environmental surcharge revenue requirement in each of the first 6 billing months following the date of this Order.

These two net under-recoveries of environmental costs will result in the monthly jurisdictional environmental surcharge revenue requirement in each of the first 6 billing months following the date of this Order being increased by \$95,494.¹⁰

⁹ Id.

¹⁰ The monthly net under-recovery from the review periods of \$37,590 plus the monthly net under-recovery from the post-review period of \$57,904.

Kentucky Power indicated that it would show the two net under-recovery adjustments as separate line items on ES Form 1.00 during the 6-month collection period. The Commission finds this reporting is reasonable and it should be approved.

SURCHARGE ROLL-IN

In Case No. 2005-00341,¹¹ the capital expenditures and operating expenses associated with the original and first amendment to the environmental compliance plan as of the test year were rolled into Kentucky Power's base rates. The test year in that case was the 12 months ending June 30, 2005, which corresponds to the last billing month of the second 2-year surcharge review period. Given the roll-in accomplished as part of its last general rate case, Kentucky Power was asked whether there was a need for a further roll-in of its environmental surcharge into its base rates. Kentucky Power indicated that it believed no roll-in of any additional environmental surcharge amounts was needed.¹² The Commission agrees.

RATE OF RETURN

In Case No. 1996-00489,¹³ the Commission found that Kentucky Power's debt portion of its weighted average cost of capital should be reviewed and re-established during each 6-month review case. The rate of return on common equity would remain

¹¹ Case No. 2005-00341, General Adjustments of Electric Rates of Kentucky Power Company, final Order dated March 14, 2006.

¹² Response to the Commission Staff's First Data Request dated April 25, 2006, Item 14.

¹³ 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.

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.¹⁴

Kentucky Power stated that it believed the 10.50 percent rate of return on common equity established in the settlement agreement in Case No. 2005-00341 was the reasonable rate of return for environmental surcharge purposes. Kentucky Power provided the outstanding balances for its long-term debt, short-term debt, accounts receivable financing, and common equity as of December 31, 2005, the last billing month of the review periods. It also provided the blended interest rates for the long-term debt, short-term debt, and accounts receivable financing as of December 31, 2005.¹⁵ Using this information, Kentucky Power calculated a weighted average cost of capital, before income tax gross-up, of 7.61 percent.¹⁶ Kentucky Power also provided the weighted average cost of capital reflecting the tax gross-up approach approved in Case No. 2005-00068.¹⁷

¹⁴ This weighted average cost of capital is applied only to the environmental compliance rate base associated with plant installed at Kentucky Power's Big Sandy generating units.

¹⁵ Response to the Commission Staff's First Data Request dated April 25, 2006, Item 16.

¹⁶ Id.

¹⁷ Response to the Commission Staff's Second Data Request dated June 13, 2006, Item 2. Kentucky Power noted in its response that in providing the requested information, it was "not waiving any objection it might have regarding the calculation of the gross-up factor based on Case No. 2005-00068, which is currently on appeal to the Franklin Circuit Court." In the response, Kentucky Power determined that the income tax gross-up factor was 1.6073 which would produce a tax grossed-up weighted average cost of capital of 10.15 percent.

The Commission notes that on October 30, 2006, the Franklin Circuit Court upheld the Commission's tax gross-up approach utilized in Case No. 2005-00068.¹⁸ The Commission has reviewed Kentucky Power's determination of the weighted average cost of capital and finds the 7.61 percent to be reasonable. The Commission has also reviewed the determination of the tax gross-up factor and finds that it is consistent with the approach approved in Case No. 2005-00068. Therefore, the Commission finds that the weighted average cost of capital of 7.61 percent and the income tax gross-up factor of 1.6073 should be used in all monthly environmental surcharge filings subsequent to the date of this Order.

REQUEST FOR CONFIDENTIAL TREATMENT

Pending before the Commission is Kentucky Power's rehearing petition seeking confidential treatment of information it provided in response to Item 17(b) of the Commission Staff's First Data Request dated April 25, 2006.¹⁹ The response contained information concerning Kentucky Power's inventories of sulfur dioxide and nitrogen oxide emission allowances for the period 2006 through 2016, and included expected additions, usage, and withdrawals from the inventories. The Commission originally denied confidential treatment of the responses by its August 16, 2006 Order but granted Kentucky Power's request for rehearing in its September 22, 2006 Order. The

¹⁸ *Commonwealth of Kentucky ex rel. Stumbo v. Kentucky Public Service Commission*, Nos. 05-CI-1534, 05-CI-1543, 05-CI-1544 (Ky. Franklin Cir. Ct. October 30, 2006). The Commission also notes that Kentucky Power has appealed the Franklin Circuit Court decision to the Kentucky Court of Appeals.

¹⁹ The Commission had previously denied confidential treatment for the response by Order dated August 16, 2006. However, the Commission granted Kentucky Power's petition for rehearing by its September 22, 2006 Order.

September 22, 2006 Order scheduled an informal conference convened for the purpose of discussing the issues raised in Kentucky Power's petition for rehearing.

At the October 5, 2006 informal conference,²⁰ Kentucky Power described the nature of the emission allowance markets, the situation faced by Kentucky Power and its parent company, the American Electric Power Company ("AEP"), in the emission allowance markets, and how transactions undertaken by AEP in the emission allowance markets could be perceived. Kentucky Power was requested to file additional information concerning the emission allowance markets in support of the petition for confidential treatment, which it did on October 27, 2006.

The participants in the emission allowance markets are not only utilities seeking to acquire emission allowances for regulatory compliance purposes, but also include entities involved in speculation trading. These markets are thinly traded, with generally low volume of transactions. The pricing in the emission allowance markets can be extremely volatile. Considering the current nature of the emission allowance markets and how Kentucky Power and AEP participate in those markets, the Commission finds that confidential treatment of the responses to Item 17(b) should be granted.

IT IS THEREFORE ORDERED that:

1. Kentucky Power shall include a \$95,494 monthly increase in its jurisdictional environmental revenue requirement determined in each of the first 6 billing months following the date of this Order, as discussed herein.

²⁰ Although the October 5, 2006 informal conference was duly noticed, neither the AG nor KIUC attended.

2. Kentucky Power shall use a weighted average cost of capital of 7.61 percent and a tax gross-up factor of 1.6073 in all monthly environmental surcharge filings subsequent to the date of this Order.

3. The petition for confidential treatment of the responses to Item 17(b) of the Commission Staff's First Data Request is granted.

Done at Frankfort, Kentucky, this 31st day of January, 2007.

By the Commission

ATTEST:



Executive Director