

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION BY THE PUBLIC SERVICE)	
COMMISSION OF THE ENVIRONMENTAL)	CASE NO.
SURCHARGE MECHANISM OF KENTUCKY)	2013-00325
POWER COMPANY FOR THE TWO-YEAR)	
BILLING PERIOD ENDING JUNE 30, 2013)	

ORDER

On September 11, 2013, the Commission initiated a two-year review of Kentucky Power Company's ("Kentucky Power") environmental surcharge as billed to customers for the two-year period July 1, 2011, to June 30, 2013.¹ Pursuant to KRS 278.183(3), the Commission must review, at six-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 two-year intervals, the Commission must review and evaluate the past operations of the environmental surcharge, disallow improper expenses, and, to the extent appropriate, incorporate surcharge amounts found just and reasonable into the existing base rates of the utility.

The Commission issued a procedural schedule on September 11, 2013, that provided for discovery, the filing of prepared testimony, an informal conference, intervenor testimony and discovery on intervenor testimony. Kentucky Power filed prepared direct testimony and responded to requests for information. There were no

¹ Since Kentucky Power's surcharge is billed on a two-month lag, the amounts billed from July 2011 through June 2013 are based on costs incurred from May 2011 through April 2013.

parties requesting intervenor status to this proceeding. Four informal conferences were held to discuss the various issues arising in this proceeding. On December 11, 2013, Kentucky Power stated that this case may be submitted for a decision based on the existing record without a public hearing. Based on the absence of intervenors and finding good cause, the Commission will grant Kentucky Power's request and decide this case on the evidence of record without a hearing.

SURCHARGE ADJUSTMENT

The September 11, 2013 Order initiating this case indicated that since the period 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 in the amount of \$3,518,900.² Kentucky Power proposed that the net under-recovery be collected by increasing the total jurisdictional environmental surcharge amount by a one-time adjustment of \$3,518,900 in its first monthly surcharge filing following the Commission's decision in this proceeding.³

In determining its surcharge adjustment, Kentucky Power found that there was a misallocation of certain charges and credits received from PJM Interconnection, LLC, ("PJM") the regional transmission organization of which Kentucky Power is a member, during the review period. The misallocations occurred during the months of July 2011 through June 2013, whereas this review period ends with the expense month of April

² Response to the Commission Staff's First Request for Information (Staff's First Request"), Item 1. Kentucky Power requested that it be allowed to refund an additional \$2,427 over collected in May and June 2013, which are outside of the review period. If included in the adjustment, the net under-recovery would be \$3,516,473.

³ Direct Testimony of Lila P. Munsey, page 11.

2013. Because only two months of misallocations occurred beyond the review period, Kentucky Power proposed to include the months of May 2013 and June 2013 in its proposed surcharge adjustment. Since the misallocations of PJM charges and credits during the months of May 2013 and June 2013 lie outside of this review period, they will not be addressed in this proceeding.

The Commission has reviewed and finds reasonable Kentucky Power's calculation of a net under-recovery of \$3,518,900 for the review period covered in this proceeding. The Commission does not agree with Kentucky Power's proposal to collect the net under-recovery in the first month following the issuance of an order in this matter.

The Stipulation and Settlement Agreement ("Settlement Agreement") in Case No. 2012-00578⁴ provides that effective January 1, 2014, the Environmental Surcharge factor will be maintained and fixed at zero percent until new base rates are set by the Commission. The Settlement Agreement does not specify whether the January 1, 2014 factor is the billing month factor (January 2014) or expense month factor (November 2013). Kentucky Power stated that its interpretation was that the zero percent factor begins with the November 2013 expense month, and the only amounts that would be reflected on customer's bills in January and February 2014 would be a small factor to account for any over- or under-recovery for the expense months of September and October 2013, which were reflected on the monthly filings for November and December

⁴ Case No. 2012-00578, Application of Kentucky Power Company for (1) A Certificate of Public Convenience and Necessity Authorizing the Transfer to the Company of an Undivided Fifty Percent Interest in the Mitchell Generating Station and Associated Assets; (2) Approval of the Assumption by Kentucky Power Company of Certain Liabilities in Connection with the Transfer of the Mitchell Generating Station; (3) Declaratory Rulings; (4) Deferral of Costs Incurred in Connection with the Company's Efforts to Meet Federal Clean Air Act and Related Requirements; and (5) all Other Required Approvals and Relief (Ky. PSC Nov. 22, 2013).

2013.⁵ Since any over- or under-recovery for September and October 2013 is used to determine the environmental surcharge billing factor to be billed to the customers in January and February 2014, and absent any definitive evidence otherwise as to the intent of the Settlement Agreement regarding whether the zero percent environmental surcharge factor is the January 2014 expense month or the billing month, the Commission believes that the January 2014 monthly environmental surcharge report should indicate a billing factor of zero percent. Thus Kentucky Power should not include any over- or under-recovery that may have occurred in September and October 2013 on customers' bills. While the Commission agrees with Kentucky Power's calculation of an under-recovery of \$3,518,900, it believes the terms of the Settlement Agreement preclude any recovery from customers.

SURCHARGE ROLL-IN

Kentucky Power is not proposing that additional amounts of the environmental surcharge need to be incorporated into existing base rates as a "roll-in" in this proceeding.⁶ Kentucky Power notes that its environmental costs represent both investment costs, which are normally reflected in demand charges, and operating and maintenance costs, which are normally reflected in energy charges. Kentucky Power argues that the best time to properly allocate or assign these different types of environmental costs is at the time of a base rate case.⁷ Kentucky Power contends that

⁵ Response to Commission Staff's Second Request for Information ("Staff's Second Request"), Item 2.

⁶ Response to Staff's First Request, Item 5.

⁷ *Id.*

whether there was a roll-in or not, there is no effect on the ratepayers or the company, because the total revenue requirement will remain the same.

The environmental surcharge statute directs the Commission to incorporate surcharge amounts found just and reasonable into the utility's existing base rates, but only "to the extent appropriate." The Commission agrees with Kentucky Power that whether or not there is a roll-in, ratepayers' total bills will be the same. The Commission also agrees that due to the potential need to revise demand charges to reflect the environmental capital costs, it is reasonable not to incorporate the environmental surcharge into existing base rates in this case.

RATE OF RETURN

In Case No. 1996-00489,⁸ the Commission found that Kentucky Power's debt portion of its weighted average cost of capital should be reviewed and re-established during each six-month review case. The rate of return on the common equity component would remain fixed and subject to review during the two-year environmental surcharge reviews. The weighted average cost of capital constitutes the rate of return for Kentucky Power's environmental compliance rate base.⁹

Kentucky Power states that it believes the 10.50 percent rate of return on common equity established in the settlement agreement in Case No. 2009-00459¹⁰ is

⁸ Case No. 1996-00489, In the Matter of the 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 Wastes and By-Products (Ky. PSC May 27, 1997).

⁹ 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.

¹⁰ Case No. 2009-00459, Application of Kentucky Power Company for a General Adjustment of Electric Rates (Ky. PSC June 28, 2010).

the reasonable rate of return for environmental surcharge purposes. Since the terms of the Settlement Agreement in Case No. 2012-00578 require Kentucky Power to maintain the environmental surcharge factor at zero percent until changed by the Commission, Kentucky Power's customers will not be impacted by updating its weighted average cost of capital. The Settlement Agreement also provides that Kentucky Power will file a base rate case by December 29, 2014, at which time the Commission will review the proposed rate of return on common equity to be used for both base rate and environmental surcharge purposes. Therefore the Commission will allow Kentucky Power to continue to use a return on equity of 10.50 percent for purposes of re-establishing its weighted average cost of capital.

Kentucky Power provided the outstanding balances for its long-term debt, short-term debt, accounts receivable financing, and common equity as of April 30, 2013, the last expense month of the review period. It also provided the blended interest rates for the long-term debt, short-term debt, and accounts receivable financing as of April 30, 2013.¹¹ Using this information, Kentucky Power calculated a weighted average cost of capital, before income tax gross-up, of 8.08 percent.¹² Kentucky Power also provided the weighted average cost of capital reflecting the tax gross-up approach approved in Case No. 2005-00068.¹³

The Commission has reviewed Kentucky Power's determination of its weighted average cost of capital and finds the 8.08 percent to be reasonable. The Commission

¹¹ Response to Staff's First Request, Item 4.

¹² *Id.*

¹³ 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 (Ky. PSC Oct. 17, 2005).

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 8.08 percent and the income tax gross-up factor of 1.5489, which produce an overall grossed-up return of 10.69 percent,¹⁴ should be used in all monthly environmental surcharge filings subsequent to the date of this Order.

OTHER ITEMS

Because the Settlement Agreement in Case No. 2012-00578 stipulates that the monthly environmental surcharge factor will be fixed and maintained at zero percent beginning January 1, 2014, until the Commission establishes new base rates, the question arises regarding the necessity of continuing with the monthly environmental surcharge filings, since there will be no recovery of environmental expenses. Kentucky Power will continue to incur environmental costs that it would be entitled to recover through the environmental surcharge, except for the fact that it will not be able to recover those costs from its customers during the time period in which the environmental surcharge factor is established at zero percent pursuant to the Settlement Agreement in Case No. 2012-00578. KRS 278.183(3) requires Kentucky Power to file with the Commission the amount of the monthly environmental surcharge ten days before it is to go into effect and also requires the Commission to conduct six-month and two-year reviews of the past operation of the environmental surcharge.

The monthly environmental surcharge filings are an integral component in facilitating the six-month and two-year reviews by Commission Staff ("Staff"). They are

¹⁴ Response to Staff's First Request, Item 4.

an essential tool for Staff in the verification of any additional environmental expenses or refunds that the company may determine. The Commission believes that because of the potential for a roll-in of environmental surcharge amounts into base rates at the time of Kentucky Power's next base rate case, Kentucky Power should continue to file monthly surcharge reports to allow the Commission to monitor and verify the ongoing environmental costs that Kentucky Power will incur. The Commission believes that as long as Kentucky Power's Tariff ES (Environmental Surcharge) is in effect, and to be in compliance with KRS 278.183(3), Kentucky Power should continue to make its monthly environmental surcharge filings and be subject to any six-month and two-year reviews that may occur during the period that the surcharge factor is fixed and maintained at zero percent. Kentucky Power agreed that it should continue to file its monthly surcharge reports while the monthly surcharge is fixed at zero percent.¹⁵

IT IS THEREFORE ORDERED that:

1. Beginning January 1, 2014, Kentucky Power's environmental surcharge billing factor will be zero percent, per the terms of the Settlement agreement in Case No. 2012-00578, and is to remain at that level until changed by the Commission.

2. Kentucky Power shall not collect the net under-recovery of \$3,518,900 per ordering paragraph 1 and the terms of the Settlement Agreement in Case No. 2012-00578.

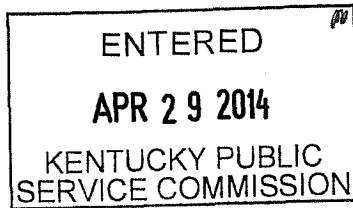
3. Kentucky Power shall use a weighted average cost of capital of 8.08 percent and a tax gross-up factor of 1.5489, a return on equity rate of 10.50 percent, and an overall grossed-up return of 10.69 percent in all monthly environmental surcharge filings subsequent to the date of this Order.

¹⁵ Response to Staff's Second Request, Item 3.

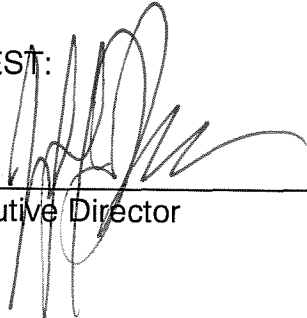
4. Kentucky Power shall continue to submit its monthly environmental surcharge filings for the period that the monthly billing factor is fixed and maintained at zero percent.

5. Other than the net under-recovery of \$3,518,900 discussed in this Order, the charges and credits billed by Kentucky Power through its environmental surcharge for the period July 1, 2011 through June 30, 2013 are approved.

By the Commission



ATTEST:



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