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 BILLING PERIODS ENDING JUNE 30, 2006 AND DECEMBER 31, 2006, AND FOR THE TWO-YEAR BILLING PERIOD ENDING JUNE 30, 2007	)	CASE NO. 2007-00381

ORDER

On September 19, 2007, the Commission initiated two 6-month reviews and one 2-year review of Kentucky Power Company's ("Kentucky Power") environmental surcharge as billed to customers for the following periods: the 6-month periods of January 1, 2006 to June 30, 2006 and July 1, 2006 to December 31, 2006; and the 2-year period of July 1, 2005 to June 30, 2007.[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 extent appropriate, incorporate surcharge amounts found just and reasonable into the existing base rates of the utility.

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[1] Kentucky Power's surcharge is billed on a 2-month lag. Thus, surcharge billings for January 2006 recover costs incurred in November 2005, and every subsequent monthly surcharge billing under review recovers costs incurred 2 months prior to billing.

The Attorney General, by and through his Office of Rate Intervention ("AG"), and Kentucky Industrial Utility Customers, Inc. ("KIUC") sought and were granted intervention in this proceeding. The Commission issued a procedural schedule on September 19, 2007 that provided for discovery, the filing of prepared testimony, an informal conference, and a public hearing. Kentucky Power filed prepared direct testimony and responded to requests for information. Neither Intervenor filed requests for information or testimony. On February 13, 2008, Kentucky Power and KIUC filed responses to the Commission's February 7, 2008 Order stating that there were no material issues of fact that warranted a hearing in this case. Kentucky Power further stated that this case may be submitted for decision on the current record without hearing.[2]

SURCHARGE ADJUSTMENT

The September 19, 2007 Order initiating this case indicated that, since each of the 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 no over- or under-recovery of its environmental costs during the periods under review.[3]

The Commission has reviewed and finds reasonable Kentucky Power's calculation that there has been no over- or under-recovery for the periods covered in this proceeding.

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[2] The AG did not file a response to the February 7, 2008 Order.

[3] Wagner Direct Testimony at 4 and Response to the Commission Staff's First Data Request dated September 19, 2007, Item 1, page 4 of 4.

While Kentucky Power determined there was no over- or under-recovery of environmental costs during the review periods, it did identify an error that impacted the calculation of its monthly surcharge factor in the first expense month immediately following the end of the last review period included in this proceeding. In June 2007, Kentucky Power discovered metering equipment inaccuracies at interconnections with two of its affiliates, Appalachian Power Company ("Appalachian") and Ohio Power Company ("Ohio Power").[4] The metering equipment inaccuracies resulted in an overstatement of Kentucky Power's demand for May 2007 and an overstatement of Kentucky Power's deficit position in the AEP Power Pool. Pursuant to the AEP interconnection agreement,[5] Kentucky Power's deficit position in the AEP Power Pool determines its monthly power pool capacity payments. As a result of the May 2007 metering equipment inaccuracies, Kentucky Power determined that it had overpaid its pool capacity payments, of which $195,078 was attributable to environmental costs.[6] Since this overpayment of environmental costs had been passed through Kentucky Power's environmental surcharge, ratepayers are entitled to a refund of that amount. Kentucky Power proposed to refund the $195,078 over-recovery through its

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[4] Appalachian, Ohio Power, and Kentucky Power are three of the five members of the American Electric Power ("AEP") Power Pool.

[5] The AEP interconnection agreement governs the allocation of costs associated with the AEP Power Pool and has been approved by the Federal Energy Regulatory Commission.

[6] The metering equipment inaccuracies also resulted in the understatement of fuel costs recoverable through Kentucky Power's Fuel Adjustment Clause ("FAC") by $9,965 and the overstatement of credits to ratepayers through Kentucky Power's System Sales Clause ("SSC") by $119,038. See Case No. 2007-00276, An Examination of the Application of the Fuel Adjustment Clause for Kentucky Power Company from November 1, 2006 through April 30, 2007.

environmental surcharge in the first month after the Commission's Order in this proceeding.[7]

Kentucky Power initially noted that the West Virginia Public Service Commission ("West Virginia Commission") might permit Appalachian to "true-up" its settlement amounts with Kentucky Power to a date earlier than May 2007. However, on June 26, 2008, the West Virginia Commission entered an order approving a stipulation and settlement agreement in the Appalachian case which did not result in additional settlement amounts to Kentucky Power.[8]

The Commission has reviewed the calculation of this post-review period over-recovery and examined the reasons why this over-recovery occurred. We note Kentucky Power has stated that the causes of the metering equipment inaccuracies have been corrected by AEP and the metering function is now more closely monitored. The Commission finds it reasonable to address this over-recovery now rather than wait until the next 6-month surcharge review. There is no benefit to either Kentucky Power or its ratepayers from delaying the refunding of this over-recovery of environmental costs. The Commission further finds that Kentucky Power's calculation of the post-review period over-recovery of $195,078 is reasonable,[9] as is its proposal to reduce the

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[7] In Case No. 2007-00276, Kentucky Power proposed that it be permitted to charge ratepayers for the understatement of fuel costs and overstatement of credits in the first month after the Commission's Order in that proceeding. Consequently, the net impact on ratepayers from correcting for the metering equipment inaccuracies would be a net refund of $66,075 (charges of $9,965 plus $119,038 offset by a refund of $195,078).

[8] See Case No. 2007-00276, June 30, 2008 filing by Kentucky Power.

[9] The Commission will address the charges for the understated fuel costs and overstated SSC credits in its Order in Case No. 2007-00276.

total jurisdictional environmental surcharge revenue requirement by $195,078 in the first billing month following the date of this Order.

SURCHARGE ROLL-IN

Kentucky Power did not propose to incorporate, or "roll-in," any of its environmental surcharge into existing base rates. Kentucky Power stated that it did not believe that additional amounts of the environmental surcharge needed to be rolled into existing base rates.[10] Kentucky Power contended that whether there was a roll-in or not, the effect on the ratepayers was the same. Kentucky Power noted that its environmental costs represent both capital costs, which are normally reflected in demand charges, and operating and maintenance costs, which are normally reflected in energy charges. Kentucky Power argued that the best time to properly allocate or assign these different types of environmental costs is at the time of a base rate case.[11]

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 notes that the only time Kentucky Power's environmental surcharge has been rolled into existing base rates was as a result of the settlement agreement approved in its last base rate case, Case No. 2005-00341.[12] The Commission agrees with Kentucky Power that whether or not there is a

[10] Response to the Commission Staff's First Data Request dated September 19, 2007, Item 12.

[11] Response to the Commission Staff's Second Data Request dated November 7, 2007, Item 4.

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

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,[13] the Commission found that Kentucky Power's debt portion of its weighted average cost of capital should be reviewed and reestablished 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.[14]

Kentucky Power stated that it believed the 10.5-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 April 30, 2007, the last expense month of the review periods. It also provided the blended interest rates for the long-term debt,

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[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.

[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.

short-term debt, and accounts receivable financing as of April 30, 2007.[15] Using this information, Kentucky Power calculated a weighted average cost of capital, before income tax gross-up, of 7.67 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]

The Commission has reviewed Kentucky Power's determination of its weighted average cost of capital and finds the 7.67 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.[18] Therefore, the Commission finds that the weighted average cost of capital of 7.67 percent and the income tax gross-up factor of 1.5768 should be used in all monthly environmental surcharge filings subsequent to the date of this Order.

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[15] Response to the Commission Staff's First Data Request dated September 19, 2007, Item 11.

[16] Id.

[17] Response to the Commission Staff's Second Data Request dated November 7, 2007, Item 3. In the response, Kentucky Power determined that the income tax gross-up factor was 1.5768, which would produce a tax grossed-up weighted average cost of capital of 10.24 percent.

[18] 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.

IT IS THEREFORE ORDERED that:

1. Kentucky Power shall reduce its jurisdictional environmental revenue requirement determined in the first billing month following the date of this Order by $195,078, as discussed herein.

2. Kentucky Power shall use a weighted average cost of capital of 7.67 percent and a tax gross-up factor of 1.5768 in all monthly environmental surcharge filings subsequent to the date of this Order.

Done at Frankfort, Kentucky, this 19th day of August, 2008.

By the Commission

Vice Chairman Gardner Abstains.

ATTEST:

Stephanie Stumbo

Executive Director