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Chairmen and Committee members, thank you for the opportunity to appear before you today to discuss the statutory basis for rate recovery of the cost of environmental controls by jurisdictional electric utilities in Kentucky.

With me today are several members of the PSC staff, who will be available to help me answer any questions you may have at the end of this presentation. They are deputy executive directors Stephanie Bell and Aaron Greenwell, Jeff Shaw of our financial analysis division, Richard Raff of our legal division and Andrew Melnykovych, our director of communications.

Before I begin my presentation, I need to make one disclaimer. As you probably know, several cases related to this issue have recently been filed with the Kentucky Public Service Commission. We anticipate more such cases in the near future. Therefore, I cannot discuss environmental compliance costs or potential rate impacts as they relate to any specific utility.

What I can do today is explain how environmental compliance costs are recovered through rates, the legal basis for that recovery and the PSC process for evaluating those environmental costs and the associated rate impacts.

Environmental cost recovery is a statutory process – the result of laws enacted by the Kentucky General Assembly, the associated PSC regulations and applicable legal precedents that have flowed from those statutes. There are two applicable statutory mechanisms: the environmental surcharge mechanism is the most important and the one that generally comes into play in these matters.

The other important statutory mechanism is the process for granting certificates of public convenience and necessity, commonly known as a CPCN and sometimes referred to as a construction certificate. It is often used in conjunction with the environmental surcharge mechanism.

Let me describe each of these in brief detail.

The environmental surcharge mechanism is the result of a statute adopted by the Kentucky General Assembly during its 1992 session. The statute was enacted principally in response to the federal Clean Air Act Amendments of 1990, which set new limits on emissions of sulfur dioxide and nitrogen oxides from coal-burning power plants. The surcharge statute took effect on January 1 of 1993.

The environmental surcharge mechanism established a streamlined process for reflecting the costs of environmental compliance in a utility's rates by allowing those costs to be considered separately and distinctly from a utility's other operating and capital expenses. Without the mechanism, utilities facing environmental compliance costs would be forced to file full-blown rate cases more frequently than they do now, thus driving up both their costs and the rates their customers pay.

Environmental surcharge mechanism cases are handled much like rate cases. The process allows for intervention by interested parties, includes sworn testimony and discovery by all parties and provides for hearings and public participation.

As you can see in this slide, which quotes Section 1 of the statute, the environmental surcharge mechanism entitles a utility to recover its current costs of environmental compliance. It applies not only to requirements under the federal Clean Air Act and its amendments, but also to any other federal, state or local environmental requirements that apply to emissions or waste products generated by coal combustion. Thus, it covers the cost of things such as scrubbers, electrostatic precipitators, bag houses, landfills and ash ponds.

The statute allows the recovery of both capital costs and operating expenses. If a utility constructs facilities for the purpose of environmental compliance, it is allowed a reasonable rate of return on those capital investments, just as it is allowed a reasonable rate of return on other capital projects. It is up to the PSC to determine what constitutes a reasonable rate of return on equity for a utility to have the opportunity to earn, subject of course to the parameters set forth in case law on this issue.

Reasonable operating expenses include not only those related to environmental compliance facilities, but also other actions related to compliance, such as the purchase of emission allowances.

Section 1 of the environmental surcharge statute further spells out the details of operating expenses, including taxes and depreciation of facilities. It makes it clear which costs utilities have a right to recover.

The remaining four sections of the statute set forth the process by which utilities apply for and the PSC considers an environmental surcharge, which consists of both an environmental compliance plan and the associated surcharge calculation. It sets a six-month deadline for the PSC to complete its consideration of environmental compliance plans, which is four months shorter than the deadline in rate cases.

The statute also requires that the surcharge be listed on an electric bill as a separate line item, so that environmental compliance costs are apparent to customers.

The PSC is required to review each utility's environmental surcharge every six months and make any necessary adjustments. A comprehensive review is required every two years. At that time, the PSC has the option of rolling all or some of the environmental costs into a utility's base rates. In practice, such roll-ins more typically occur in conjunction with general rate cases that the utility brings to the Commission.

There are several important things to keep in mind about the environmental surcharge, including two key presumptions.

The first of those presumptions is that a utility will comply with environmental mandates imposed upon it at the federal, state or local level. The PSC does not pass judgment on whether such mandates are appropriate – it only reviews the costs of complying with such mandates.

Secondly, the environmental surcharge mechanism statute grants a utility the presumption of the timely recovery of environmental compliance costs. In other words, if a utility is required to incur environmental compliance costs, it is entitled to recover those costs through its rates, in the form of the environmental surcharge.

Furthermore, the statute grants the utility the right to earn a reasonable rate of return on any PSC-approved capital investments it makes in furtherance of environmental compliance. Simply put, that means that an investor-owned utility's shareholders are entitled to the opportunity to earn a comparable return on equity on the scrubber at a power plant as they are on the rest of the plant itself.

You will note that the statute includes the words reasonable in several places. That means that the PSC, in its review of both a utility's compliance plan and the associated surcharge calculations, subjects rates of return and expenses to an examination similar to that applied in general rate cases.

A similar parallel holds in the review of any construction of facilities proposed within a utility's environmental compliance plan. Utilities have the option of requesting a certificate of public convenience and necessity as part of an environmental surcharge application. They typically choose to do so, in large measure because the environmental surcharge statute requires the PSC to render a decision within six months. There is no deadline if a construction certificate is sought under the CPCN statute itself. The PSC applies the same standards of review under both statutes.

Neither the CPCN statute – which is very general – nor the environmental surcharge statute speaks to the standards of review for construction certificates. Rather, those standards have evolved over time and largely within the legal context of other issues such as keeping rates as low as possible

The basic parameters are as follow:

- The applicant must show that a facility is needed. As I noted earlier, there is a presumption of compliance with environmental mandates, so utilities must show that a facility is necessary for such compliance. In general terms, need is considered to mean necessary for the provision of adequate, reliable and safe service.
- A utility must show that it has considered a range of reasonable options for meeting a need.
- Wasteful duplication of facilities is prohibited. This is to prevent overbuilding that drives up rates.

- The prohibition of wasteful duplication leads to the principle of “least cost” among reasonable options. That is to say, a utility should not only consider a range of reasonable alternatives, but – in doing so – should evaluate them over the projected lifetime of the facility. That means looking beyond simply the up-front costs of any given option and examining all options on an equal footing over the long term to determine which carries the lowest cost.
- Being able to evaluate a proposed facility from the perspective of its long-term cost is critical because, once the PSC grants a CPCN, that approval carries with it a presumption in favor of the utility’s future recovery of reasonable costs associated with the project.

Finally, I should note that the CPCN process applies only to the construction of new facilities or projects which result in substantial alteration or renovation of existing facilities. There is no equivalent process in statute for the retirement of facilities a utility deems no longer necessary or useful. However, if a utility chooses to close an old facility and replace it with a new one, the utility generally will need to obtain a CPCN for the new facility. In the course of that process, the PSC can require the utility to examine the option of keeping the old facility in use as an alternative to new construction.

That concludes my prepared remarks. I would be happy to answer whatever questions you may have.