COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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	)))))))	CASE NO. 2005-00068

O R D E R

On March 8, 2005, Kentucky Power Company ("Kentucky Power") filed an application, pursuant to KRS 278.183, seeking Commission approval of an amended environmental compliance plan and to amend its Environmental Surcharge ("E.S.") tariff. Kentucky Power states that the proposed amendments allow it to include the cost of pollution control projects that are required by the Clean Air Act[1] ("CAA") that are charged to it pursuant to Federal Energy Regulatory Commission ("FERC") approved agreements between Kentucky Power and affiliated American Electric Power, Inc. ("AEP") operating companies. Kentucky Power proposed that its amended E.S. tariff become effective for bills rendered on and after April 29, 2005.

On March 21, 2005, the Commission found that further proceedings were necessary to investigate the reasonableness of the proposed amendments to Kentucky

[1] As amended, 42 U.S.C.A. § 7401 *et seq*.

Power's compliance plan and E.S. tariff.[2] The Commission stated that until that determination was made, Kentucky Power's proposed E.S. tariff could not be implemented under KRS 278.183. A procedural schedule was established providing for the completion of this investigation within 6 months.

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"). A public hearing was held on July 28, 2005. All information requested at the public hearing has been filed, and the parties have submitted briefs.

BACKGROUND

Kentucky Power is a privately owned electric utility that generates, transmits, distributes, and sells electricity to approximately 174,700 customers in all or parts of 20 counties in eastern Kentucky. Kentucky Power is a wholly owned subsidiary of AEP.[3] Kentucky Power and four other AEP subsidiaries[4] make up the AEP Power Pool ("AEP Pool"). The AEP Interconnection Agreement, which created the AEP Pool, is a tariff that contains rates and terms of service for the wholesale sale of power and is subject

[2] Pursuant to KRS 278.183(2), the Commission has 6 months to complete its investigation and determine the reasonableness of a compliance plan and rate surcharge.

[3] As a subsidiary of AEP, Kentucky Power is a member of the integrated AEP System, an interstate public utility holding company system registered under the Public Utility Holding Company Act of 1935. Subsequent to its merger in 2000 with Central and South West Corporation, AEP has operations in Arkansas, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Tennessee, Texas, Virginia, and West Virginia.

[4] The subsidiaries are Appalachian Power Company ("Appalachian"), Columbus Southern Power Company ("Columbus Southern"), Indiana Michigan Power Company ("I&M"), and Ohio Power Company ("Ohio Power").

to regulation by FERC. The members of the AEP Pool share generating capacity and either make or receive capacity-related payments pursuant to FERC-approved rates. Kentucky Power owns two generating units at its Big Sandy Generating Station ("Big Sandy") in Louisa, Kentucky. It also receives power from I&M's Rockport Generating Station ("Rockport") pursuant to the Rockport Unit Power Agreement ("Rockport Agreement"). The Rockport Agreement is also subject to regulation by the FERC. Even with the Rockport capacity, Kentucky Power has less generating capacity than it is responsible for under the terms of the AEP Interconnection Agreement and is considered a deficit member of the AEP Pool. Thus, it is required to make capacity payments to the AEP Pool members that have more capacity than they are responsible for under the AEP Interconnection Agreement.[5]

KRS 278.183 provides that a utility shall be entitled to the current recovery of its costs of complying with the CAA as amended and those federal, state, or local environmental requirements that apply to coal combustion wastes and by-products from facilities utilized for the production of energy from coal. Pursuant to KRS 278.183(2), a utility seeking to recover its environmental compliance costs through an environmental surcharge must first submit to the Commission a plan that addresses compliance with the applicable environmental requirements. The plan must also include the utility's testimony concerning a reasonable return on compliance-related capital expenditures and a tariff addition containing the terms and conditions of the proposed surcharge

[5] Appalachian and Columbus Southern are also deficit members of the AEP Pool. I&M and Ohio Power are surplus members.

applied to individual rate classes. Within 6 months of submission, the Commission must conduct a hearing to:

> (a) Consider and approve the compliance plan and rate surcharge if the plan and rate surcharge are found reasonable and cost-effective for compliance with the applicable environmental requirements;
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> (b) Establish a reasonable return on compliance-related capital expenditures; and
>
> (c) Approve the application of the surcharge.

Kentucky Power's original compliance plan and environmental surcharge were approved by the Commission in 1997 in Case No. 1996-00489.[6] The original compliance plan ("1997 Plan") was comprised of five projects at Big Sandy involving low nitrogen oxide ("NOx") burners,[7] continuous emission monitors ("CEMs"), sulfur dioxide ("SO_2") emission allowances, Kentucky air emission fees, and three projects at

[6] 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.

[7] In its May 27, 1997 Order in Case No. 1996-00489, the Commission excluded the low NOx burners at Big Sandy Units 1 and 2 from the approved compliance plan. After the Commission denied rehearing, Kentucky Power appealed. In *Commonwealth of Kentucky ex rel. Chandler v. Kentucky Public Service Commission*, Nos. 97-CI-01138, 97-CI-01144, 97-CI-01319 (Ky. Franklin Cir. Ct. May 14, 1998), the Franklin Circuit Court reversed in part and directed the Commission to permit Kentucky Power's recovery of low NOx burner costs incurred after May 19, 1997. The Commission and the parties appealed to the Kentucky Court of Appeals. As part of a unanimous settlement in Case No. 1999-00149, the parties agreed to: (1) dismiss their appeals to the Kentucky Court of Appeals; and (2) allow Kentucky Power to recover through its environmental surcharge mechanism the costs associated with the Big Sandy Units 1 and 2 low NOx burners beginning January 1, 2000. See Case No. 1999-00149, Joint Application of Kentucky Power Company, American Electric Power Company, Inc. and Central and South West Corporation Regarding a Proposed Merger, final Order dated June 14, 1999.

generating stations owned by members of the AEP Pool.[8] The original E.S. tariff included a formula to calculate the retail monthly environmental surcharge net revenue requirement ("ES revenue requirement") and applicable monthly surcharge factor.[9] The authorized rate of return on environmental capital expenditures was Kentucky Power's overall rate of return on capital.[10] This authorized rate of return on environmental capital expenditures was applied to the compliance rate base for the Big Sandy capital expenditures.[11]

[8] The three projects are Kentucky Power's assigned portion of the costs for the installation of scrubbers at Ohio Power's Gavin Generating Station ("Gavin"), the installation of CEMs at Rockport, and the Indiana Air Emissions Fee for Rockport. The allocation of these costs to Kentucky Power is governed by the AEP Interconnection Agreement and the Rockport Agreement.

[9] Kentucky Power's surcharge mechanism compares a base period revenue requirement with a current period revenue requirement. Retired or replaced environmental compliance plant and associated expenses already included in existing rates are reflected in the determination of the base period revenue requirement, while the current cost of the approved compliance plan is reflected in the determination of the current period revenue requirement. The net of the base period and current period revenue requirement produces the ES revenue requirement. The ES revenue requirement is then divided by the Kentucky retail revenues for the current expense month. The current expense month is defined as the second month preceding the month in which the environmental surcharge is billed.

[10] The overall rate of return on capital was determined to be 9.178 percent, which included a rate of return on common equity of 11.50 percent. The overall rate of return reflected Kentucky Power's capital structure and cost rates as of December 31, 1999. The overall rate of return was grossed up to reflect the income tax effect resulting from the return on common equity. The gross-up factor reflects a composite uncollectible accounts factor, federal income tax rate, and state income tax rate. The gross-up rate of return on the Big Sandy compliance rate base was 12.35 percent.

[11] The Commission's authorized rate of return was not applied to the Gavin or Rockport projects. Any rate of return on the Gavin scrubbers is reflected in the charges governed by the AEP Interconnection Agreement. The rate of return on the Rockport CEMs was established by the provisions of the Rockport Agreement.

Kentucky Power's first amendment to its compliance plan and environmental surcharge was approved by the Commission in 2003 in Case No. 2002-00169.[12] The first amendment to the compliance plan ("2003 Plan") was comprised of four projects at Big Sandy involving the installation of an Over-Fire Air system ("OFA") to control NOx emissions at Unit 1, improvements to the electrostatic precipitator at Unit 2, the installation of Selective Catalytic Reduction equipment ("SCR") at Unit 2, an upgrade of the reverse osmosis water system at Unit 2, and NOx emission allowances. The existing E.S. tariff was amended to include the cost recovery for the 2003 Plan.[13]

[12] 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 Cost Recovery Surcharge Tariff, final Order dated March 31, 2003.

[13] The base period revenue requirement determination was expanded to recognize the return on retired utility plant and the removal of associated operating expenses relating to the 2003 Plan additions. The current period revenue requirement determination was expanded to include a return on the 2003 Plan projects and related operating expenses, a cash working capital allowance reflecting operation and maintenance expenses associated with the 1997 and 2003 Plans, and the net proceeds from the sale or transfer of NOx emission allowances. In addition, for purposes of the E.S. tariff, Total Company Revenues is defined as not including Non-Physical Revenues. In March 2004, Kentucky Power filed Case No. 2004-00081, seeking Commission approval to recover additional operating and maintenance ("O&M") expenses associated with the compliance projects approved in Case No. 2002-00169. Kentucky Power stated that the additional O&M expenses were not possible to identify during the processing of Case No. 2002-00169. The Commission's April 16, 2004 Order in Case No. 2004-00081 granted Kentucky Power's request. See Case No. 2004-00081, Motion of Kentucky Power Company d/b/a American Electric Power for Approval of Additional Operating Expenses Associated with Its Environmental Compliance Plan, final Order dated April 16, 2004.

Kentucky Power's overall rate of return on capital was continued as the authorized rate of return on the Big Sandy environmental capital expenditures.[14]

2005 COMPLIANCE PLAN

In its second amendment to its environmental compliance plan ("2005 Plan"), Kentucky Power is seeking to include its member load ratio share of environmental compliance costs associated with 53 projects located at Ohio Power and I&M generating stations.[15] Kentucky Power contends that the 53 projects relate to its, and AEP's, compliance with the CAA and other federal, state, or local environmental requirements that apply to coal combustion and by-products from facilities used to generate electricity from coal. The 53 projects are listed in Appendix A to this Order.[16] The environmental compliance costs Kentucky Power seeks to include in its environmental surcharge are determined under the provisions of the AEP Interconnection Agreement and the Rockport Agreement. Based on the provisions of those agreements, Kentucky Power estimated that the annual retail ES revenue

[14] The Commission included Kentucky Power's accounts receivable financing in the determination of the overall rate of return on capital, which was determined to be 7.46 percent. The overall rate of return on capital reflected Kentucky Power's capital structure and costs rates as of December 31, 2002. The Commission authorized a rate of return on common equity of 11.00 percent. Consistent with the approach used in Case No. 1996-00489, the overall rate of return was grossed up. The gross-up rate of return on the Big Sandy compliance rate base was 10.20 percent.

[15] Application at 3.

[16] Information shown in Appendix A is taken from McManus Direct Testimony, Exhibit JMM-1, as corrected at the July 28, 2005 hearing. See Transcript of Evidence ("T.E."), July 28, 2005, at 7-8.

requirement would increase approximately $1.9 million, an annual increase in retail revenue of 0.61 percent.[17]

In support of the 2005 Plan, Kentucky Power explained the steps taken by AEP to ensure that the environmental projects were undertaken in a reasonable and cost-effective manner. Kentucky Power described the optimization model used by AEP to evaluate the reasonableness and cost effectiveness of each project. Kentucky Power also provided the capital improvement requests ("CIs") submitted to AEP management for approval of the 2005 Plan projects. Kentucky Power stated that the CIs constitute the written evaluations made by the AEP Service Corporation after considering the results of the optimization model runs. Kentucky Power contended that this information has been presented to assure the Commission that AEP has adequately evaluated the projects for reasonableness and cost effectiveness.[18] The AG did not challenge the reasonableness or the cost effectiveness of the proposed 2005 Plan.

KIUC has challenged the inclusion of the 2005 Plan projects in Kentucky Power's environmental compliance plan. KIUC argued that Kentucky Power has failed the most basic requirement of KRS 278.183 by not submitting a compliance plan for Commission approval of Ohio Power's and I&M's environmental costs incurred in Ohio, Indiana, and West Virginia.[19] KIUC contended that the Commission cannot reasonably conclude in this case that the compliance actions by Ohio Power and I&M were or are reasonable and cost effective given that the Commission has never had jurisdiction over these

[17] Application at 5.

[18] Kentucky Power Brief at 12.

[19] KIUC Brief at 7.

projects or the decisions to proceed with them.[20] KIUC recommended that the proposed amendment to the environmental compliance plan be denied.

The appropriateness of Kentucky Power's inclusion of projects dealing with the mitigation of sulfur trioxide ("SO_3") emissions was also raised as an issue.[21] Kentucky Power acknowledged that there are statements contained in the CIs indicating there are no specific regulatory requirements for the emission of SO_3 and that the AEP companies were installing the SO_3 mitigation equipment in order to address community concerns arising from an SO_3 plume.[22] At the public hearing, Kentucky Power stated that while there were no emissions requirements for SO_3, the existence of this chemical can impact the plume that exits from the stack at a generating station. The measure of the visual appearance of the plume is known as opacity, and Kentucky Power contended that there are limits on the opacity of the plume.[23] In its brief, Kentucky Power quoted a journal article discussing the potential problems that could result if SO_3 emissions were not controlled. Kentucky Power further argued that SO_3 emissions are related to the operation of SCRs, and reasoned that since SCRs are required to meet

[20] Kollen Direct Testimony at 11.

[21] The CIs submitted by Kentucky Power identify projects at Cardinal Unit 1 and the Gavin Units as specifically dealing with SO_3 mitigation. The CIs also identify SO_3 mitigation costs at the Amos Unit 3 SCR project. There may be SO_3 mitigation costs included with the Muskingum River Unit 5 SCR project; however, the submitted CIs do not reference any SO_3 mitigation costs.

[22] Kentucky Power Brief, Attachment 2, pages 3 and 4 of 4.

[23] T.E., July 28, 2005, at 20-22.

the NOx limitations of the CAA, the SO_3 mitigation projects can be included in its environmental compliance plan.[24]

Based on the evidence of record and being otherwise sufficiently advised, the Commission finds that, with the exception of the SO_3 projects discussed below, Kentucky Power has submitted an environmental compliance plan that conforms to KRS 278.183. As a member of the AEP Pool, Kentucky Power purchases energy from the other pool members under the terms of the AEP Interconnection Agreement. Under the terms of that agreement, Kentucky Power is required to pay its member load ratio share of the cost of environmental projects installed by the surplus members of the AEP Pool.

In this case, Kentucky Power is proposing to amend its compliance plan to include the costs of the environmental projects that Kentucky Power is required to pay under the AEP Interconnection Agreement. Since that agreement is a FERC-approved rate, the judicial doctrine of federal preemption forecloses any inquiry here into the reasonableness of that rate or the costs recovered through that rate.

However, while Kentucky Power's costs under the AEP Interconnection Agreement must be accepted as reasonable for rate-making purposes, that does not mean that such costs must be accepted for recovery by environmental surcharge under KRS 278.183. To qualify under KRS 278.190 and 278.192 for rate recovery in a base or general rate case, a cost must be reasonable, and any cost incurred pursuant to a FERC rate is presumed to be reasonable. Thus, a FERC-approved rate cannot be disallowed as unreasonable. But to qualify under the restrictive provisions of

[24] Kentucky Power Brief at 13-14.

KRS 278.183 for environmental surcharge recovery, a cost must be "reasonable and cost-effective for compliance with the applicable environmental requirements." Thus, even though a FERC-approved rate is presumed to be reasonable, there is no presumption that such a rate is both reasonable and cost effective for complying with the environmental requirements listed in KRS 278.183. Kentucky Power must carry its burden to prove that a FERC-approved rate qualifies for environmental surcharge recovery.

The Commission has reviewed the information provided by Kentucky Power that addresses the need for the projects. Seven of the projects involved the installation of CEMs at various locations, and the documentation demonstrates that CEMs were the only alternative to comply with the CAA. One project involved the upgrade of the electrostatic precipitator controls at Tanners Creek Unit 4, and the evidence shows that no other feasible option was available for the Tanners Creek project. For the remaining projects, it appears that AEP does conduct some optimization modeling of compliance options, but does not document the results of that modeling in a manner similar to previous analyses Kentucky Power has filed with this Commission. A review of the CIs submitted for the projects does reveal that compliance alternatives have been noted by AEP's engineering staff. While the documented evaluation of the reasonableness and cost effectiveness of the projects in this case does not match the analyses Kentucky Power provided in its certificate application for a SCR at Big Sandy, the documentation does support a finding that the projects are reasonable and cost-effective means of controlling SO_2, SO_3, and NOx emissions.

However, the Commission is not persuaded by Kentucky Power's arguments linking the control of SO_3 with the need for SCRs. The CIs submitted by Kentucky Power clearly state that there are no regulations that limit SO_3 emissions, no regulatory issues associated with SO_3 mitigation, and no regulations specific to SO_3 emission levels. Although Kentucky Power claims that SO_3 must be controlled to avoid violating opacity limits, it has provided no evidence of what those opacity limits are or how SO_3 controls will enable the affected units to be in compliance with opacity limits. KRS 278.183(1) expressly limits the environmental compliance plan to projects used to comply with the CAA or other federal, state, or local environmental requirements that apply to coal combustion wastes and by-products from facilities utilized for production of energy from coal. Since Kentucky Power has not cited any environmental requirements dealing with SO_3 mitigation or emission limits, the Commission finds the SO_3 mitigation projects at Amos Unit 3, Cardinal Unit 1, and the Gavin Units cannot be included in Kentucky Power's environmental compliance plan. Further, if there are SO_3 mitigation costs included with the Muskingum River Unit 5 SCR project, the SO_3 mitigation costs must be excluded from Kentucky Power's environmental compliance plan. The only exception is for a project at the Phillip Sporn Generating Station that uses the injection of SO_3 to improve the performance of electrostatic precipitators to collect fly ash and allow compliance with existing particulate emission limits. As this project uses SO_3 to control particulate emissions that have established regulatory limits, the Commission finds that this project qualifies for inclusion in Kentucky Power's approved environmental compliance plan.

Therefore, the Commission finds that the projects proposed by Kentucky Power to be included in its environmental compliance plan should be approved, with the exception of projects relating to the mitigation of SO_3 emissions. The listing of projects shown in Appendix A to this Order includes an indication of the projects approved for inclusion in Kentucky Power's environmental compliance plan.

SURCHARGE MECHANISM AND CALCULATION

Costs Associated with the 2005 Plan

Kentucky Power has proposed to incorporate the costs associated with the 2005 Plan into the existing surcharge mechanism used for the 1997 and 2003 Plans. As noted previously in footnote 9, Kentucky Power's surcharge mechanism determines the ES revenue requirement by comparing the base period revenue requirement with the current period revenue requirement. Kentucky Power proposed to include its member load ratio share of environmental compliance costs charged to it under the AEP Interconnection Agreement and the Rockport Agreement.

Kentucky Power stated that because the costs to be recovered here are incurred in exactly the same manner as the Gavin scrubber costs recovered in its original surcharge, Case No. 1996-00489, it has relied upon the following language in the Commission's May 27, 1997 Order in that case:

> The Commission finds that federal preemption mandates our acceptance of the FERC jurisdictional agreements as reasonable. To the extent that environmental costs are part of the total costs Kentucky Power is allocated under the terms of these agreements, the costs must be accepted as reasonable. Contrary to KIUC's position, federal preemption is applicable and controls in this instance, not only for the allowance purchases required under the IAA, but also for the costs Kentucky Power is required to pay under the terms of the Rockport Unit Power Agreement and the Interconnection Agreement. Due to the application of federal preemption, the Commission is required to accept as reasonable the costs

> incurred under these FERC agreements. Consequently, all of the arguments presented by the AG and KIUC in opposition to the reasonableness of such costs are not appropriate for consideration by this Commission.[25]

KIUC argued that Kentucky Power has inappropriately attempted to disaggregate the FERC-approved rate pursuant to the AEP Interconnection Agreement into multiple separate, hypothetical rates reflecting the environmental costs associated with the 53 projects.[26] KIUC contended that the proper recovery mechanism for Kentucky Power's costs associated with the AEP Interconnection Agreement was a base rate case.[27] KIUC stated its belief that the Kentucky General Assembly never envisioned that KRS 278.183 would be used to allow a utility to establish an environmental surcharge based on facilities located outside of Kentucky.[28] KIUC further argued that the costs proposed for surcharge recovery in this case are not Kentucky Power's costs of compliance, but the costs of compliance of Ohio Power and I&M, and thus are not recoverable through the environmental surcharge.[29] Therefore, KIUC reasoned the costs cannot be included for environmental surcharge recovery.

In response to Kentucky Power's reliance on the Commission's decision in Case No. 1996-00489, KIUC claimed that recovering the Gavin scrubber costs through the environmental surcharge was permissible due to the provisions of the IAA, which

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[25] Case No. 1996-00489, May 27, 1997 Order at 16.

[26] Kollen Direct Testimony at 7-8.

[27] KIUC Brief at 4 and 7.

[28] Id. at 8-9.

[29] Id. at 8.

exclusively pertained to environmental costs and specifically to the Gavin scrubber. KIUC noted that the IAA does not apply to the costs Kentucky Power is seeking to recover through its surcharge in this case.[30] For all these reasons, KIUC recommended that the surcharge cost recovery be denied.

The AG contended the costs associated with the 2005 Plan were not Kentucky Power's cost of achieving environmental compliance for its own generation, and claimed that Kentucky Power's only cost of achieving compliance is limited to the generation over which it has control. Like KIUC, the AG argued that these specific compliance costs should be recovered through a future base rate case. The AG further argued that KRS 278.183 acts as an incentive mechanism that should not be diluted or turned into a windfall surcharge recovery by using an overbroad reading of what constitutes a utility's cost of compliance.[31]

Kentucky Power responded to KIUC's arguments by first rejecting the notion that it was attempting to disaggregate the FERC-approved rate under the AEP Interconnection Agreement. Kentucky Power stated that it relies on federal preemption to establish that the costs being incurred by it are reasonable for purposes of the environmental surcharge, a determination required by KRS 278.183. Kentucky Power noted that this position does not require the disaggregation of a preemptive FERC rate. Kentucky Power contended that the environmental compliance portion of the charges under the AEP Interconnection Agreement and the Rockport Agreement are its costs of

[30] Id. at 13-14.

[31] AG Brief at 1-4. As noted previously, the AG did not file testimony in this proceeding.

compliance as a member of the AEP Pool, and are recoverable through the environmental surcharge.[32]

The Commission has reviewed the positions of the parties and finds the arguments of KIUC and the AG are not persuasive. The environmental surcharge statute expressly authorizes a utility to recover by surcharge its costs of complying with specified environmental requirements. The statute does not restrict surcharge recovery to costs incurred at facilities owned by the utility or at facilities located in Kentucky. The language of the statute is unambiguous, and neither KIUC nor the AG have raised a claim to the contrary. Under these circumstances, it is not the Commission's role to determine legislative intent for purposes of interpreting an unambiguous statute.

Kentucky Power has identified the environmental compliance costs for the 2005 Plan projects charged to it under the provisions of the FERC-approved AEP Interconnection Agreement and Rockport Agreement. These are the costs for the 2005 Plan projects that Kentucky Power proposes to recover through its environmental surcharge. The Gavin scrubber costs, the Rockport CEMs, and Indiana air emission fees in the original environmental surcharge case were handled in the same manner. The costs identified here by Kentucky Power are eligible for surcharge recovery if they are shown to be reasonable and cost effective for complying with the environmental requirements specified in KRS 278.183.

The Commission notes that KIUC's argument concerning the treatment of the Gavin scrubber is a mischaracterization of the facts. The IAA addressed the Gavin SO_2 emissions, the Gavin SO_2 emission allowances, the allocation of SO_2 emission

[32] Kentucky Power Brief at 15-16.

allowances throughout the AEP system, and the compensation of companies for SO_2 emission allowances. It did not address the recovery of the costs of the Gavin scrubber. The Commission finds that the costs identified for the 2005 Plan projects, with the exception of the SO_3 mitigation projects, have been shown to be reasonable and cost effective for environmental compliance. Thus, they are reasonable and should be approved for recovery through Kentucky Power's environmental surcharge.

Margins on Allowances Consumed to Make Off-System Sales

When the members of the AEP Pool make power sales to a non-affiliate[33] that makes a cash settlement for the SO_2 emission allowances consumed to provide the power, the difference between the cost of the allowances consumed and the cash settlement, or margin, is allocated to the AEP Pool members. This treatment of allowances consumed when making off-system sales is set forth in Article 4.3 of the IAA, which states as follows:

> When allowances are consumed for power sales to foreign companies, the customer has the option of reimbursing the supplying company with allowances in kind, or paying cash for the allowances at the current market rate. If the customer reimburses in kind, the allowances shall be retained by the supplying Member (Member company that generated the energy and consumed the allowances); and a cash settlement shall be made to each Member based on its MLR-share[34] of the current value of the allowances received. If cash is received, in lieu of allowances, it shall be shared by each member based on its current MLR. The supplying Member's consumed cost of allowances for sale to foreign companies shall be allocated to each Member based on its current MLR. The method for determining the allowances consumed in generating the energy for

[33] These sales are commonly referred to as off-system sales.

[34] MLR is the Member Load Ratio, the basis for cost allocations within the AEP Pool.

POWER SALES TO FOREIGN COMPANIES is set forth in Appendix E to this Agreement.[35]

A similar process is followed for NOx allowances consumed in conjunction with an off-system sale; however, the NOx emission allowance transactions are not governed by the IAA.

Kentucky Power includes the margins from the consumed SO_2 and NOx allowances as part of the off-system sales margins included in its System Sales Clause. Under the provisions of Kentucky Power's System Sales Clause, all margins above the level established in Kentucky Power's last general rate case are shared on a 50/50 basis with ratepayers. Likewise, if the margins are below the level established in the last rate case, the deficit is shared 50/50 with ratepayers.

KIUC argued that when SO_2 emission allowances are consumed to make an off-system sale, the transaction is in effect an indirect sale of allowances.[36] KIUC contended that the margins allocated to Kentucky Power for the allowances consumed should be included as an offset in determining the environmental surcharge revenue requirement, rather than being reflected in the System Sales Clause.[37] KIUC argued that Kentucky Power is in violation of the Commission's Order in Case No. 1996-00489, and based its position on three statements from the Commission's May 27, 1997 Order in Case No. 1996-00489:

[35] KIUC Cross Exhibit No. 1, IAA, at 13-14.

[36] Kollen Direct Testimony at 16.

[37] KIUC Brief at 14-15 and 19.

4. The net gain or net loss resulting from emission allowance sales, either from the annual EPA auctions or those amounts allocated to Kentucky Power under the terms of the IAA.

* * *

In addition, any EPA auction proceeds and any net gains or net losses allocated Kentucky Power under the IAA will be included as offsets to the current period revenue requirement in the month received by Kentucky Power.

* * *

AS = Net Gain or Net Loss resulting from Emission Allowance Sales, from either EPA Auctions or IAA Allocations, reflected in the month of receipt.[38]

KIUC also contended that NOx allowances consumed to make off-system sales constituted indirect sales of those allowances. Based on this reasoning, KIUC argued that Kentucky Power is in violation of the Commission's March 31, 2003 Order in Case No. 2002-00169, citing the following statement:

> The net proceeds from any sale or transfer of NOx allowances should be included in the appropriate environmental surcharge monthly report as an offset to that month's current period revenue requirement.[39]

KIUC noted that if Kentucky Power's violations of Commission Orders were corrected, the allowance margins would no longer be reflected in the System Sales Clause. Although KIUC originally advocated that these violations should be corrected prospectively only, its brief argued that all of the margins received since the completion of the last 2-year surcharge review should be refunded to ratepayers.[40]

[38] Case No. 1996-00489, May 27, 1997 Order at 27-28 and Appendix A, page 2.

[39] Case No. 2002-00169, March 31, 2003 Order at 14.

[40] KIUC Brief at 19-20.

Kentucky Power argued during this case that KRS 278.183 provides for a hearing on the compliance plan submitted by the utility, and does not provide that an intervenor can "inject issues unrelated to the plan presented by the utility."[41] While noting that the treatment of margins on allowance sales was not included in its application, Kentucky Power responded to the merits of KIUC's position by arguing that the Commission's statements in the May 27, 1997 Order referred only to sales of SO_2 allowances, not the consumption of allowances in conjunction with off-system sales. Kentucky Power contended that this has been its consistent position during the 8 years its environmental surcharge has been in operation, and that it has not tried to hide this position. Kentucky Power argued that the consumption of SO_2 and NOx allowances does not constitute an indirect sale of those allowances; rather, the allowances are used up and are not available for use by the non-affiliate power purchaser.[42] Based on these arguments, Kentucky Power contended that the System Sales Clause is the appropriate means to share these margins with ratepayers.

The Commission believes this issue is appropriate for consideration in this case, as Kentucky Power is proposing to amend its existing environmental surcharge mechanism. The recognition and treatment of allowance sale proceeds is a component of the current surcharge mechanism.

Consequently, the Commission has carefully reviewed the language in the IAA and the two previous Commission Orders. First, the Commission does not agree with KIUC that the consumption of SO_2 and NOx emission allowances in conjunction with

[41] Kentucky Power Brief at 19.

[42] Id. at 20-23.

off-system sales constitutes an indirect sale of those allowances. The allowances are used up, not transferred to the power purchaser for use at a later date. Thus, these transactions are not sales, either direct or indirect. Second, all the cited statements from the Commission's previous Orders, except one, clearly state that the net gains or net losses from the "sale" or "sale or transfer" of emission allowances shall be included as offsets to the current period environmental revenue requirement. The only exception appears in the May 27, 1997 Order:

> Under the terms of the IAA and the annual EPA emission allowance auctions, Kentucky Power has received $2,319,057 in allowance sale proceeds. As the Commission has included a return on the allowance inventory, it is appropriate to return these net sales proceeds to ratepayers as an offset in the surcharge mechanism. The Commission finds it is appropriate to return these proceeds over a 12-month period. Therefore, each of the first 12 surcharge filings will include a reduction to the current period revenue requirement of $193,255. In addition, any EPA auction proceeds and any net gains or net losses allocated to Kentucky Power under the IAA will be included as offsets to the current period revenue requirement in the month received by Kentucky Power.[43]

The Commission notes that the context of this quote is the treatment of SO_2 allowance sale proceeds resulting from previous Environmental Protection Agency annual auctions of SO_2 allowances. The quote does not refer to the situation described in Article 4.3 of the IAA. Based upon our review, the Commission finds that the consumption of SO_2 and NOx emission allowances to make an off-system sale does not constitute an indirect sale of the allowances by Kentucky Power. The Commission further finds that Kentucky Power has complied with the provisions of the Commission's previous environmental surcharge Orders concerning the treatment of SO_2 and NOx emission allowance sale proceeds. Consequently, KIUC's recommendation should be rejected

[43] Case No. 1996-00489, May 27, 1997 Order at 27-28, with footnotes omitted.

and the margins on allowances consumed to make off-system sales should continue to be reflected in the System Sales Clause calculations.

Qualifying Costs

As noted previously, Kentucky Power's environmental surcharge mechanism determines the ES revenue requirement by comparing a base period revenue requirement with a current period revenue requirement. The qualifying costs included in Kentucky Power's base period revenue requirement will be the same as described in the Commission's March 31, 2003 Order in Case No. 2002-00169, plus the recognition of the net investment for the Rockport Unit 1 original burners as of December 1990.[44] The qualifying costs included in the current period revenue requirement will reflect the Commission-approved environmental projects from Kentucky Power's 1997, 2003, and 2005 Plans. Should Kentucky Power desire to include other environmental projects in the future, it will have to apply for an amendment to its approved compliance plans.

Rate of Return

Kentucky Power did not request a rate of return on the 2005 Plan projects, but sought only the recovery of the environmental costs it incurred to comply with the CAA as a result of the costs its incurs under the AEP Interconnection Agreement and the Rockport Agreement.[45] KIUC stated that Kentucky Power did not propose a rate of return on the 2005 Plan projects because the rate of return had already been set by FERC through the AEP Interconnection Agreement and the Rockport Agreement. KIUC

[44] Response to the Commission Staff's Second Data Request dated April 18, 2005, Item 12.

[45] Wagner Direct Testimony at 12.

argued that because the Commission could not determine a reasonable rate of return on the 2005 Plan projects, the proposed costs could not be included in the environmental surcharge under KRS 278.183.[46] Kentucky Power responded that the Commission had previously properly recognized the Gavin scrubber costs and Rockport CEM costs in its original surcharge mechanism without determining a rate of return on those projects. Kentucky Power argued that its proposed 2005 Plan cost recovery reflected the same kinds of costs and should be approved.[47]

The Commission is not persuaded by KIUC's arguments. As previously noted in this Order, the Commission addressed the role of federal preemption in Case No. 1996-00489. KIUC has offered no evidence to justify a different conclusion here. The Commission has determined above that the 2005 Plan costs qualify for recovery in Kentucky Power's environmental surcharge.[48] Therefore, the Commission will not set a rate of return for the 2005 Plan projects. The rate of return authorized on the 1997 and 2003 Plan projects will remain unchanged.

Calculation of Gross-Up Factor for Rate of Return

KIUC proposed that two recent changes relating to tax law should be reflected in the gross-up factor used in Kentucky Power's environmental surcharge mechanism. First, KIUC argued that a new deduction resulting from the American Jobs Creation Act of 2004 should be recognized. This deduction, referred to as Section 199 of the Internal

[46] KIUC Brief at 8.

[47] Kentucky Power Brief at 16-17.

[48] As noted previously, the approved 2005 Plan costs exclude any costs associated with SO_3 mitigation projects.

Revenue Code ("Section 199"), is a phased-in deduction starting at 3 percent for 2005 and 2006, increasing to 6 percent for 2007 through 2009, and 9 percent after 2010. KIUC contended this change would apply to the current period rate of return calculations for the rate base for both Big Sandy and Rockport.[49] Second, KIUC argued that the reduction in the Kentucky corporate income tax, House Bill 272 from the 2005 Regular Session of the General Assembly, should also be recognized. The Kentucky corporate income tax rate is lowered from 8.25 percent to 7.00 percent for 2005 and 2006, and lowered to 6 percent in 2007.[50] KIUC stated this change would only be applicable in the Big Sandy rate of return calculations. KIUC noted that both tax law changes were reflected in the Commission's decisions earlier this year in environmental surcharge cases for Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU").[51]

Kentucky Power contended that this issue could not be addressed in this proceeding, as the issue of changes in tax law was not included in its application. While not waiving this argument, Kentucky Power opposed KIUC's recommendations. Kentucky Power argued that the Section 199 provision is a tax deduction, not a tax rate reduction, and there is no basis for treating this deduction any differently than the treatment of tax deductions for labor costs, depreciation, or property taxes.[52] Kentucky Power contended that KIUC has over-simplified the effects of House Bill 272, as

[49] Kollen Direct Testimony at 31.

[50] Id. at 32.

[51] KIUC Brief at 22.

[52] Kentucky Power Brief at 24.

Kentucky Power and the other AEP companies will have to file a consolidated Kentucky income tax return, which could result in a higher effective income tax rate for Kentucky Power than 7.00 percent.[53] Kentucky Power also argued that whatever LG&E and KU agreed to in their surcharge cases has no precedential effect in this case, as it had offered expert testimony explaining why KIUC's arguments were wrong.[54] As an alternative, Kentucky Power introduced the suggestion that the effects of the changes in federal and state income tax laws should be incorporated into a line item for estimated income tax expense in the surcharge revenue requirements calculation.[55]

In order to reflect the income tax effect of the rate of return on capital authorized for the 1997 and 2003 Plans in Kentucky Power's environmental surcharge, a gross-up factor is applied to the common equity component of the rate of return on capital. This gross-up factor approximates the income tax effect on the additional revenues generated by the environmental surcharge. It is not designed to exactly match the actual income tax calculations Kentucky Power makes annually when it prepares its federal and state income tax returns.

The Commission finds that this issue is appropriate for consideration in this case. The gross-up factor is a component of Kentucky Power's existing environmental surcharge mechanism which it now seeks to amend. The Commission believes the arguments offered by KIUC on this issue are persuasive and reasonable. As acknowledged by Kentucky Power, the Section 199 tax deduction is determined on an

[53] Kelley Rebuttal Testimony at 10-11.

[54] Kentucky Power Brief at 24.

[55] Id. at 26.

annual basis and is based upon the taxpayer's annual facts and circumstances. The deduction itself is calculated by first determining the taxpayer's qualified production activity income and then applying the Section 199 deduction percentage to that income.[56] Thus, contrary to the claims of Kentucky Power, the Section 199 deduction is not the same as tax deductions for labor costs, depreciation, or property taxes.

The Commission notes that neither Kentucky Power's past environmental surcharge applications, nor its present application, included a proposal to recognize the effects of tax laws or the effective income tax rates as a line item in the surcharge revenue requirement determination. While noting in its rebuttal testimony in this case that certain tax effects should be reflected in the surcharge filings, Kentucky Power did not provide a specific proposal to accomplish this. By offering this suggestion in its brief, Kentucky Power has prevented the parties from conducting any discovery or otherwise investigating the reasonableness of the suggestion.

The Commission disagrees with Kentucky Power's contention that the decisions in the LG&E and KU environmental surcharge cases should not be considered when making the decision on the same issue in this case. While the Commission has attempted to recognize unique differences among the utilities that have adopted environmental surcharges, we believe it is reasonable to be consistent in the application of surcharge components such as the tax gross-up factor.

Therefore, the Commission finds the effects of the changes in the federal and state income tax statutes should be recognized and reflected in the gross-up factor. KIUC's proposal provides for a convenient and clear means to reflect these tax law

[56] Kelley Rebuttal Testimony at 3.

changes. Appendix B of this Order reflects the Commission's determination of the revised gross-up factor. Kentucky Power should be required to use this factor with the first monthly surcharge filing submitted after the date of this Order.

The revised gross-up factor will be applied only to the rate of return calculations for Big Sandy's environmental surcharge rate base. The Commission does not agree with KIUC that the Section 199 impact should be applied to the rate of return for the Rockport rate base. While KIUC has stated that the Rockport Agreement is a cost-based tariff, it has not shown that the Rockport Agreement would recognize the effect of the Section 199 deduction. Consequently, the rate of return applied to the Rockport rate base should not be adjusted to reflect the Section 199 deduction.

Surcharge Formulas

The inclusion of the 2005 Plan into Kentucky Power's existing surcharge mechanism will not result in changes to the surcharge formulas. However, the description of the items included in the components of the formulas will change. The Commission finds that the formulas used to determine the ES revenue requirement as proposed by Kentucky Power[57] should be approved, subject to the exclusion of SO_3 mitigation projects discussed previously in this Order.

Reporting Formats

The inclusion of the 2005 Plan into the existing surcharge mechanism will require modifications to the monthly environmental surcharge reporting formats. Kentucky

[57] Application, Exhibit 3.

Power provided revised formats in response to a data request.[58] The Commission finds that Kentucky Power's revised monthly environmental surcharge reporting formats should be approved, subject to the exclusion of the SO_3 mitigation projects discussed previously in this Order.

SURCHARGE ALLOCATION

No party to this case proposed to change the allocation of the environmental surcharge, which is now based on total revenues. This allocation was found to be reasonable by the Commission in Case No. 2002-00169 and it should continue to be used for Kentucky Power's environmental surcharge.

TARIFF EFFECTIVE DATE

Kentucky Power proposed that its amended E.S. tariff should become effective for bills rendered on and after April 29, 2005. As noted previously in this Order, the Commission's March 21, 2005 Order rejected this effective date, as KRS 278.183(2) provides that the Commission has 6 months to review and approve environmental surcharge compliance plans and surcharge mechanisms. The Commission finds that the E.S. tariff, as discussed and modified in this Order, should become effective for service rendered on and after the date of this Order. The Commission will not make the revised E.S. tariff effective for bills rendered on and after the date of this Order because doing so would result in retroactive rate-making by requiring customers to pay for increases in environmental costs prior to the approval of those increases.

[58] Response to the Commission Staff's Second Data Request dated April 18, 2005, Item 12.

OTHER ISSUES

On August 5, 2005, Kentucky Power filed a petition for confidential treatment of a post-hearing data response that included a strategy and policy document discussing the effect of the AEP NOx compliance plan on AEP's unregulated generation fleet in Ohio and West Virginia. Neither KIUC nor the AG has filed comments on the requested confidential treatment. The Commission will grant the petition for confidential treatment.

IT IS THEREFORE ORDERED that:

1. Kentucky Power's 2005 Plan, as modified herein to exclude the SO_3 mitigation projects as discussed in the above findings, is approved.

2. Kentucky Power's E.S. tariff as modified herein is approved for service rendered on and after the date of this Order.

3. Kentucky Power's proposed E.S. tariff is denied.

4. KIUC's proposal to recognize the margins on SO_2 and NOx emission allowances consumed in conjunction with off-system sales in Kentucky Power's environmental surcharge is rejected.

5. The base period and current period revenue requirements shall be calculated using the formulas described in this Order.

6. The reporting formats described in this Order shall be used for each Kentucky Power monthly surcharge filing. Previous reporting formats shall no longer be submitted.

7. Kentucky Power shall use the income tax gross-up factor included in Appendix B, which is attached hereto and incorporated herein, when determining the return on the Big Sandy environmental compliance rate base.

8. Kentucky Power's August 5, 2005 petition for confidentiality is granted.

9. Within 10 days of the date of this Order, Kentucky Power shall file with the Commission revised tariff sheets setting out the E.S. tariff as modified and approved herein.

Done at Frankfort, Kentucky, this 7th day of September, 2005.

By the Commission

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2005-00068 DATED September 7, 2005

SCHEDULE OF ENVIRONMENTAL PROJECTS PROPOSED AND APPROVED FOR INCLUSION IN KENTUCKY POWER COMPANY'S ENVIRONMENTAL COMPLIANCE PLAN		
COMPANY and GENERATING UNIT	PROJECT DESCRIPTION	APPROVED FOR INCLUSION
Ohio Power – Amos	Unit 3 – CEMs	Yes
	Unit 3 – Low NOx Burners	Yes
	Unit 3 – SCR	Yes, except for SO_3 Mitigation System
Ohio Power – Cardinal	Unit 1 – CEMs	Yes
	Unit 1 – Low NOx Burners	Yes
	Unit 1 – SCR and Associated SO_3 Mitigation System	SCR – Yes SO_3 Mitigation System – No
Ohio Power – Gavin	Unit 1 – Low NOx Burners	Yes
	Unit 1 – SCR Catalyst Replacement	Yes
	Unit 2 – Low NOx Burners	Yes
	Common – SCR Associated SO_3 Mitigation System	No
Ohio Power – Kammer	Unit 1 – OFA and Duct Modification	Yes
	Unit 2 – OFA and Duct Modification	Yes
	Unit 3 – OFA and Duct Modification	Yes
	Common – CEMs	Yes
Ohio Power – Mitchell	Unit 1 – Low NOx Burners	Yes
	Unit 1 – Water Injection and Low NOx Burner Modification	Yes
	Unit 2 – Low NOx Burners	Yes
	Unit 2 – Low NOx Burners Modifications	Yes

SCHEDULE OF ENVIRONMENTAL PROJECTS PROPOSED AND APPROVED FOR INCLUSION IN KENTUCKY POWER COMPANY'S ENVIRONMENTAL COMPLIANCE PLAN		
COMPANY and GENERATING UNIT	PROJECT DESCRIPTION	APPROVED FOR INCLUSION
Ohio Power – Mitchell (continued)	Common – CEMs	Yes
	Common – Replace Burner Barrier Valves	Yes
Ohio Power – Muskingum River	Unit 1 – Low NOx Ductwork and OFA	Yes
	Unit 1 – OFA Modification and Water Injection	Yes
	Unit 1 – Water Injection Modification	Yes
	Unit 2 – Low NOx Ductwork and OFA	Yes
	Unit 2 – OFA Modification and Water Injection	Yes
	Unit 3 – OFA	Yes
	Unit 3 – OFA Modification	Yes
	Unit 3 – NOx Instrumentation	Yes
	Unit 4 – OFA	Yes
	Unit 4 – OFA Modification	Yes
	Unit 5 – Low NOx Burners	Yes
	Unit 5 – Low NOx Burner Modification and Weld Overlays	Yes
	Unit 5 – SCR	Yes, except for any SO_3 Mitigation System
	Common – CEMs	Yes
Ohio Power – Phillip Sporn	Unit 2 – Low NOx Burners	Yes
	Unit 2 – Low NOx Burner Modifications	Yes
	Unit 4 – Low NOx Burners and Modulating Injection Air	Yes
	Unit 4 – Low NOx Burner Modifications	Yes

SCHEDULE OF ENVIRONMENTAL PROJECTS PROPOSED AND APPROVED FOR INCLUSION IN KENTUCKY POWER COMPANY'S ENVIRONMENTAL COMPLIANCE PLAN		
COMPANY and GENERATING UNIT	PROJECT DESCRIPTION	APPROVED FOR INCLUSION
Ohio Power – Phillip Sporn (continued)	Unit 5 – Low NOx Burners and Modulating Injection Air	Yes
	Common – SO_3 Injection System	Yes
	Common – CEMs	Yes
I&M – Rockport	Unit 1 – Low NOx Burners and OFA	Yes
	Unit 2 – Low NOx Burners and OFA	Yes
I&M – Tanners Creek	Unit 1 – Low NOx Burners	Yes
	Unit 1 – Low NOx Burners Modifications	Yes
	Unit 1 – Low NOx Burner Leg Replacement	Yes
	Unit 2 – Low NOx Burners	Yes
	Unit 2 – Water Injection	Yes
	Unit 3 – Low NOx Burners	Yes
	Unit 3 – Low NOx Burner Modification	Yes
	Unit 4 – OFA and Low NOx Burners	Yes
	Unit 4 – Electrostatic Precipitator Controls Upgrade	Yes
	Common – CEMs	Yes

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2005-00068 DATED September 7, 2005

Determination of Gross-Up Factor

The income tax gross-up factor to be applied to the rate of return for the Big Sandy environmental rate base is as follows:

1. Pre-tax Production Income	100.0000
2. Uncollectible Accounts Expense (0.20%)	0.2000
3. State Taxable Production Income before § 199 Deduction	99.8000
4. State Income Tax Expense, Net of § 199 Deduction (see below)	6.7907
5. Federal Taxable Production Income before § 199 Deduction	93.0093
6. § 199 Deduction Phase-In	2.7903
7. Federal Taxable Production Income	90.2190
8. Federal Income Tax Expense After § 199 Deduction (35%)	31.5767
9. After-tax Production Income	58.6423
10. Gross-Up Factor for Production Income:	
11. After-tax Production Income	58.6423
12. § 199 Deduction Phase-In	2.7903
13. Uncollectible Accounts Expense	0.2000
14. Total Gross-Up Factor for Production Income (rounded)	61.6326
15. Blended Federal and State Tax Rate:	
16. Federal (line 8)	31.5767
17. State (line 4)	6.7907
18. Blended Tax Rate	38.3674
19. Gross Revenue Conversion Factor (100.00 / line 14)	1.6225

State Income Tax Calculation:

1. Pre-tax Production Income	100.0000
2. Uncollectible Accounts Expense (0.20%)	0.2000
3. State Taxable Production Income before § 199 Deduction	99.8000
4. Less: State § 199 Deduction	2.7903
5. State Taxable Production Income	97.0097
6. State Income Tax Rate	7.0000
7. State Income Tax Expense (line 5 x line 6)	6.7907