

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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MAR 09 2004

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)

**PUBLIC SERVICE
COMMISSION**

CASE NO. 2002-00169

* * * * *

MOTION TO APPROVE ADDITIONAL OPERATING EXPENSES

Kentucky Power Company d/b/a American Electric Power (“Kentucky Power”) moves the Commission, for an Order approving all O&M expenses associated with the approved capital projects in Kentucky Power’s approved environmental compliance plan subject to reconsideration in the next six month review pursuant to KRS 278.183(3). In support of this motion the movant states as follows:

On September 30, 2002 Kentucky Power filed an application, pursuant to KRS 278.183, seeking Commission approval of an amended environmental compliance plan containing new capital projects required to meet requirements of the Federal Clean Air Act. The amended compliance plan (“2003 Plan”) included projects contained in the existing 1997 Plan and the following additional projects:

- 1) Installation of Over-Fire Air with Water Injection and Boiler Tube Overlays at Big Sandy Unit 1.
- 2) Precipitator improvements at Big Sandy Unit 2.
- 3) Installation of Selective Catalytic Reduction equipment (“SCR”) at Big Sandy Unit 2.

- 4) Upgrade the existing Reverse Osmosis (“RO”) Water System, which is needed in conjunction with the installation of the SCR.
- 5) A return on NO_x Allowances purchased by Kentucky Power.

After discovery and a formal hearing, the Commission issued an order on March 31, 2003 (“March Order”) approving the requested projects in full except for the RO Water System. In its March 2003 Order, the Commission noted that “[w]ith the exception of the upgrade to the RO Water system, Kentucky Power proposed to include 100 percent of the capital expenditures and operating expenses associated with the 2003 Plan.” March Order at 15. In regard to the requested operation and maintenance expenses, the Commission further stated in its March Order:

Operating expenses associated with the 2003 Plan that will include the monthly depreciation expense, monthly property tax expense, and monthly non-fuel operation and maintenance (“O&M”) expense. Kentucky Power will only recover those operating expenses identified in this proceeding. Kentucky Power will have to seek Commission approval to recover any other operating expenses associated with the 2003 Plan that have not been identified in this proceeding.

March Order at 20.

In response to the Commission Staff’s First Data Request Kentucky Power had identified its monthly non-fuel O&M expenses as the variable cost for on-going cladding at the Big Sandy Unit 1 over-fire air project and the urea consumption and catalyst replacement at Big Sandy Unit 2 as well as the cost of NO_x emission allowances consumed as part of its O&M expenses associated with the 2003 Plan. See March Order fn32.

The environmental surcharge statute, KRS 278.183, provides for current recovery of a utility’s costs of complying with the Federal Clean Air Act, including operating expenses which by statute include “all costs of operating and maintaining environmental facilities”. Thus, because it was impossible at the time of the formal hearing to identify all future categories of

operation and maintenance expenses, Kentucky Power believed that the Commission would review and approve new categories of operation and maintenance expenses associated with elements of the approved environmental compliance plan as they arose and were incurred subject to further review at the six month proceeding. Accordingly, in the cover letter to its January 2004 Environmental Surcharge Report, Kentucky Power advised the Commission that it had incurred equipment operation and maintenance costs in the amount of \$22,324 which were not associated with the O&M categories previously identified in earlier filings and had therefore added a line to the ES Form 3.10 to reflect those additional costs. Kentucky Power explained that these O&M costs “are only associated with the environmental facilities included in the environmental surcharge.” See Exhibit A hereto. Kentucky Power believed this approach to be consistent with its surcharge tariff, as approved by the Commission, which states: “The Operating Expenses for both Kentucky Power and Rockport should reflect the current operating expenses associated with the 1997 Plan and the 2003 Plan.” See Exhibit B hereto at paragraph 4 (“Current Period Revenue Requirement, CRR”).

By letter dated February 25, 2004, the Commission’s Executive Director responded, citing page 20 of the March Order, that “AEP cannot include the Equipment Operation and Maintenance costs in its monthly surcharge reports and cannot recover these costs through the surcharge at the present time.” See Exhibit C hereto. As support for its determination that the Equipment O&M costs cannot presently be recovered, the letter stated:

Pursuant to KRS 278.183, a utility is entitled to recover by surcharge only those environmental compliance costs set forth in a compliance plan that has been approved by the Commission. Until such time as this category of operation and maintenance costs have been included in an amended compliance plan and approved by the Commission, no surcharge recovery is permissible.

Exhibit C at 2.

Kentucky Power believes the conclusion that a utility cannot recover O&M expenses associated with the capital components of an approved plan unless they are pre-approved by the Commission in the initial proceeding for approving the plan is not in accord with the statute. It appears the Commission has read the statute as requiring the company's plan to address all conceivable components of O&M, rather than compliance-related capital expenditures, in order for the utility to be able to recover, on a current basis, its O&M costs. The statute, however, does not require that the plan include all possible O&M expenses or that the Commission give prior approval for such expenses. Rather, the statute provides that the utility must submit an environmental compliance plan for Commission approval and that "plan shall include the utility's testimony concerning a reasonable return on compliance related capital expenditures and a tariff addition containing the terms and conditions of a proposed surcharge as applied to individual rate classes." KRS 278.183(2). The Commission must then "[c]onsider and approve the plan and rate surcharge ..." *Id.* The statute further states in subsection 1, that subject to the requirements of subsection 2 (*i.e.* the approval of the plan containing the capital expenditures), the utility is entitled to current recovery of its environmental compliance costs, including "reasonable operating expenses." Operating expenses are defined to include "*all costs of operating and maintaining environmental facilities. ...*" KRS 278.183(1) (emphasis added).

Kentucky Power believes, therefore, that the statute unambiguously entitles it to recover all O&M expenses associated with the capital components of an approved environmental compliance plan. Because the Clean Air Act requirements involve the installation of brand new technology such as the SCR, the O&M associated with such technology cannot be specifically identified and categorized when the plan is approved, *i.e.* before construction and operation. Moreover, because the technology is so new, the O&M expenses may be substantial.

Accordingly, it is imperative that the Commission and Kentucky Power resolve any misunderstandings as to how the O&M costs are to be recovered.

Additionally, Kentucky Power has not been able to ascertain whether the Commission will consider in the six-month proceeding O&M costs that could not be identified in the initial surcharge approval proceeding. Kentucky Power believes it would be reasonable to allow the costs to be included as they are incurred subject to review and approval or disallowance as a part of the six-month review. Kentucky Power is also concerned because in the past the Commission has taken the position that cost recovery pursuant to KRS 278.183 will not be allowed on a retrospective basis. Thus, Kentucky Power is concerned that even if the Commission were to find that O&M costs in new categories were necessary and reasonable, it would only allow recovery of similar costs going forward and would disallow the same kinds of costs that were incurred between the initial proceeding and the six-month review. This problem is exacerbated by the fact that the six-month reviews have not been held for the amended plan.

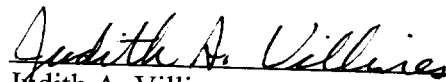
Because Kentucky Power expects to be incurring substantial equipment maintenance costs associated with the SCRs that are required by the Federal Clean Air Act, and because there is uncertainty whether it will be allowed to recover those costs unless the Commission gives prior approval for such costs, Kentucky Power seeks to clarify this matter. Accordingly, Kentucky Power seeks an order directing the following:

1. Approval of all immediate recovery through Kentucky Power's environmental surcharge for operating costs associated with the capital projects contained in the environmental compliance plan that has been approved by the Commission subject to review and adjustment in accordance with KRS 278.183(3) at the six month review.

2. Alternatively, written confirmation that all O&M costs will be considered in an expedited six-month review proceeding and all costs in approved categories can be recovered even if incurred prior to the order in the six month proceeding.

Because of the exigency of the circumstances, Kentucky Power further requests an immediate informal conference to discuss these issues and expedited scheduling of the six-month review proceeding.

Respectfully submitted,



Judith A. Villines

Bruce F. Clark

STITES & HARBISON PLLC

421 West Main Street

P.O. Box 634

Frankfort, Kentucky 40602-0634

Telephone: 502-223-3477

COUNSEL FOR:

KENTUCKY POWER COMPANY d/b/a

AMERICAN ELECTRIC POWER

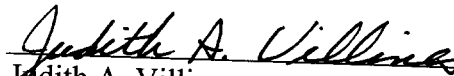
CERTIFICATE OF SERVICE

I hereby certify that a true and accurate copy of the foregoing Motion to Approve Additional Operating Expenses was served by United States First Class Mail, postage prepaid, upon:

Elizabeth E. Blackford
Kentucky Attorney General
1024 Capital Center Drive
P.O. Box 2000
Frankfort, Kentucky 40602-2000

Micahel L. Kurtz
Boehm, Kurtz & Lowry
2110 CBLD Center
36 East 7th Street
Cincinnati, Ohio 45202

on this the 9th day of March, 2004



Judith A. Villines

American Electric Power
101A Enterprise Drive
PO Box 5190
Frankfort, KY 40602-5190
www.aep.com



Thomas M. Dorman, Executive Director
Attn.: Isaac S. Scott
Public Service Commission
P. O. Box 615
211 Sower Boulevard
Frankfort, KY 40602

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FEB 20 2004

PUBLIC SERVICE
COMMISSION

February 20, 2004

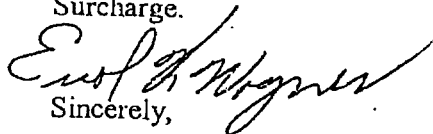
Re: Monthly Environmental Surcharge Report

Dear Mr. Dorman:

Pursuant to KRS 278.183(3), American Electric Power files herewith an original and five copies of its Environmental Surcharge Report for the month of January 2004. The report is in compliance with the Commission's Order dated March 31, 2003 in Case No. 2002-00169. The report shows the calculation and supporting documentation of American Electric Power's Environmental Surcharge Factor that will be billed with service on and after March 1, 2004.

The Withdrawals section of ES FORM 3.11 - SO₂ Emissions Allowances – Adjustments includes an adjustment of 34,941 emission allowances. The Company did a comparison of the emission allowances from the EPA's website verses the number of emission allowances in the AEP records and found an out of balance condition as to the quantity. The Company adjusted the quantity to reflect what EPA had for Kentucky Power. The review also determined that the dollar values were correct and should not be changed. The change in quantity thus results in a change in average unit cost.

Also, a line was added on ES FORM 3.10 for the Monthly Environmental Equipment Operation and Maintenance Costs (See LINE NO 18) that are not part of any operation and maintenance cost already being filed. These operation and maintenance costs are only associated with the environmental facilities included in the Environmental Surcharge.


Sincerely,

Errol K. Wagner
Director Regulatory Services

AEP: America's Energy Partner®

ENVIRONMENTAL SURCHARGE (E.S.)

RATE (Cont'd)

The Rate of Return for Kentucky Power is a weighted average cost of capital calculation, reflecting the cost of debt as of December 31, 1990 and the rate of return on common equity authorized in Case No. 1996-00489. The Kentucky Power component in the Base Period Revenue Requirement is a result of the adoption of the settlement agreement in Case No. 1999-00149. As Kentucky Power's last general rate case had been settled, Kentucky Power proposed and the Commission accepted the use of the rate of return on common equity established in Case No. 1996-00489.

(T)

The Rate of Return for Rockport should reflect the requirements of the Rockport Unit Power Agreement.

The Base Period Revenue Requirement will remain fixed until either a) a 2-year review case results in the roll-in of the surcharge into existing base rates, or b) further retirements or replacements of pollution control utility plant occur due to the installation of new pollution control utility plant associated with the approved compliance plan.

4. Current Period Revenue Requirement, CRR

(T)

$$CRR = ((RB_{KP(C)}) (ROR_{KP(C)}) / 12) + OE_{KP(C)} + (((RB_{RM(C)}) (ROR_{RM(C)}) / 12) + OE_{RM(C)}) (.15) - AS$$

Where:

- RB_{KP(C)} = Environmental Compliance Rate Base for Big Sandy.
- ROR_{KP(C)} = Annual Rate of Return on Big Sandy Rate Base; Annual Rate divided by 12 to restate to a Monthly Rate of Return.
- OE_{KP(C)} = Monthly Pollution Control Operating Expenses for Big Sandy.
- RB_{RM(C)} = Environmental Compliance Rate Base for Rockport.
- ROR_{RM(C)} = Annual Rate of Return on Rockport Rate Base; Annual Rate divided by 12 to restate to a Monthly Rate of Return.
- OE_{RM(C)} = Monthly Pollution Control Operating Expenses for Rockport.
- AS = Net proceeds from the sale of SO₂ emission allowances, ERCs, and NO_x emission allowances, reflected in the month of receipt. The SO₂ allowance sales can be from either EPA Auctions or the AEP Interim Allowance Agreement Allocations.

"KP(C)" identifies components from the Big Sandy Units - Current Period, and "RM(C)" identifies components from the Indiana Michigan Power Company's Rockport Units - Current Period.

The Rate Base for both Kentucky Power and Rockport should reflect the current costs associated with the 1997 Plan and the 2003 Plan. The Rate Base for Kentucky Power should also include a cash working capital allowance based on the 1/8 formula approach, due to the inclusion of Kentucky Power's accounts receivable financing in the capital structure and weighted average cost of capital. The Operating Expenses for both Kentucky Power and Rockport should reflect the current operating expenses associated with the 1997 Plan and the 2003 Plan.

The Rate of Return for Kentucky Power is the weighted average cost of capital as authorized by the Commission in Case No. 2002-00169.

PUBLIC SERVICE COMMISSION
OF KENTUCKY
EFFECTIVE

(Cont'd on Sheet 23-3)

MAR 31 2003

PURSUANT TO 807 KAR 5:011

SECTION 9(1)

DATE OF ISSUE April 10, 2003 SERVICE RENDERED ON OR AFTER March 31, 2003

ISSUED BY E.K. Wagner BY Frankie D. [Signature]

NAME E.K. WAGNER TITLE FRANKFORD, KENTUCKY ADDRESS

Issued by authority of an Order of the Public Service Commission in Case No. 2002-000169 dated March 31, 2003

ENVIRONMENTAL SURCHARGE (E.S.)

RATE (Cont'd)

The Rate of Return for Rockport should reflect the requirements of the Rockport Unit Power Agreement.

Net Proceeds from the sale of emission allowances and ERCs that reflect net gains will be a reduction to the Current Period Revenue Requirement, while net losses will be an increase.

The Current Period Revenue Requirement will reflect the balances and expenses as of the Expense Month of the filing.

5. Environmental costs "E" shall be the Company's costs of compliance with the Clean Air Act and those environmental requirements shall apply to coal combustion wastes and by-products, as follows:

- (a) cost associated with Continuous Emission Monitors (CEMS)
- (b) costs associated with the terms of the Rockport Unit Power Agreement
- (c) the Company's share of the pool capacity costs associated with Gavin scrubber(s)
- (d) return on SO₂ allowance inventory
- (e) costs associated with air emission fees
- (f) over/under recovery balances between the actual costs incurred less the amount collected through the environmental surcharge
- (g) costs associated with any Commission's consultant approved by the Commission
- (h) costs associated with Low Nitrogen Oxide (NO_x) burners at the Big Sandy Generating Plant
- (i) costs associated with the consumption of SO₂ allowances
- (j) costs associated with the Selective Catalytic Reduction at the Big Sandy Generating Plant
- (k) costs associated with the upgrade of the precipitator at the Big Sandy Generating Plant
- (l) costs associated with the over-fire air with water injection at the Big Sandy Generating Plant
- (m) costs associated with the consumption of NO_x allowances
- (n) return on NO_x allowance inventory
- (o) 25% of the costs associated with the Reverse Osmosis Water System (the amount is subject to adjustment at subsequent 6 month surcharge reviews based on the documented utilization of the RO Water System by the SCR)

6. The monthly environmental surcharge shall be filed with the Commission ten (10) days before it is scheduled to go into effect, along with all necessary supporting data to justify the amount of the adjustments which shall include data and information as may be required by the Commission.

PUBLIC SERVICE COMMISSION
OF KENTUCKY

MAR 31 2003

PURSUANT TO 807 KAR 5:011
SECTION 9 (1)

DATE OF ISSUE April 10, 2003 SERVICE RENDERED ON OR ABOUT March 31, 2003
ISSUED BY E. K. Wagner BY Cheryl L. Dyer
NAME E. K. WAGNER DIRECTOR OF REGULATORY SERVICES TITLE FRANKEORT, KENTUCKY
ADDRESS

Issued by authority of an order of the Public Service Commission in Case No. 2002-000169 dated March 31, 2003



Ernie Fletcher
Governor

Lajuana S. Wilcher
Secretary

Commonwealth of Kentucky
Environmental and Public Protection Cabinet
Public Service Commission
211 Sower Blvd.
P.O. Box 615
Frankfort, Kentucky 40602-0615
Telephone: (502) 564-3940
Fax: (502) 564-3460

February 25, 2004

Mr. Errol K. Wagner
Director Regulatory Services
American Electric Power
101A Enterprise Drive
P. O. Box 5190
Frankfort, Kentucky 40602-5190

RE: Monthly Environmental Surcharge Report for January 2004

Dear Mr. Wagner,

In your cover letter dated February 20, 2004 accompanying the January 2004 Monthly Environmental Surcharge Report, you state that AEP has added a line to ES Form 3.10, line 18, for "Monthly Environmental Equipment Operation and Maintenance Costs." You note that these expenses are not part of any other operation and maintenance cost already being filed, and that the costs are only associated with the environmental facilities included in the Environmental Surcharge.

The Staff have reviewed the Orders issued in Case Nos. 1996-00489 and 2002-00169 relating to the approval of an environmental surcharge and can find no mention of or reference to an Equipment Operation and Maintenance Cost as part of the approved operation and maintenance costs that can be recovered through the surcharge. The Commission stated on page 20 of its March 31, 2003 Order in Case No. 2002-00169,

Kentucky Power will only recover those operating expenses identified in this proceeding. Kentucky Power will have to seek Commission approval to recover any other operating expenses associated with the 2003 Plan that have not been identified in this proceeding.

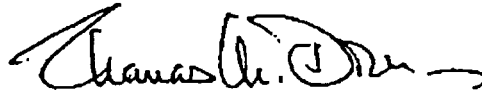
Letter to Mr. Wagner
February 25, 2004
Page 2

Pursuant to KRS 278.183, a utility is entitled to recover by surcharge only those environmental compliance costs set forth in a compliance plan that has been approved by the Commission. Until such time as this category of operation and maintenance costs have been included in an amended compliance plan and approved by the Commission, no surcharge recovery is permissible.

Consequently, AEP cannot include the Equipment Operation and Maintenance Costs in its monthly surcharge reports and cannot recover these costs through the surcharge at the present time. AEP will have to either adjust the surcharge factor to be applied to its March 2004 bills to remove the costs or adjust the expenses included in the February 2004 Monthly Environmental Surcharge Report.

If you have any questions concerning this determination, please feel free to contact Isaac Scott at (502) 564-3940, extension 444.

Sincerely,



Thomas M. Dorman
Executive Director