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July 12, 2005

Beth O'Donnell  
Executive Director  
Public Service Commission of Kentucky  
211 Sower Boulevard  
P.O. Box 615  
Frankfort, Kentucky 40602-0615

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JUL 12 2005  
PUBLIC SERVICE  
COMMISSION

Judith A. Villines  
(502) 209-1230  
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Re: Kentucky Power Company's Second Amended Environmental  
Compliance Plan and Second Revised Tariff  
PSC Case No. 2005-00068

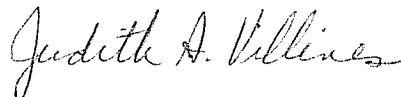
Dear Ms. O'Donnell:

Enclosed for filing are the originals and ten (10) copies of Kentucky Power Company's Rebuttal Testimony of Errol K. Wagner and Michael J. Kelley rebutting the testimony of Lane Kollen for the intervenor KIUC. By making this filing in accordance with the scheduling order in this case, Kentucky Power does not waive any claim under its previously filed motion to disallow the testimony of Kollen on the grounds that it is irrelevant and immaterial to this proceeding.

Please contact me or Bruce Clark at 502-223-3477 if you have any questions or require anything further.

Sincerely,

STITES & HARBISON, PLLC



Judith A. Villines

JAV:las

Enclosures

cc: Michael L. Kurtz (w/enclosures)  
Elizabeth E. Blackford (w/enclosures)  
Errol K. Wagner (w/o enclosures)  
Kevin F. Duffy (w/o enclosures)

KE057:KE113:12306.1:FRANKFORT

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JUL 12 2005

PUBLIC SERVICE  
COMMISSION

**COMMONWEALTH OF KENTUCKY**  
**BEFORE THE**  
**PUBLIC SERVICE COMMISSION OF KENTUCKY**

**IN THE MATTER OF**

**KENTUCKY POWER COMPANY'S SECOND )  
AMENDED ENVIRONMENTAL COMPLIANCE )  
PLAN AND SECOND REVISED TARIFF )**

**Case No. 2005-00068**

**REBUTTAL TESTIMONY AND EXHIBITS**

**ON BEHALF OF  
KENTUCKY POWER COMPANY**

**July 12, 2005**



**COMMONWEALTH OF KENTUCKY**  
**BEFORE THE**  
**PUBLIC SERVICE COMMISSION OF KENTUCKY**

**IN THE MATTER OF**

**KENTUCKY POWER COMPANY'S SECOND     )**  
**AMENDED ENVIRONMENTAL COMPLIANCE    )**     **Case No. 2005-00068**  
**PLAN AND SECOND REVISED TARIFF        )**

**REBUTTAL TESTIMONY AND EXHIBITS**  
**OF**  
**MICHAEL J. KELLEY**

**ON BEHALF OF**  
**KENTUCKY POWER COMPANY**

**July 12, 2005**

REBUTTAL TESTIMONY OF  
MICHAEL J KELLEY, ON BEHALF OF  
KENTUCKY POWER COMPANY  
BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

INTRODUCTION

1

2 Q. Please state your name and business address.

3 A. My name is Michael J. Kelley. My business address is American Electric Power, 1  
4 Riverside Plaza, Columbus, Ohio 43215.

5 Q. Please indicate by whom you are employed and in what capacity.

6 A. I am the Director of Domestic Tax Planning and Analysis for American Electric  
7 Power Service Corporation (AEPSC), a wholly owned subsidiary of American  
8 Electric Power Company, Inc. (AEP).

9 Q. What are your principal areas of responsibility?

10 A. My primary responsibility is federal and state tax planning for AEP and its  
11 subsidiaries, including the analysis of federal and state tax laws and the restructuring  
12 of entities. My work includes corporate and asset acquisitions, mergers,  
13 reorganizations and dispositions as the company expanded into and has withdrawn  
14 from various lines of business. I coordinate my activities with tax compliance and tax  
15 accounting as well as coordination with financial accounting, treasury operations and  
16 legal.

17 Q. Please briefly describe your educational background and business experience.

18 A. I earned a Bachelor of Business Administration Degree in Accounting from The  
19 University of Tulsa in 1982, a Bachelor of Science in Curriculum and Instruction

1 (with Math and Physics) from Texas A&M University in 1973 and a Master of  
2 Education in Education Psychology from Texas A&M University in 1974. I am a  
3 Certified Public Accountant and have been certified in Oklahoma since 1983. I am  
4 also a member of the American Institute of Certified Public Accountants and the Tax  
5 Executives Institute. In 1974, I entered the United States Air Force as a Second  
6 Lieutenant and left in 1978 as a First Lieutenant. In 1978, I began work in the  
7 accounting and tax area at the Tom Walters Company in Tulsa, Oklahoma where I  
8 provided both tax and accounting services for various individuals and small  
9 businesses. In 1990, I joined Central and South West Corporation (“CSW”) at its gas  
10 pipeline subsidiary, Transok, Inc. At Transok and later at Central and South West  
11 Service Corporation, I served in various positions within the tax area including the  
12 position as Manager of Tax Planning. In this position I was responsible for both  
13 domestic and international tax planning and international tax compliance. When  
14 CSW merged with AEP in 2000, I was promoted to my current position of Director of  
15 Domestic Tax Planning and Analysis.

16 Q. Have you previously testified before a regulatory body?

17 A. Yes. I provided testimony in January 2005 before the Public Utility Commission of  
18 Louisiana in the Investigation of Southwestern Electric Power Company Revenue  
19 Requirement Review Conducted Pursuant To Merger Order U-23327.

20 Q. What was the topic of your testimony?

21 A. I testified on the application of the new IRC §199 and Louisiana corporate franchise  
22 tax.

PURPOSE OF TESTIMONY

1

2 Q. What is the purpose of your testimony?

3 A. The purpose of my testimony is to rebut the testimony of the Kentucky Industrial  
4 Utility Customers, Inc.'s consultant, Mr. Lane Kollen as it relates to certain tax issues  
5 in this case. This testimony will specifically discuss his recommendation concerning  
6 the federal and Kentucky corporate tax rate for manufacturers as related to the  
7 computation of the ECR revenue requirement.

8

TAX RELATED MANUFACTURING DEDUCTION

9 Q. In his testimony, Mr. Kollen concludes that the IRC §199 deduction should be reflected,  
10 as an adjustment to the federal and state corporate tax rate, is that premise correct?

11 A. No. The IRC §199 deduction is a deduction against taxable income; it does not purport  
12 to change the federal or state tax rate in any way. To claim that this deduction is  
13 effectively a tax rate reduction would mean any tax deduction (such as labor costs)  
14 would effectively be tax rate reduction.

15 Q. Please explain.

16 A. IRC §199 allows for a reduction in federal taxable income by a portion of a taxpayer's  
17 separately identifiable Qualified Production Activity Income ("QPAI"). QPAI is a  
18 subset of the taxpayer's federal taxable income. The IRC §199 deduction is  
19 determined on an annual basis and is based upon the taxpayer's annual facts and  
20 circumstances.

21 The IRC §199 deduction is determined and allocated based upon a group larger than  
22 the federal consolidated tax group. As stated in Notice 2005-14, "IRC §199(d)(4)(A)

1 provides that all members of an expanded affiliated group (“EAG”) are treated as a  
2 single corporation for purposes of IRC §199.” An EAG is defined as an affiliated  
3 group that includes not only members of the federal consolidated tax group (in which  
4 ownership is 80% or more), but includes other corporate entities in which ownership  
5 is at least 50%, as defined in IRC §1504(a).

6 Furthermore, a separate legal entity within an EAG (as in the case of Kentucky Power  
7 Company and AEP Generating Company) does not determine its IRC §199 deduction  
8 based solely upon its separate facts and circumstances. Once the EAG determines its  
9 QPAI and the corresponding deduction, the IRC §199 deduction is allocated only to  
10 those members of the EAG that had positive QPAI on a stand-alone basis. The  
11 allocation is made based upon the member’s relative portion of the positive QPAI to the  
12 total QPAI of the EAG. It is likely that a member of an EAG will not be allocated an  
13 IRC §199 deduction equal to its stand-alone IRC §199 deduction at either the federal or  
14 state level.

15 Q. Please provide examples.

16 A. I have a simple example. Assume first that neither of the two limitations that apply to  
17 the determination of the IRC §199 deduction applies. These limitations are in order:  
18 first, that the IRC §199 deduction cannot be greater than the product of the taxpayer’s  
19 taxable income times the applicable deduction percentage; and second, the IRC §199  
20 deduction cannot be greater than the 50% of the taxpayer’s W-2 wages for the taxable  
21 year. Also note that the “taxpayer” for purposes of this deduction is the EAG. This



1 example looks only at the impact at the federal level and does not include a more  
2 complicated look at the state income impact.

3 Companies A, B and C all have manufacturing activities in addition to business  
4 activities. Company A and Company B both have separately computable QPAI of \$400  
5 and \$300, respectively. Company C has negative QPAI of \$350. All three companies  
6 are the sole members of an EAG, with a combined QPAI of \$350 ( $\$400 + \$300 - \$350$   
7  $= \$350$ ). Assuming that the full deduction percentage of 9% is in effect, the tentative  
8 IRC §199 deduction is \$31.5 ( $\$350$  times 9%). Pursuant to §199(d)(4)(C), the IRC  
9 §199 deduction is allocated to Companies A and B in proportion to their respective  
10 amount of their QPAI (*i.e.*,  $4/7$  and  $3/7$  respectively) in the amounts of \$18 and \$13.5 of  
11 the EAG's IRC §199 deduction.

12 Q. Is this the same amount of the IRC §199 deduction that the companies would have  
13 received on a separate basis?

14 A. No. If the calculation of the IRC §199 deduction were based solely upon their separate  
15 company QPAI, Company A and Company B would each have had IRC §199  
16 deductions of \$36 and \$27, respectively ( $\$400$  times 9% and  $\$300$  times 9%). As  
17 detailed in EXHIBIT MJK-1, neither Company A nor Company B would recognize an  
18 IRC §199 deduction benefit equal to their stand-alone benefit. Therefore, neither  
19 Company A nor Company B would receive the full benefit of the IRC §199 deduction,  
20 and their effective tax rates would not be reduced as generously as Mr. Kollen would  
21 propose.

1 Q. Would there be any impact on the “effective” tax rate?

2 A. In this example, while there is a contended effective tax rate of 31.85% for both  
3 Company A and Company B, their actual tax liability would be at a rate of 33.43%  
4 each, almost 1.6% higher. Thus, Mr. Kollen’s approach would understate the  
5 “effective” tax rate by 5%. For Company C, its effective tax rate remains at 35%.

6 Q. What is the effect of the IRC §199 deduction on past or future years?

7 A. Since this deduction is a permanent item and based upon the current year’s facts and  
8 circumstances and based further upon the fact that there is no carryback or carryforward  
9 of unused IRC §199 deductions, there is no means by which the EAG or its individual  
10 members could lower their effective tax rate in future or past tax years.

11 Q. What other complexities are there in determining the IRC §199 deduction?

12 A. Please refer to EXHIBIT MJK-2, EXHIBIT MJK-3 and EXHIBIT MJK-4. In EXHIBIT  
13 MJK-2, I show what would happen if the State of Kentucky applied the taxable income  
14 limitation to determine the amount of the IRC §199 deduction. Company C, which  
15 would otherwise be allowed the deduction at the federal level, would be denied the  
16 deduction at the state level. In EXHIBIT MJK-3, I show what can happen at the state  
17 level when the required IRC §861 allocation redistributes expenses between companies.  
18 IRC §861 is the method whereby certain expenses of the consolidated tax group are  
19 reallocated to members of the group. In this example, Company B loses the IRC §199  
20 deduction for both federal and state income tax purposes. Before the §861 reallocation,  
21 Company B would qualify for a \$22.5 deduction, but after the reallocation of expense,  
22 Company B has a negative QPAI and receives no share of the group’s IRC §199

1 deduction. Company C's IRC §199 deduction is also reduced for federal purposes and,  
2 because of the taxable income limitation, Company C's IRC §199 deduction is  
3 eliminated at the stand-alone state level. However, Company A, because of the  
4 reallocation, has an increased QPAI and receives a larger IRC §199 deduction benefit  
5 for both federal and state income purposes.

6 Once again, this example demonstrates that the IRC §199 deduction is driven by facts  
7 and circumstances and cannot be reduced to an income tax rate adjustment.

8 Q. Any other examples?

9 A. Yes. Please refer to EXHIBIT MJK-4. This example addresses what happens when a  
10 net operating loss ("NOL") is carried back into a prior tax year. For simplicity, I have  
11 assumed that for all years in this example that the company's taxable income and its  
12 QPAI are the same. In this example, in the tax years 2015 and 2016, this company  
13 incurs a federal taxable net operating losses. The company carries back its NOLs into  
14 2013 and 2014. On its original returns for 2013 and 2014, the company claimed IRC  
15 §199 deductions of \$19 and \$81, respectively. However, as shown in the example, the  
16 carry back of the NOLs eliminated the company's taxable income for both 2013 and  
17 2014. Because the company's recomputed taxable incomes for 2013 and 2014 are now  
18 reduced to zero, the tax benefit previously enjoyed through the IRC §199 deductions for  
19 2013 and 2014 are eliminated.

20 Since the 2013 and 2014 IRC §199 deductions are eliminated by the NOL carrybacks,  
21 the federal effective income tax rate of the 2015 and 2016 is increased to a percentage

1 greater than the statutory federal income tax rate of 35%. Since the loss of the  
2 deduction is permanent, there is no deferred tax offset.

3 Once again, the facts and circumstances of this case demonstrate that the IRC §199  
4 deduction cannot be replicated by erroneously treating a tax deduction as an income  
5 tax rate reduction.

6 Q. Has the Federal Energy Regulatory Commission (“FERC”) made any statement on the  
7 treatment of the IRC §199 deduction?

8 A. Yes. FERC, on June 2, 2005, issued “Guidance order on Tax deduction for  
9 Manufacturing Activities Under the American Jobs Creation Act Of 2004”. In this  
10 order, FERC stated that the “Tax deduction for Manufacturing Activities (TDMA)” is  
11 a special deduction. The order directs that the deduction must be taken into account  
12 in the determination of income tax cost.

13 Q. In the background section of the Order, FERC stated that the deduction will be the  
14 equivalent of reducing the effective Corporate Income Tax rate. Is that statement  
15 correct?

16 A. No. The statement is overly simplistic and not in keeping with the “Discussion”  
17 section of the order wherein FERC clearly states that IRC §199 is a deduction used to  
18 arrive at taxable income in order to determine income tax expense.

19 Q. Do you propose to address the matter with FERC?

20 A. I have discussed this aspect of the FERC Order with other tax experts within the Tax  
21 Section of the Edison Electric Institute. The Tax Section is in discussion with FERC  
22 and believes it will reach a satisfactory resolution clarifying the matter.

1 Q. For financial account purposes, how is the IRC §199 deduction treated?

2 A. IRC §199 is recognized as a deduction to income, not an adjustment to the tax rate.  
3 Specifically, on December 21, 2004 (effective immediately), the Financial Accounting  
4 Standards Board issued FASB Staff Position No. FAS 109-1 (Title: Application of  
5 FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on  
6 Qualified Production Activities Provided by the American Jobs Creation Act of 2004).  
7 The pronouncement states that the deduction is a “special deduction” in accordance with  
8 Statement 109 as opposed to a rate reduction (reference paragraph 4).

9 Q. What other issues associated with the computation of the IRC §199 deduction should be  
10 considered in relation to ECR filings?

11 A. I have two concerns. The first concern is that the United States Treasury has not issued  
12 regulations for this new Internal Revenue Code section. On June 20, 2005, George  
13 Manousos, a taxation specialist for the Treasury’s Office of Tax Legislative Counsel,  
14 told a panel at a meeting of the American Institute of Certified Public Accounts  
15 (“AICPA”) that he did not expect the regulations until year-end (2005), but no later than  
16 April 21, 2006. While the IRS issued Notice 2005-14 on January 19, 2005, that notice  
17 did not provide useful guidance for public utilities and, in particular, it did not address  
18 the issues of fully integrated utilities with bundled rates. Therefore, some uncertainty  
19 exists as to application of this tax deduction as related to the manufacture of electricity.  
20 My second concern arises from this lack of guidance from the IRS. There has been no  
21 formal determination as to whether the revenues that are derived from environmental

1 investments will qualify for the § 199 deduction. Without such confirmation, I do not  
2 believe the ECR filing should reflect a computation for the IRC §199 deduction.

3 Q. In his testimony, Mr. Kollen states that the Kentucky Income Rate has been reduced to  
4 7.0% effective January 1, 2005 and is further reduced to 6.0% effective January 1, 2007.  
5 Mr. Kollen also states that Kentucky House Bill 272 adopted the Internal Revenue Code  
6 as of December 31, 2004. Are those statements correct?

7 A. Yes.

8 Q. Are those the only changes to the Kentucky Tax Code made by House Bill 272?

9 A. No. This legislation made major changes to the Kentucky Tax Code. Kentucky created  
10 a new standard for income tax nexus in an attempt to establish taxing jurisdiction  
11 without a physical presence. This new standard applies a liberal “economic presence”  
12 standard. There is some uncertainty as to how this new standard will affect Kentucky  
13 Power Company’s cost of operations.

14 Q. Are there other changes in the Kentucky Tax Code, which will impact other AEP  
15 companies?

16 A. Yes. Kentucky now requires mandatory filing of a consolidated tax return for members  
17 of an “affiliated group”. An affiliated group is defined as one or more chains of  
18 “includible corporations” that satisfy an 80% ownership test. An includible corporation  
19 is defined as a corporation doing business in Kentucky. Wherein historically AEP  
20 corporations doing business in Kentucky have filed separate returns, the application of  
21 the expanded nexus standard discussed above could result in these corporations filing a  
22 consolidated Kentucky income tax return with other AEP Corporations.

1 Q. What impact could the filings of a consolidated Kentucky Corporate Income Tax return  
2 have on Kentucky Power Company?

3 A. Based upon these legal changes under the new Kentucky law, Kentucky Power  
4 Company could have a higher state income tax cost and, hence, a higher effective tax  
5 rate. The actual Kentucky Power Company effective state income tax rate should be  
6 used to compute gross-up factors employed in determining the Company's effective rate  
7 of return.

8 Q. What other change in the Kentucky Tax Code could affect Kentucky Power Company's  
9 State Income Tax expense?

10 A. Kentucky's new law has a provision that disallows certain related party expenses such  
11 as intangible expenses, intangible interest expense, and management fees. There are  
12 safe harbor provisions that, if satisfied, would generally allow the continued expensing  
13 of these items. However, a possible disallowance of these expenses for Kentucky  
14 income tax purposes should be factored into the computation of taxable income in  
15 relation to the ECR filings.

16 Q. Is Mr. Kollen's calculation to the ECR – Income Gross-Up Factor for Big Sandy –  
17 Exhibit (LK-4) correct?

18 A. No. Mr. Kollen's calculation treats the IRC §199 deduction as a tax rate reduction. As  
19 I have stated above, it is not a tax rate reduction as a matter of federal tax law. The  
20 federal tax rate remains at 35%. And since the amount of the IRC §199 deduction is  
21 determined on an annual basis based upon facts and circumstances not wholly  
22 determined at the individual member level within the EAG, the result is a variable

1 income tax expense deduction. There is no basis in the federal tax law to treat this  
2 deduction as anything other than a deduction against taxable income; the FERC has  
3 defined this item as a deduction; and the accounting authorities have mandated  
4 treatment as a deduction. Therefore, the IRC §199 deduction cannot and should not be  
5 treated as an effective tax rate reduction. Furthermore, the ECR should not be subject to  
6 adjustment for the IRC §199 deduction.

7 Q. Please summarize your conclusions.

8 A. First, the IRC §199 deduction is not a reduction in the effective federal or state  
9 income tax rate. Furthermore, the IRC §199 deduction is computed on an annual  
10 basis and is not subject to itself being carried back into prior tax years or carried  
11 forward into future tax years. In addition, the deduction should not be applied to the  
12 ECR recovery calculation.

13 Second, three changes in the Kentucky income tax code will likely influence  
14 Kentucky Power Company's overall state income tax expense. The application of a  
15 new economic nexus standard and the requirement to file a consolidated tax return for  
16 the "affiliated group" could increase Kentucky Power Company's effective state  
17 income tax rate that should be reflected in the calculation of its state tax gross-up.  
18 And the disallowance of certain inter-company expenses should be reflected in the  
19 calculation of state taxable income. For these reasons, the total effect of such state  
20 tax law changes should be reflected in the ECR filings.

21 Q. Does this conclude your testimony?

22 A. Yes.



COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

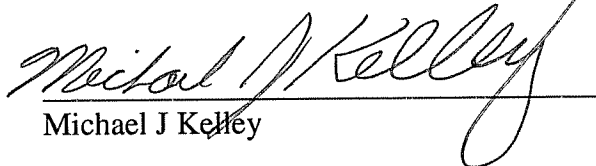
STATE OF OHIO

CASE NO. 2005-00068


COUNTY OF FRANKLIN

AFFIDAVIT

Michael J Kelley, upon first being duly sworn, hereby makes oath that if the foregoing questions were propounded to him at a hearing before the Public Service Commission of Kentucky, he would give the answers recorded following each of said questions and that said answers are true.

  
Michael J Kelley

Subscribed and sworn to before me by Michael J Kelley this 2 day of July, 2005.

  
Notary Public



My Commission Expires \_\_\_\_\_

DAVID BILENKO  
Attorney at Law  
Notary Public, State of Ohio  
My Commission Has No Expiration  
Section 147.03 R.C.

**KENTUCKY POWER COMPANY**  
**Example of Manufacturing Deduction allocation within an Expanded Affiliated Group ("EAG")**

Company	Separate Company QPAI	Tentative Manufacturing Deduction	Allocation of Allowed Deduction	Separate Company Taxable Income	Tax at 35%	Effective Tax Rate	Contended Effective Tax Rate	Excess of Actual ETC or Contended ETC
A	400.0	36.0	18.0	382.0	133.7	33.43%	31.85%	1.58%
B	300.0	27.0	13.5	286.5	100.3	33.43%	31.85%	1.58%
C	<u>(350.0)</u>	<u>0.0</u>	<u>0.0</u>	<u>(350.0)</u>	<u>(122.5)</u>	35.00%	31.85%	3.15%
TOTAL QPAI	350.0	63.0	31.5	318.5	111.5			
Deduction Percentage	9.0%							
Deduction	31.5							

- Assumptions:
- a. There is no limitation on the overall QPAI as a result of EAG taxable income.
  - b. There is no limitation on the overall QPAI as a result of the W-2 wage limitation.

Contended Effective Tax Rate.

Taxable Income before QPAI deduction	100.00
QPAI deduction @ 9%	<u>(9.00)</u>
Taxable income	91.00
Federal tax rate	35.0%
Federal tax	31.85
Contended effective tax rate	31.85%

**KENTUCKY POWER COMPANY**

Exhibit MJ~~K~~-2

**Impact on State Taxes of disallowed QPAI deduction**

**Assumption: State adopts federal Sec 199 regime**

**Assumption: State returns filed on a standalone basis**

Company	Taxable income before Sec 199 deduction	QPAI	Allocation of QPAI Deduction	Federal Taxable income	State Taxable income
A	300.0	100.0	(6.0)	294.0	294.0
B	200.0	(50.0)	0.0	200.0	200.0
C	<u>(200.0)</u>	<u>50.0</u>	<u>(3.0)</u>	<u>(203.0)</u>	<u>(200.0)</u> Note 1
<b>TOTAL</b>	<b>300.0</b>	<b>100.0</b>	<b><u>(9.0)</u></b>	<b>291.0</b>	<b>294.0</b>
<b>IRC SEC 199 deduction</b>		<b><u>9.0</u></b>			

**Note 1** Since taxable income without regard to the Sec 199 deduction is negative, no deduction at state level allowed. Benefit is lost.

Exhibit MJK-3

KENTUCKY POWER COMPANY

Impact on State Taxes of disallowed QPAI deduction

Assumption: State adopts federal Sec 199 regime

Assumption: State returns filed on a standalone basis

Company	Taxable income before Sec 199 deduction	QPAI before Sec 861 reallocation of expenses	QPAI after Sec 861 Reallocation	Allocation of QPAI Deduction	Federal Taxable income	State Taxable income
A	1,000.0	800.0	1,150.0	(99.4)	900.6	900.6
B	750.0	250.0	(50.0)	0.0	750.0	750.0
C	(350.0)	150.0	100.0	(8.6)	(358.6)	(350.0) Note 1
<b>TOTAL</b>	<b>1,400.0</b>	<b>1,200.0</b>	<b>1,200.0</b>	<b>(108.0)</b>	<b>1,292.0</b>	<b>1,300.6</b>
					<b>IRC SEC 199 deduction</b>	<b>(108.0)</b>

Note 1 Since taxable income without regard to the Sec 199 deduction is negative, no deduction at state level allowed. Benefit is lost.





**COMMONWEALTH OF KENTUCKY**  
**BEFORE THE**  
**PUBLIC SERVICE COMMISSION OF KENTUCKY**

**IN THE MATTER OF**

**KENTUCKY POWER COMPANY'S SECOND )  
AMENDED ENVIRONMENTAL COMPLIANCE )  
PLAN AND SECOND REVISED TARIFF )**

**Case No. 2005-00068**

**REBUTTAL TESTIMONY AND EXHIBIT  
OF  
ERROL K WAGNER**

**ON BEHALF OF  
KENTUCKY POWER COMPANY**

**July 12, 2005**

REBUTTAL TESTIMONY OF  
ERROL K WAGNER, ON BEHALF OF  
KENTUCKY POWER COMPANY  
BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

1 Q: Please state your name, position and business address.

2 A: My name is Errol K. Wagner. My position is Director of Regulatory Services for  
3 Kentucky Power Company (KPCo or Company). My business address is 101 A  
4 Enterprise Drive, Frankfort, Kentucky 40602.

5 Q: Have you previously submitted testimony in this proceeding?

6 A: Yes. My direct testimony was included as part of the Company's original filed  
7 application.

8 Q: What is the purpose of your rebuttal testimony?

9 A: The purpose of this testimony is to rebut Kentucky Industrial Utility Customers,  
10 Inc.'s (KIUC) recommendation: to reject the Company's request to include the  
11 environmental costs associated with power plants owned by Ohio Power  
12 Company (OPCo) and Indiana Michigan Power Company (I&M) in the  
13 Company's Environmental Surcharge Tariff; and to rebut the KIUC's  
14 recommendation to reduce the Company's Environmental Surcharge revenue  
15 requirement calculations by the amount of margins earned by making off-system  
16 sales from the utilization of emission allowances.

17 **The Company's Request to Include the Environmental Costs**  
18 **Associated with Power Plants owned by OPCo and I&M in the**  
19 **Company's Environmental Surcharge Tariff**



1 Q: The KIUC has stated that it is inappropriate to recognize the environmental costs  
2 associated with the plants owned by OPCo and I&M in KPCo's environmental  
3 surcharge monthly calculations. Does the Company agree with that statement?

4 A: No. As explained in my direct testimony, pages 3-12, KPCo is a member of the  
5 AEP System and, as such, is a member of three (3) intercompany agreements: the  
6 AEP Interconnection Agreement (Interconnection Agreement or Pool  
7 Agreement), the Rockport Unit Power Agreement and the AEP Interim  
8 Allowance Agreement (IAA). All three agreements have been filed with and  
9 approved by the Federal Energy Regulatory Commission (FERC).

10 Q: What is the role of the AEP Interconnection Agreement?

11 A: The role of the AEP Interconnection Agreement is to define the obligations of the  
12 members and the methodology for allocating the cost of generation among the  
13 operating companies. KPCo has only 1,450 MW (1,060 at Big Sandy and 390  
14 MW at Rockport) of generating capacity. When KPCo's customers place a  
15 demand on KPCo's system greater than 1,450 MW (peak demand is 1,685 MW),  
16 or when any of KPCo's generating facilities are out-of-service due to  
17 maintenance, the Company, by utilizing the AEP Interconnection Agreement, has  
18 access to OPCo's and I&M's generating facilities (and their associated  
19 environmental investments) to meet the Kentucky customer's electricity  
20 requirements. For this access right, KPCo pays a capacity charge to the AEP Pool  
21 based on the average cost of the surplus companies' investment, which includes  
22 their investment in these environmental facilities.

1 Q: What is the importance to KPCo of the environmental investments installed at  
2 OPCo and I&M?

3 A: If the OPCo and I&M generating facilities did not have these environmental  
4 investments installed, KPCo as well as AEP could not have met the electricity  
5 requirements of its customers at the relatively same low costs while complying  
6 with the Federal Clean Air Act.

7 Q: Are there any other reasons that support KPCo's position?

8 A: Yes. The Commission's May 27, 1997 order in Case No. 96-489 supports the  
9 Company's position that federal preemption mandates the Commission's  
10 acceptance of the FERC jurisdictional agreements as reasonable. At page 16 the  
11 Commission stated:

12 "The Commission finds that federal preemption mandates our acceptance  
13 of the FERC jurisdictional agreements as reasonable. To the extent that  
14 environmental costs are part of the total costs Kentucky Power is allocated  
15 under the terms of these agreements, the costs must be accepted as  
16 reasonable. Contrary to KIUC's position, federal preemption is applicable  
17 and controls in this instance, not only for the allowances purchased  
18 required under the IAA, but also for the costs Kentucky Power is required  
19 to pay under the terms of the Rockport Unit Power Agreement and the  
20 Interconnection Agreement. Due to the application of federal preemption,  
21 the Commission is required to accept as reasonable the costs incurred  
22 under these FERC agreements. Consequently, all of the arguments  
23 presented by the AG and KIUC in opposition to the reasonableness of  
24 such costs are not appropriate for consideration by this Commission."  
25

26 At page 18 the Commission stated:

27 "Therefore, the actions taken by Kentucky Power under the terms of these  
28 FERC agreements must be presumed to be reasonable for retail  
29 ratemaking. Consequently, this Commission has no discretion to exclude  
30 these projects from Kentucky Power's environmental surcharge  
31 compliance plan on the grounds that the evidence fails to demonstrate that  
32 the projects are reasonable".  
33

1           Contrary to the KIUC's representation, the Commission did not say the  
2 terms of only the FERC Interim Allowance Agreement must be presumed to be  
3 reasonable for retail ratemaking. Nor did the Commission say that it has  
4 discretion to exclude the costs from the Interconnection Agreement from  
5 Kentucky Power's environmental surcharge compliance plan. Rather, the  
6 Commission clearly said the costs allocated under the terms of these FERC  
7 agreements, meaning all three agreements (IAA, Interconnection Agreement and  
8 the Rockport Unit Power Agreement) must be accepted as reasonable.

9   Q:   KIUC states in its testimony that none of these environmental projects are related  
10 to a KPCo compliance plan. Does the Company agree with this statement?

11   A:   No. In all of the environmental filings before this Commission, the Company has  
12 stated that compliance with the Federal Clean Air Act is done on an AEP System-  
13 wide basis. This benefits all of AEP's ratepayers. In the Company's first  
14 environmental filing, Case No. 96-489, included in the compliance plan were  
15 many environmental facilities, including OPCo's Gavin Scrubber, (See Exhibit  
16 JMM-1), that were in-service prior to the Company's filing. With the exception of  
17 two projects disallowed on other grounds, the Commission approved the  
18 Company's compliance plan in that proceeding even though the AG argued that  
19 "no compliance project costs are recoverable under the surcharge statute unless  
20 the compliance project was reviewed and approved by the Commission before the  
21 project is undertaken by the utility". See May 27, 1997 Order in Case No. 96-489  
22 at pages 3 and 4.

1 Q: KIUC states in its testimony that the Company cannot possibly meet the  
2 requirements of KRS 278.183 by allowing recovery of the disaggregated  
3 components of a federal rate. Does the Company agree with this statement?

4 A: No. The Company is using the same methodology as was approved by the  
5 Commission in Case No. 96-489, as it relates to the environmental costs allocated  
6 to KPCo under the terms of these FERC agreements. KRS 278.183 specifically  
7 allows recovery of environmental costs incurred for compliance with the Federal  
8 Clean Air Act. As noted above, the Commission has consistently recognized that  
9 environmental costs that are part of the total costs Kentucky Power is allocated  
10 under the Interconnection Agreement are presumed reasonable and are  
11 recoverable pursuant to the statute. See Commission's May 27, 1997 Order in  
12 Case No. 96-489. See also page 13 of the May 27, 1997 Order, *supra*, stating:  
13 "Since Gavin is owned by Ohio Power, a portion of the FERC capacity settlement  
14 payment Kentucky Power pays each month includes a portion of the Gavin  
15 scrubber costs."

16 **Margins On Utilization Of Allowances For Off-System Sales By AEP**  
17 **Should Not Be Included In The Environmental Surcharge**  
18 **Calculations**

19  
20 Q: KIUC has stated that the portion of off-system sales margins realized from  
21 allowances consumed by the AEP System in making off-system sales should be  
22 included in the environmental surcharge calculations. Does the Company agree  
23 with this statement?

24 A: No. KPCo and AEP are not selling allowances directly or indirectly when they  
25 sell kilowatt hours (kWh) off-system. Rather KPCo and AEP are consuming

1 allowances when they make off-system sales. This was explained to the  
2 Commission in Case No. 96-489. See Staff Data Request 1st Set Item No. 31  
3 attached hereto as Exhibit EKW Rebuttal – 1.

4 Q: Is the consumption of allowances in making off-system sales similar to the  
5 consumption of coal?

6 A: Yes. KPCo and AEP are not selling coal when they make an off-system sale that  
7 consumes coal. The profit based on the difference between the cost of coal  
8 consumed and the selling price of the kWh sold off-system, is reflected in the  
9 system sales clause where the profits above or below a base level for such sales  
10 are shared 50-50 with KPCo's retail customers. Similarly, the difference between  
11 the cost of the allowance consumed and the selling price of the kWh sold off-  
12 system is currently included in the system sales clause calculations. The KIUC  
13 position erroneously wants to treat KPCo's consumption of allowances as a direct  
14 sale of the allowances. Such simply is not the case.

15 Q: Are there any other reasons the Company believes these margins should not be  
16 included in the environmental surcharge calculations?

17 A: Yes. The Commission, in Case No. 96-489, ordered the format of the monthly  
18 environmental schedules filed with the Commission. The Commission reviewed  
19 the Company's monthly environmental schedules in both Case No. 2000-107 and  
20 Case No. 2002-00393 and the Commission, in those proceedings, did not find that  
21 the portion of off-system sales margins that relate to the allowances consumed  
22 should be reflected in the environmental surcharge calculations. The KIUC was a  
23 party to both of those proceedings. The Company believes these facts support the

1 position that it was not the intent of the Commission in Case No. 96-489 to  
2 include margins associated with allowances consumed for off-system sales in the  
3 monthly environmental surcharge calculations.

4 Q: The KIUC in its testimony made the statement the Company's costing  
5 methodology for allowances does not directly assign the highest cost allowances  
6 to the allowances sold to third parties. Does the Company agree with this  
7 statement?

8 A: Yes.

9 Q: Please explain why the Company's costing methodology does not directly assign  
10 the highest cost allowances to the allowances sold to third parties.

11 A: The FERC Order 552 requires the Company to use the weighted average cost  
12 methodology for allowance inventory accounting. This weighted average cost  
13 methodology has been used for accounting for coal inventory for many years, and  
14 is so reflected in the system sales clause.

15 Q: Has the Company reviewed the KIUC's illustration of the effect of including  
16 every \$100 of margins on the utilization of allowances to supply off-system sales  
17 in the environmental surcharge calculations (See page 28 of the KIUC's direct  
18 testimony)?

19 A: Yes.

20 Q: Does the Company agree with the KIUC's conclusion?

21 A: No we do not. The Company does not agree that it is appropriate to change the  
22 way the allowance margins have been handled since Case No. 96-489; nor does  
23 the Company agree with the KIUC's underlying rationale for the proposed change

1 which is based on faulty assumptions and calculations. For example, it appears  
2 that in order to reach the \$81 revenue requirement, KIUC concluded that the  
3 entire \$38 associated with the allowance went into the system sales tracker;  
4 however, that is not the way the environmental surcharge calculation calculates  
5 the allocation percentages. Referring to ES Form 3.30 of the monthly  
6 environmental calculations, KIUC's 38% would be allocated to three different  
7 categories or classes of revenues: FERC Wholesale, Associated Utilities, and  
8 Non-Associated Utilities (or Off-System Sales). Only the amount allocated to the  
9 Non-Associated Utilities flows through the System Sales Clause. The one half of  
10 the \$38 (or \$19) which was added to the \$62 to arrive at the \$81 over-stated the  
11 effect. Therefore, KIUC's conclusion that the retail revenue requirement will be  
12 reduced by \$31 ( $\$62 + \$19 - \$50$ ) is also over-stated.

13 Q: KIUC has stated that if the margins on the utilization of allowances for off-system  
14 sales were included in the monthly environmental surcharge calculations, the  
15 Kentucky retail revenue requirement on a net basis would have been reduced by  
16 \$2,614,431. Does the Company agree with that statement?

17 A: No, we do not agree. The Company has analyzed the KIUC calculations and we  
18 believe their conclusion is again over-stated.

19 Q: Would you please explain the Company's analysis?

20 A: Yes. It appears the way the KIUC calculated the \$2,614,431 was to take 66.71%  
21 (the average Kentucky retail customer allocation environmental surcharge  
22 percentage for the twelve months ending March, 2005) times the \$7,838,118, the  
23 twelve months' margins on the utilization of allowances and that result is

1 \$5,228,862. From that result it appears they deducted one half of the \$5,228,862  
2 to arrive at \$2,614,431. It is unclear why one would deduct one half of the  
3 66.71% amount of the total \$7,838,118. The amount that should have been  
4 deducted from the \$5,228,862 is one half of the \$7,838,118 (or \$3,919,059)  
5 resulting in \$1,309,803.

6 Q: Why should the one half of the \$7,838,118 be deducted from the \$5,228,862  
7 rather than one half of the \$5,228,862?

8 A: The ratepayers have already received a reduction in the revenue requirement of  
9 \$3,919,059 by way of the system sales clause. To deduct only \$2,614,431 would  
10 be to over-state the net revenue requirement adjustment by \$1,304,628  
11 (\$3,919,059 - \$2,614,431).

12 Q: Are there any other comments regarding the Company's analysis of the KIUC's  
13 recommendation to include the margins on the utilization of the allowances to  
14 supplying off-system sales in the environmental surcharge calculations?

15 A: Yes. KIUC's analysis discussed two elements relating to determining Kentucky  
16 retail revenue requirement. However, there are two additional elements or effects  
17 the KIUC has omitted in their calculations. First, the portion of the off-system  
18 sales margins that the KIUC is proposing to include in the environmental  
19 surcharge will allocate approximately 22.7 % of the \$7,838,118 (or \$1,781,114)  
20 of the off-system sales margins to the system sales tracker. This will result in a net  
21 reduction in the Kentucky retail revenues requirement of \$890,557. Second, the  
22 KIUC has omitted from their calculations the environmental costs allocated to  
23 system sales that were not included in the system sales clause calculations during



1 the twelve months ended March 31, 2005. In all prior environmental surcharge  
2 reviews, the Company's position has been that, because a portion of the  
3 environmental costs are allocated to the off-system sales revenues, that portion of  
4 the environmental costs should also be included in the calculation of the system  
5 sales clause monthly factor. The Commission's December 13, 2004 order in Case  
6 No. 2004-00420 recognized this fact. Therefore, during the KIUC's twelve-month  
7 analysis, they failed to reflect the \$3,920,652 (April through October) of  
8 environmental costs allocated to off-system sales that were not included in the  
9 system sales clause calculations. This would have resulted in a reduction of the  
10 off-system sales margins reflected in the system sales clause, thereby increasing  
11 the Kentucky retail revenue requirement by \$1,960,326.

12 Q: Using the KIUC's proposal, what would be the net change in the Kentucky retail  
13 revenue requirement if KIUC had properly reflected all four elements of the  
14 change?

15 A: Although the Company disagrees with the KIUC's proposal of including the  
16 portion of off-system sales margins associated with the allowances consumed for  
17 off-system sales, if the KIUC had reflected all four elements (the off-system sales  
18 margins associated with allowances consumed to make the off-system sales; the  
19 removal from system sales clause calculations the off-system sales margins  
20 associated with allowances consumed to make the off-system sales; the inclusion  
21 in the system sales clause calculations the environmental costs allocated to off-  
22 system sales; and, the inclusion in the system sales clause calculations the portion  
23 of the off-system sales margins associated with allowances consumed to make the

1 off-system sales allocated to the system sales revenue in the environmental  
2 surcharge calculations) the Kentucky retail revenue requirement would be  
3 reduced by \$240,054 (\$5,228,863 -\$3,919,061-\$1,960,326+ \$890,577).

4 Q: Is it the Company's position that the portion of off-system sales margins that are a  
5 result of consuming allowances should be reflected in the environmental  
6 surcharge?

7 A: No. The Company does not believe that the portion of off-system sales margins as  
8 a result of consuming allowances should be reflected in the environmental  
9 surcharge. Moreover, the Commission's monthly schedules ordered in Case No.  
10 96-489 did not have accommodations to reflect these margins; and the  
11 Commission's two year reviews found no reason to change the reporting  
12 procedures in the monthly environmental surcharge calculations. The Company  
13 believes that the manner in which the monthly environmental surcharge currently  
14 is calculated is correct.

### 15 Summary

16 Q: Do you have any final comments on KIUC's testimony?

17 A: There are inconsistencies in the KIUC's position not to include the environmental  
18 investment cost at OPCo and I&M in the environmental surcharge calculations.  
19 One, KIUC seems to have ignored the fact that these very environmental facilities  
20 are needed to meet the load of the Kentucky retail customers, and, at times, the  
21 AEP System utilizes these very same environmental facilities in making off-  
22 system sales. Two, the KIUC wants to enjoy the off-system sales profit through  
23 the system sales tracker; yet they do not want to include the cost of these

1 environmental facilities either in the calculation of the off-system sales margins or  
2 the environmental surcharge calculations. Finally, the AEP System uses these  
3 environmental facilities when making off-system sales, which sales generate  
4 profit margins that reduce the electric bills of the Kentucky ratepayers. Therefore,  
5 to exclude the costs associated with these environmental facilities which are used  
6 to provide reliable electric service to the Kentucky ratepayers and to make off-  
7 system sales, while at the same time proposing to have off-system sales margins  
8 exclude the same environmental costs is inconsistent and illogical. If the  
9 environmental costs associated with the OPCo and I&M environmental facilities  
10 are excluded from the off-system sales calculation, the off-system sales margin  
11 will be over-stated and the environmental surcharge costs will be under-stated.

12 Q: Does this conclude your rebuttal testimony?

13 A: Yes it does.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

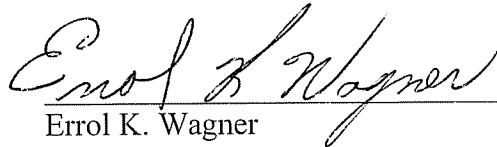
COMMONWEALTH OF KENTUCKY

CASE NO. 2005-00068

COUNTY OF FRANKLIN

AFFIDAVIT

Errol K. Wagner, upon first being duly sworn, hereby makes oath that if the foregoing questions were propounded to him at a hearing before the Public Service Commission of Kentucky, he would give the answers recorded following each of said questions and that said answers are true.

  
Errol K. Wagner

Subscribed and sworn to before me by Errol K. Wagner this 12<sup>th</sup> day of July, 2005.

  
Notary Public

My Commission Expires

January 14, 2009

KPSC Case No. 96-489  
STAFF (1st Set)  
Dated January 13, 1997  
Item No. 31  
Sheet 1 of 1

Kentucky Power Company  
d/b/a  
American Electric Power

REQUEST:

Describe the method used in the IAA to allocate emissions liability and allowance transfers associated with power and energy sales to non-affiliated companies.

RESPONSE:

There are no allowance transfers between pool members associated with energy sales to non-affiliated companies. The cost of consumed allowances, like the cost of fuel and other variable costs, associated with the generation of such energy, is allocated to each member based on the Member Load Ratios (MLR's). The non-affiliated customer is billed for the allowances consumed at a current market index price. The proceeds from the allowance billing are also allocated to each member based on MLR's.

WITNESS: M. D. KYLE

117-STAFF