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Via Overnight Mail

July 14, 2005

Beth A. O'Donnell, Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

Re: Case No. 2005-00068

Dear Ms. O'Donnell:

Please find enclosed the original and twelve (12) copies of the Kentucky Industrial Utility Customers, Inc.'s Response to Kentucky Power Company's Motion to Strike testimony of Lane Kollen in the above-referenced matter. By copy of this letter, all parties listed on the Certificate of Service have been served.

Please place this document of file.

Very Truly Yours,

Michael L. Kurtz, Esq.
BOEHM, KURTZ & LOWRY

MLKkew
Attachment
cc: Certificate of Service

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served by mailing a true and correct copy, by first-class postage prepaid mail, unless otherwise noted, to all parties on the 14th day of July, 2005.

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COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION IN THE MATTER OF:

KENTUCKY POWER COMPANY'S SECOND AMENDED ENVIRONMENTAL COMPLIANCE PLAN AND SECOND REVISED TARIFF	)) CASE NO. 2005-00068)	

KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.'S RESPONSE TO KENTUCKY POWER COMPANY'S MOTION TO STRIKE TESTIMONY OF LANE KOLLEN

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1. INTRODUCTION

On March 8, 2005 the Kentucky Power Company ("KPCo" or "the Company") filed its Application requesting Kentucky Public Service Commission ("the Commission") approval to amend its environmental surcharge tariff. Specifically, the Company requests that certain environmental costs incurred at the facilities of out-of-state American Electric Power Company, Inc. ("AEP") operating companies be recovered through the Kentucky environmental surcharge. These environmental projects were put in service between 1993 and 2005 at the following AEP facilities[1]:

- Amos Plant (West Virginia)
- Cardinal Plant (Ohio)
- Gavin Plant (Ohio)
- Kammer Plant (West Virginia)
- Mitchell Plant (West Virginia)
- Muskingum Plant (Ohio)
- Philip Sporn Plant (West Virginia)
- Rockport Plant (Indiana)

[1] KPCo Exhibit JMM-2.

- Tanners Creek Plant (Indiana)

On June 7, 2005 the Kentucky Industrial Utility Customers, Inc. ("KIUC") filed the direct testimony of its expert witness Lane Kollen. Mr. Kollen recommended that the Commission reject the Company's request for surcharge recovery of environmental costs derived by disaggregating the AEP Pool capacity rates incurred pursuant to the AEP Interconnection Agreement,[2] that the Commission direct the Company to reflect environmental revenues mandated by the Interim Allowance Agreement and reduce its ECR revenue requirement by the amount of the margins earned from the utilization of emission allowances to supply off-system sales,[3] and that the Commission incorporate the effective reductions in the federal and state corporate income tax rates.[4] No party other than the Company and KIUC submitted testimony in this matter.

On June 30, 2005 the Company filed its Motion to Strike Testimony of Lane Kollen stating that Mr. Kollen's testimony offers legal opinions, that KIUC cannot submit testimony regarding preemption because the Commission has *"unequivocally ruled on this issue,"* that Mr. Kollen's testimony concerning the Interim Allowance Agreement is outside the scope of this proceeding and that Mr. Kollen's testimony concerning the treatment of certain emission allowance revenues and changes to state and federal tax laws are new issues that cannot be addressed in this proceeding.[5] For the reasons set out below KIUC requests that the Commission deny KPCo's Motion to Strike in its entirety.

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[2] Kollen Direct Testimony pp. 6-15.
[3] Id. pp. 16-30.
[4] Id. pp. 31-36.
[5] KPCo Motion to Strike Testimony of Lane Kollen, pp. 4-5.

II. ARGUMENT

1. The Company's Motion To Strike Ignores Kentucky Law Stating That The Commission Is Not Bound By Formal Rules Of Evidence.

The Company's Motion to Strike asks the Commission to engage in the extreme act of excluding the testimony of an expert witness in a Commission proceeding. Mr. Kollen's testimony is admissible before the KPSC which is not bound by formal rules of evidence. KRS 278.310 states:

> "All hearings and investigations before the commission or any commissioner shall be governed by rules adopted by the commission, and in the conduct thereof neither the commission nor the commissioner shall be bound by the technical rules of legal evidence." (emphasis added)

In a recent environmental surcharge proceeding (KPSC Case Nos. 2004-00421, 00426) the Commission offered its interpretation of this statute in the course of explaining its decision to overrule a Motion to Strike a witness' testimony. The Chairman characterized a motion to strike as an "extraordinary request" and denied that motion.

> "The Commission has considered the motion and the respective oral positions of the parties... and the Commission would state that a motion to strike testimony before an administrative body is a fairly extraordinary request. We are certainly not bound by the strict rules of evidence and... items of an evidentiary nature are given a little more leeway than they would be in a regular trial court. Because it is an extraordinary request and because there is some... dispute, and reasonable dispute, in issue under the statute as to whether or not this testimony is appropriate, the Commission will overrule the motion to strike ..."[6] (emphasis added)

The Company's Motion, and specifically its allegation that Mr. Kollen has offered a legal opinion, runs roughshod over this well established rule that the Commission is not bound by formal rules of evidence and that striking the testimony of an expert witness before the Commission is only done in extreme circumstances. Striking Mr. Kollen's testimony in this case would be particularly extreme because Mr. Kollen's testimony is the only intervenor testimony submitted in this case. The Company's Motion would expunge all testimony contrary to its own in this matter leaving the

[6] KPSC Case Nos. 2004-00421 and 00426. Transcript of Evidence (May 10, 2005) p. 23, lines 19-25, p. 24, lines 1-6.

Commission with a dramatically one-sided record.

In support of its Motion, the Company cites Tamme v. Commonwealth, KY., 973 S.W.2d 13 (1998) which states that *a "witness generally cannot testify to conclusions of law."* (Id. p. 32.) This case is distinguishable. Tamme involved a criminal case before the Kentucky Supreme Court. The criminal rules of evidence are strict and closely adhered to in order to protect the constitutional rights of individuals facing prison time or even death. As shown by KRS 278.310, the Legislature does not believe that the strict procedural safeguards accorded to criminal defendants should also apply to participants at the Commission. The Tamme Court's conclusions regarding criminal evidence are not relevant to this KPSC proceeding.

The Commission is an expert body that must base its decision on a complex interplay between law, economics and policy. It is not susceptible to being misled by irrelevant and unsubstantiated testimony in the same way that a jury in a criminal trial is likely to be misled. The Commission routinely hears evidence from non-lawyer expert witnesses concerning whether or not certain technical statutory requirements have been met. The testimony of KPCo witness Errol Wagner submitted in this case concerning the Company's compliance with the Federal Clean Air Act falls into this general category. Such testimony is critical to a reasonable resolution of Commission matters and the Commission is quite capable of putting this evidence into its proper context.

The Commission does not need the protection of and is not bound by strict evidence rules. Although KIUC will address each of the Company's specific arguments concerning the admissibility of Mr. Kollen's testimony below, the Company's Motion fails because Mr. Kollen's testimony falls well within the spectrum of evidence ordinarily heard by this Commission and the Commission will exclude evidence only in the most extraordinary circumstances.

2. An Environmental Surcharge Proceeding Necessitates Testimony As To Whether The Requirements of KRS 278.183 Are Met.

The Company argues that Mr. Kollen's testimony contains legal opinions regarding federal preemption which he is not qualified to provide.[7] The Company asks the Commission to exclude this testimony as outside the field of Mr. Kollen's expertise. The Commission should reject the Company's argument.

First, this Commission routinely accepts expert testimony addressing the application of statutes, rules, orders, and legal concepts, such as "fair rate of return," "federal preemption," and the "filed rate doctrine." Virtually every rate of return witness appearing before this Commission cites the *Hope* and *Bluefield* decisions by the U.S. Supreme Court and applies those decisions in their testimony. Mr. Kollen is a nationally recognized expert in ratemaking and the application of statutes, rules, orders, and legal concepts, such as federal preemption and the filed rate doctrine, for ratemaking purposes. His testimony on the application of KRS 278.183 and the Commission's prior orders implementing the statute has been accepted by this Commission on numerous occasions that are listed in Mr. Kollen's Exhibit___(LK-1) attached to his testimony in this proceeding, including prior KPCo proceedings where Mr. Kollen testified on the application of KRS 278.183, the Commission's prior orders, and federal preemption.

Second, the characterization of Mr. Kollen's testimony as *"purely legal"* is unfounded. Mr. Kollen's testimony speaks to the central issue in this case, namely whether the disaggregated environmental costs incurred by the Company through its FERC-approved agreements meet the requirements of KRS 278.183 for recovery through the environmental surcharge. This is a mixed question of law and fact. The costs that KPCo requests be included in the environmental surcharge are environmental costs that have been and will be incurred in Ohio, West Virginia and Indiana generation facilities that are not owned by KPCo. Mr. Kollen testified that the Company's Application fails to meet the requirements of KRS 278.183 predominantly because these costs were incurred by

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[7] Id. p. 4.
[9] Id. p. 7, lines 9-13.

out-of-state utilities that are not subject to the jurisdiction of the KPSC and no federal rate mandates a contrary result.

Mr. Kollen notes that since the Company's Application fails to meet the requirements of 278.183 the only theory that KPCo could use to justify the recovery of these costs through the surcharge is federal preemption. In this context preemption is a mixed question of law and fact. Mr. Kollen's discussion of preemption is directed toward the factual conclusion that the Company's disaggregation of the FERC-approved Interconnection Agreement rate into *"21 separately computed and hypothetical environmental rates based on dozens of environmental cost components"* should not be treated with the deference afforded to the actual federal rate approved by FERC.[9] Mr. Kollen has appeared as an expert witness on accounting finance, ratemaking and planning issues before regulatory commissions and courts at the state and federal levels on more than one hundred occasions and has developed and presented papers at conferences on ratemaking, accounting and tax issues.[10] Mr. Kollen has testified before this Commission on many occasions including several cases involving the environmental surcharge statute. Mr. Kollen is certainly qualified to make the observation that when the Company disaggregates the Interconnection Agreement rate in order to fabricate 21 novel *"rates,"* these invented *"rates"* should not be given the same weight as the actual FERC-approved rate.

The Company's Application does not meet the requirements of 278.183 and the *"rates"* it seeks to pass through the ECR are not federal rates but are merely fabricated rates ostensibly derived from a federal rate. Mr. Kollen's testimony relating to preemption should be admitted and given the weight the Commission determines is appropriate.

3. KPCo's Argument That The Commission "Unequivocally" Ruled On The Appropriateness Of Passing Environmental Costs Incurred Pursuant To The AEP Pool Agreement Is Not Correct.

[10] Kollen Testimony p. 2.

KPCo argues that the Commission should strike Mr. Kollen's testimony because the Commission *"unequivocally ruled"* on whether costs incurred through the AEP Pool Agreement in Case No. 96-489 can be recovered through the ECR statute. The issues presented in this case are distinguishable from those related to Case No. 96-489. The critical distinction is the pivotal role played by the Interim Allowance Agreement in the prior case.

As Mr. Kollen notes in his testimony, the Commission's Order in Case No. 96-489 addressed the costs incurred through the AEP Pool capacity rates only in conjunction with the cost of allowances incurred pursuant to the AEP Interim Allowance Agreement. All costs incurred by the Company pursuant to the AEP Interim Allowance Agreement were considered to be environmental costs and therefore recoverable through the ECR. In Case No. 96-489 the Interim Allowance Agreement supported the Company and mandated the result. The Commission determined that it was appropriate *"in this instance"* to include the costs paid by the Company through the AEP Pool capacity rates for the Gavin scrubber in the environmental surcharge.[11] In Case No. 96-489, the Commission adopted only a limited disaggregation of the AEP Pool rates because that computation was required to fully incorporate the Interim Allowance Agreement. In this case, the Company cannot and does not rely on the Interim Allowance Agreement.

According to its interpretation of Case No. 96-489 the Company can cherry-pick any environmental cost incurred by an out of state affiliate that finds its way into the Pool Capacity Rate and recover that cost automatically through the Kentucky ECR statute. If this interpretation is adopted, then the Company presumably could recover the entire cost of a future integrated gasification combine cycle ("IGCC") facility built outside of Kentucky as an environmental cost. The Commission's Order in Case No. 96-489 is not a license for the Company to disaggregate any environmental costs it deems to be embedded in each of its federal rates and recover these costs

[11] KPSC Case No. 96-489 Order (May 27, 1997) p.16.

through KRS 278.183 when such costs were incurred in Ohio, Indiana, West Virginia or even Texas. The out-of-state costs listed in KPCo's Application are properly recoverable in base rates not through the environmental surcharge.

Finally, if the Commission eventually determines that Case No. 96-489 is not distinguishable from the present matter it should make this determination only after a hearing in which each party's arguments on the issue are carefully considered. It would be improper for the Commission to exclude KIUC's evidence based on the assertion that this issue has been decided in a prior Commission Order when that Commission Order clearly states that the decision was based on the facts and circumstances of that proceeding.

4. The Issue Of The Company's Accounting Of SO2 Allowances And The Appropriate Treatment Of New State And Federal Tax Laws Are Proper Issue For Consideration In This Proceeding.

The Company argues that Mr. Kollen's testimony concerning the Company's treatment of SO2 emission allowances and certain changes in tax laws should be excluded from the record. The Company contends that intervenors are not permitted to *"inject issues"* that were not raised in KPCo's Application.[12] KPCo's depiction of these sections of Mr. Kollen's testimony as new issues is unfounded. Mr. Kollen has flagged these items because the Company failed to account for them in their Application. KIUC would not have to *"inject"* these issues into this case if KPCo had properly treated their SO2 emission allowances, this new Section of the Internal Revenue Code, and the state income tax rates in its Application.

Mr. Kollen's testimony concerning the accounting for the sale of SO2 emission allowances is relevant to this proceeding because the Company's direct and indirect sale of these allowances represents a margin that must be deducted from the Company's ECR revenue requirement. KPCo receives revenues from the sale of emission allowances in three ways. First, the Company receives the

[12] KPCo Motion to Strike, p. 7.

entirety of proceeds from the EPA's sale of certain SO2 and NOx allowances belonging to the Company. Second, the Company sells allowances directly to third parties. Third, the Company indirectly sells allowances when they are utilized to supply power for off-system sales by the AEP System to third parties.[13]

Although the Company uses the margins from direct sales to third parties and revenues from EPA sales to reduce the revenue requirement in its monthly ECR filings it does not treat the margins on its indirect sales of allowances utilized to supply power for off-system sales in the same manner. KPCo is allocated and reports the margins on the indirect sales of allowances utilized to supply power for off-system sales for financial statement purposes. These allowance sales are shown as income on the Company's books. But the Company does not use these margins to reduce the ECR revenue requirement in its monthly filings. The failure to use these margins in its monthly ECR filings results in an excessive ECR revenue requirement. The Company's treatment of its indirect sales of allowances utilized to supply power for off-system sales violates the Commission's Order in Case No. 96-489 which required the Company to reduce the environmental surcharge by *"any net gains or net losses allocated to Kentucky Power under the IAA."* [14]

As Mr. Kollen explains in his testimony, the effect of properly including the margins on the utilization of allowances in the ECR is significant. This accounting correction would reduce the Kentucky retail revenue requirement on a net basis by $2,614,431 for the twelve month period ending March 2005.[15]

Mr. Kollen's testimony concerning the accounting for indirect sales of emission allowances utilized to supply power for off-system sales is not a new issue injected into this case by KIUC as KPCo contends. This testimony identifies an error that should have been accounted for in KPCo's

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[13] Kollen Testimony p. 16, lines 8-18.
[14] Kollen Testimony p. 17, lines 3-8.
[15] Id. p. 29, lines 16-20, p. 30, lines 1-2.

filing.

Mr. Kollen's testimony concerning the proper treatment of state and federal tax law changes is likewise not a new issue, but a correction to the Company's failure to account for a new tax deduction and lower state income tax rates. These same issues were raised by KIUC in the recent Louisville Gas & Electric Company ("LG&E") and Kentucky Utilities Company ("KU") ECR proceedings (Case Nos. 2004-00421 and 2004-00426). In those cases, LG&E and KU conceded that KIUC was correct in its treatment of these tax law changes and the Commission ultimately incorporated KIUC's recommendation on this issue in its final Order of June 20, 2005.[16]

Specifically, Mr. Kollen points out that the new Internal Revenue Code Section 199 allows electric utilities to deduct 9% of the lesser of the utility's annual *"qualified production activities income"* or taxable income. This new deduction is phased in over several years, with a 3% deduction available for 2005 and 2006, a 6% deduction available for 2007 through 2009, and a 9% deduction available for 2010 and thereafter.[17]

Further, Kentucky House Bill 272 ("HB 272"), enacted on March 18, 2005, adopted the Internal Revenue Code as of December 31, 2004 for Kentucky state income tax purposes. Thus, the Kentucky income tax law allows for the same deduction against qualified production activities income as the federal income tax law.

HB 272 also reduced the Kentucky state income tax from 8.25% to 7.0% effective January 1, 2005 and reduced it further to 6.0% effective January 1, 2007. This reduction in Kentucky state income tax rates applies to all taxable income, not just qualified production activities income.

These changes to state and federal tax laws reduce the Company's ECR revenue requirement

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[16] KPSC Case Nos. 2004-00421 and 00426, p. 28.
[17] Kollen Testimony p. 31, lines 11-15.

by $368,689 based on the Company's ECR filing for the March 2005 expense month.[18]

These corrections to the KPCo's filing detailed in Mr. Kollen's testimony are not new issues that are outside the scope of this environmental surcharge proceeding as the Company contends. These issues were addressed in this case through Mr. Kollen's testimony because the Company incorrectly failed to include them in its Application.

Respectfully submitted,

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[18] Id. p. 35, lines 14-15.