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 September 27, 2005, Kentucky Power Company ("Kentucky Power") filed a petition for rehearing challenging the methodology used to gross-up income taxes in the Commission's September 7, 2005 Order approving an amended environmental compliance plan and amended Environmental Surcharge ("E.S.") tariff. On September 28, 2005, the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), and Kentucky Industrial Utility Customers, Inc. ("KIUC") filed a joint petition for rehearing challenging the approval of Kentucky Power's amended environmental compliance plan. On October 6, 2005, Kentucky Power filed its response in opposition to the AG's and KIUC's joint petition for rehearing.

Based on the petitions and being otherwise sufficiently advised, the Commission makes the following findings of fact on each of the issues raised on rehearing:

Calculation of Gross-Up Factor for Rate of Return

The September 7, 2005 Order found that the effects of the changes in the federal and state income tax statutes should be recognized and reflected in the gross-up factor, as was proposed by KIUC. The change in the federal income tax statutes was the creation of a new tax deduction resulting from the American Jobs Creation Act of 2004. This deduction, referred to as Section 199 of the Internal 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. The change in the state income tax statutes was the reduction in the Kentucky corporate income tax rate, enacted by House Bill 272 of the 2005 Regular Session of the General Assembly. The Kentucky corporate income tax rate was lowered from 8.25 percent to 7 percent for 2005 and 2006, and lowered to 6 percent in 2007. In rejecting Kentucky Power's arguments against recognizing the changes in income tax statutes in the gross-up factor, the September 27, 2005 Order noted that Kentucky Power had delayed, until the filing of its post-hearing brief, to make a proposal to recognize the effects of tax laws or effective income tax rates as a line item in the surcharge determination. In its rebuttal testimony and at the hearing, Kentucky Power had acknowledged that certain tax effects should be reflected in the surcharge, but offered no specific proposal to recognize these tax effects.

In its petition for rehearing, Kentucky Power argued that the methodology adopted in the September 7, 2005 Order is flawed and results in an overstatement of the tax benefits to be received and an understatement of its gross-up factor. Kentucky Power requested rehearing on three issues relating to the tax gross-up factor:

(a) Whether, under KRS 278.183, the effect of the changes from the Section 199 deduction and House Bill 272 should be estimated through a misuse of the gross-up factor for rate of return, or accurately reflected as a negative expense item in the E.S. tariff;

(b) Whether, under KRS 278.183, if the referenced tax changes are to be reflected in the calculation of the gross-up factor for rate of return purposes in the environmental surcharge, the calculation of the gross-up factor should be modified to more accurately reflect the true economic benefits of the Section 199 tax change, and the amount of the tax benefit related to Kentucky Power's environmental facilities; and

(c) Whether, in any event, under KRS 278.183, an annual "true-up" mechanism should be recognized in the E.S. tariff which would allow the estimated tax benefits reflected in the environmental surcharge to be adjusted to reflect the actual tax benefits received by Kentucky Power under Section 199 and House Bill 272.[1]

Concerning the first issue, Kentucky Power argued that the approach in the September 7, 2005 Order fundamentally mischaracterizes the nature and purpose of the gross-up factor, contending that the gross-up factor is not designed to be an estimate of income tax expense. Kentucky Power noted that as a member of the American Electric Power ("AEP") system, it files a consolidated federal income tax return, and that it will only receive Section 199 benefits to the extent they are produced by filing a consolidated return. Kentucky Power contended that the gross-up factor set forth in Appendix B of the September 7, 2005 Order did not take into account the fact that the Section 199 deduction is based on 100 percent of the manufacturing or generating assets. Since the cost of its environmental investment is approximately 60 percent of its total plant in service, Kentucky Power argued that the September 7, 2005 Order assigns 100 percent of the Section 199 benefits to the environmental investment, when only 60 percent is appropriate. Kentucky Power renewed the

[1] Kentucky Power Petition for Rehearing at 2.

suggestion first raised in its post-hearing brief that the actual tax benefits from Section 199 and House Bill 272 should be shown as a line item in the E.S. tariff so that the actual amount of tax benefit will be reflected in the environmental surcharge, as required by KRS 278.183. Kentucky Power contended that although this approach was simpler, more direct, and more accurate, it was rejected because the parties did not have an opportunity to conduct discovery or otherwise investigate its reasonableness. Kentucky Power now seeks rehearing to afford the parties and the Commission an opportunity to investigate its proposal.[2] Finally, Kentucky Power requested that the Commission apply rate-making methodology in the environmental surcharge "that is designed to accurately reflect the factual and legal circumstances confronting the utility."[3]

On the second tax issue, Kentucky Power argued that the simplified approach included in the September 7, 2005 Order is so flawed as to merit full reconsideration, rejection, and substitution with the line item approach Kentucky Power proposed in its post-hearing brief. However, as an alternative, Kentucky Power requested that the September 7, 2005 Order be modified to adjust the gross-up factor for the percentage of the Section 199 deduction actually received by Kentucky Power and the percentage of the Section 199 deduction associated with the environmental facilities located at the Big Sandy generating station. Without this modification, Kentucky Power contended that the result is an overstatement of the actual tax benefit received. Kentucky Power

[2] Id. at 3-5.

[3] Id. at 4.

included calculations that claimed this overstatement of the Section 199 benefit to be approximately 42 percent.[4]

On the last tax issue, Kentucky Power requested that regardless of whether rehearing is granted on the treatment of the Section 199 deduction, the E.S. tariff should be modified to allow for annual rate adjustments associated with the Section 199 deduction to reflect the actual tax benefit received. Kentucky Power argued that KRS 278.183 mandates that a utility is entitled to recover its costs of compliance, and without a true-up adjustment, the statutory mandate would be violated.[5]

As stated in the September 7, 2005 Order, to properly reflect the impact of income taxes in the calculation of the authorized rate of return on capital, an income tax gross-up factor is applied to the common equity component of the rate of return on capital. The use of a gross-up factor was proposed by Kentucky Power in this case. The gross-up factor approximates the income tax effect on the additional revenues generated by the environmental surcharge. It was not designed to exactly match the actual income tax expense or tax calculations Kentucky Power makes annually when it prepares its federal and state income tax returns. As correctly noted by Kentucky Power, it files consolidated federal income tax returns as part of the AEP system. However, Kentucky Power has never previously objected to the accuracy of using a gross-up factor based on statutory income tax rates instead of reflecting the effective federal income tax rate in its surcharge mechanism. Further, Kentucky Power has neither in past environmental surcharge applications, nor its present application,

[4] Id. at 7.

[5] Id.

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.

Kentucky Power had a full and fair opportunity in this proceeding to propose an alternative means of reflecting income taxes in the rate of return calculation for the environmental surcharge. In fact, Kentucky Power's original position was that no tax issue could be considered in this case because its application did not propose any income tax changes. The tax issue was first raised by KIUC to properly recognize the Section 199 deduction and the effects of House Bill 272 in the tax gross-up factor. Kentucky Power had the opportunity in its rebuttal testimony to propose a line item in the surcharge mechanism to reflect income tax effects and to present evidence to show that KIUC's tax proposal might be flawed, but Kentucky Power chose to do neither. The statutory standard for the presentation of new evidence on rehearing is set forth in KRS 278.400. That standard provides that "any party may offer additional evidence that could not with reasonable diligence have been offered on the former hearing." Kentucky Power had full knowledge of the tax issue raised by KIUC and Kentucky Power's rebuttal testimony could have included the evidence it now seeks to present on rehearing. Based on a review of all of Kentucky Power's rehearing arguments, the Commission finds that rehearing should be denied.

2005 Environmental Compliance Plan ("2005 Plan") and Associated Costs

Kentucky Power's 2005 Plan included its member load ratio share of environmental compliance costs associated with 53 projects located at generating stations owned by affiliates, Ohio Power Company and Indiana and Michigan Power Company. Kentucky Power contended that the 53 projects related to its own

compliance and that of AEP with the Clean Air Act[6] and other federal, state, or local environmental requirements that apply to coal combustion wastes and by-products from facilities used to generate electricity from coal. The September 7, 2005 Order found that, except for projects relating to the mitigation of sulfur trioxides ("SO_3"), Kentucky Power had submitted an environmental compliance plan that conformed to the requirements of KRS 278.183 and that environmental compliance plan was approved.

The environmental compliance costs Kentucky Power sought to include in its environmental surcharge associated with its 2005 Plan were determined under the provisions of the AEP Interconnection Agreement and the Rockport Unit Power Agreement, both of which are subject to the exclusive jurisdiction of the Federal Energy Regulatory Commission ("FERC"). The September 7, 2005 Order found that the costs identified for the 2005 Plan projects, with the exception of the SO_3 mitigation projects, were shown to be reasonable and cost effective for environmental compliance, were reasonable, and were approved for recovery through Kentucky Power's environmental surcharge.

In their joint petition for rehearing, the AG and KIUC argued that the costs proposed for recovery by Kentucky Power did not qualify for surcharge recovery. The AG and KIUC contended that KRS 278.183 was enacted to provide an incentive for utilities in Kentucky to use high-sulfur western Kentucky coal. The AG and KIUC stated that Kentucky Power's proposal for surcharge recovery of the costs of environmental compliance facilities incurred by other utilities outside of Kentucky several years after the facilities were put into service was counter to the purpose of KRS 278.183 and

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

contrary to judicial precedent.[7] They noted that KRS 278.183(1) and 278.183(2) clearly assume that the Commission has jurisdiction over the entity making the decisions about environmental compliance. The AG and KIUC argued that Kentucky Power's environmental costs, which were incurred pursuant to the AEP Interconnection Agreement, must be recovered in a base rate case and not by environmental surcharge because KRS 278.183 does not allow for the recovery of these costs. The AG and KIUC contended that Kentucky Power did not file a compliance plan and, in the alternative, the plan that was filed by Kentucky Power failed to meet the requirements of the statute because the Commission did not have jurisdiction over the facilities owned by AEP affiliates outside of Kentucky. The AG and KIUC claimed that the costs Kentucky Power proposed to recover through the environmental surcharge were not Kentucky Power's costs of environmental compliance and, based on the provisions of the surcharge statute, those costs could not be recovered by environmental surcharge. Lastly, the AG and KIUC argued that the environmental surcharge requires that the Commission, and not FERC, set the rate of return on compliance-related capital investments recovered through the surcharge.

In its October 6, 2005 response, Kentucky Power stated that the issues raised by the AG and KIUC had already been raised several times and properly rejected by the Commission. Kentucky Power argued that the legislative intent of KRS 278.183 did not preclude the recovery of its requested environmental compliance costs. Kentucky Power noted that the Commission clearly held that the statute was unambiguous and

[7] *Kentucky Utility Customers, Inc. v. Kentucky Utilities Company*, 983 S.W.2d 493 (Ky. 1998).

that it was not necessary to look beyond the clear language of the statute to effectuate legislative intent. Kentucky Power stated that the rehearing arguments of the AG and KIUC did not establish any ambiguity in KRS 278.183 and that the AG and KIUC had not shown that the September 7, 2005 Order was inconsistent with the legislative intent. Kentucky Power argued that the AG and KIUC incorrectly applied the principles enunciated by the Kentucky Supreme Court in the *Kentucky Utilities* decision, noting that while the Court prohibited the inclusion of environmental projects begun prior to the effective date of KRS 278.183, all of Kentucky Power's compliance projects were constructed after the statute's effective date. Kentucky Power noted that limiting the surcharge statute to apply only to in-state projects as requested by the AG and KIUC could violate the Commerce Clause of the United States Constitution.

Kentucky Power also asserted that KRS 278.183 does not require the Commission to have jurisdiction to approve the construction of compliance projects, only that the Commission determine whether the projects are reasonable and cost-effective for compliance with environmental requirements. Kentucky Power indicated that the costs it is required to pay under the terms of the AEP Interconnection Agreement are incurred by Kentucky Power to provide service to its customers. Consequently, Kentucky Power asserted that these are its costs and the requirements of KRS 278.183 are satisfied. Finally, Kentucky Power argued that it was not required to offer testimony on a reasonable rate of return because its 2005 Compliance Plan included only expenses incurred pursuant to the FERC-approved AEP Interconnection Agreement. To the extent those expenses included a rate of return established by

FERC, the doctrine of federal preemption required the Commission to accept that rate of return.

The Commission has considered the rehearing arguments of the AG and KIUC and finds them to be unpersuasive. The majority of their rehearing arguments were previously raised and rejected by the September 7, 2005 Order. The language of KRS 278.183 is clear and unambiguous with respect to the issues raised here. The statute authorizes surcharge recovery of qualifying environmental compliance costs without reference to the location or ownership of the facilities. The only requirement is that the compliance costs be costs of the utility seeking the surcharge recovery. The Supreme Court decision in the *Kentucky Utilities* case did not limit surcharge recovery to facilities located within Kentucky or to facilities owned by the applicant. In addition, while the Court prohibited surcharge recovery of projects constructed prior to the statute's effective date of 1993, the Court did not prohibit surcharge recovery of post-1993 projects that were constructed prior to their inclusion in a utility's compliance plan.

In their joint petition for rehearing, the AG and KIUC fail to acknowledge that the Gavin (Ohio) generating station scrubber costs, the Rockport (Indiana) continuous emission monitor costs, and the Indiana air emission fees, all of which were included in Kentucky Power's original environmental surcharge plan, are already included in Kentucky Power's surcharge in the same manner as the 2005 Plan costs. Environmental compliance costs associated with projects outside of Kentucky have been included in Kentucky Power's environmental surcharge mechanism since 1997. In the September 7, 2005 Order, the Commission found that Kentucky Power did submit an environmental compliance plan, that the plan was reasonable and cost-effective, and

that the costs associated with the plan were eligible for recovery through Kentucky Power's environmental surcharge mechanism. The AG and KIUC have offered no arguments or identified any evidence to persuade us to grant a rehearing.

IT IS THEREFORE ORDERED that:

1. Kentucky Power's petition for rehearing is denied.

2. The joint petition for rehearing filed by the AG and KIUC is denied.

Done at Frankfort, Kentucky, this 17th day of October, 2005.

By the Commission

ATTEST:

Executive Director