

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

PUBLIC SERVICE  
COMMISSION

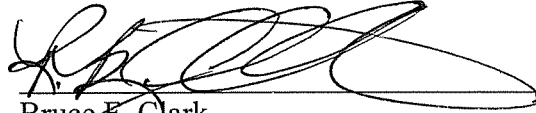
AN EXAMINATION BY THE PUBLIC SERVICE )  
COMMISSION OF THE ENVIRONMENTAL )  
SURCHARGE MECHANISM OF KENTUCKY )  
POWER COMPANY FOR THE SIX-MONTH )  
BILLING PERIODS ENDING DECEMBER 31, 2002, )  
DECEMBER 31, 2003, JUNE 30, 2004, )  
DECEMBER 31, 2004, AND DECEMBER 31, 2005, )  
AND FOR THE TWO-YEAR BILLING PERIODS )  
ENDING JUNE 30, 2003 AND JUNE 30, 2005 )

CASE NO. 2006-00128

**KENTUCKY POWER COMPANY’S SUPPLEMENTAL SUBMISSION IN SUPPORT  
OF ITS PETITION FOR CONFIDENTIAL TREATMENT FOR CERTAIN  
INFORMATION DISCLOSED IN RESPONSE TO CERTAIN DATA REQUESTS**

Kentucky Power Company, by and through counsel, hereby submits the following documents in compliance with the request made by the Commission staff at the informal conference held on this matter on October 5, 2006: (1) An overview of the emission allowance market and Kentucky Power’s participation in the market (Attached as Exhibit 1); and (2) A chart showing price fluctuations in the emission allowance market (Attached as Exhibit 2). These documents illustrate the extent to which forecasted market participation information for Kentucky Power and American Electric Power (“AEP”) will negatively impact pricing for Kentucky Power, leading to increased costs for its customers. Should the Commission require any additional information in deciding this issue, Kentucky Power will be pleased to produce it upon request.

Respectfully submitted,



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COMPANY

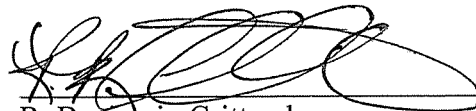
**CERTIFICATE OF SERVICE**

I hereby certify that a true and accurate copy of the foregoing was served by first class mail, postage prepaid, upon the following:

Michael L. Kurtz  
Boehm, Kurtz & Lowry  
Suite 1510  
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Cincinnati, Ohio 45202

Elizabeth E. Blackford  
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Frankfort, Kentucky 40601-8204

on this 27th day of October, 2006.

  
R. Benjamin Crittenden

## KPCo Allowance Market Discussion

The number of SO<sub>2</sub> and NO<sub>x</sub> allowances purchased or sold by KPCo depends on many variables including the unit output performance of affiliate members' facilities as well as the FERC approved Interim Allowances Agreement ("IAA"). The market in which AEP must purchase and sell allowances is thinly traded and populated by participants other than utilities, whose sole purpose is financial gain on speculatively traded positions. Thus, the knowledge of future purchases/sales by a large utility such as AEP will have a direct detrimental impact to the cost of serving KPCo customers. Provided below is a discussion of the emission allowance market and the impact that the release of forecasted emission allowance information would have on KPCo.

Q. Who are the market participants in the emission allowance market?

A. Allowances may be bought, sold and traded by any individual, corporation, or governing body, including brokers, municipalities, environmental groups, and private citizens.

Some of the SO<sub>2</sub> major players include:

Utilities: Duke, TXU, Constellation, Mirant, DTE, Dominion, PP&L

Banks: JP Morgan, Morgan Stanley, Credit Suisse

Hedge Funds: Saracen, Centaurus, Alpha, Louis Dreyfus

Other: BP Energy, Koch

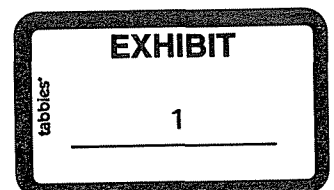
The major NO<sub>x</sub> players include:

Utilities: Duke (Cinergy), Constellation, DTE, Dominion

Other: Koch

Q. What is the principal motivation of these market participants?

A. The market for trading such allowances contains a broad spectrum of participants as noted above. Participants, such as utilities, are primarily engaged in purchasing and selling allowances for compliance purposes in order to meet EPA mandated requirements. However, there are other market participants whose primary motivation is not to fulfill the requirement to offset physical emissions of SO<sub>2</sub> and NO<sub>x</sub>. These participants include financial institutions and hedge funds whose principal business is to create revenue based on speculatively traded positions. The ability of the participants to benefit from trading allowances is enhanced by any competitive information, including forecasted purchases and sales of major holders of allowances, such as KPCo (AEP).



## KPCo Allowance Market Discussion

Q. Describe the emission allowance market?

A. There is formalized OTC trading with and without brokers. However, no particular exchange handles these transactions.

The SO<sub>2</sub> emission allowance market is a thinly traded, illiquid market. A typical trading day produces from eight (8) to ten (10) SO<sub>2</sub> trades for a total of 8,000 to 10,000 allowances.

The NO<sub>x</sub> market is also a very thinly traded market. NO<sub>x</sub> allowances are more regional in nature and require more detailed knowledge of geographical constraints, thus exacerbating the impact of forecasted information being made publicly available. There is no typical NO<sub>x</sub> trading day. When trades are made, it is usually for 50 to 100 allowances.

Q. Describe the volatility of the allowance market.

A. The price of an SO<sub>2</sub> allowance traded in a relatively narrow range prior to 2004, with prices between \$100 and \$250/allowance. Since mid-2004, prices have been very volatile, and prices as high as \$1,600/ton have recently been observed. An SO<sub>2</sub> allowance price of \$1,600/ton equates to adding approximately \$10/MWh to the variable cost of operating an AEP unit. Exhibit Number 1 provides the dollar per ton at which SO<sub>2</sub> traded from 2000 through 2005 along with the volatility of these prices. Due to the thinly traded market, SO<sub>2</sub> prices are volatile and the price can move significantly on small volumes. For example, in a recent two day period in mid-October, while less than 18,000 tons were sold, the market moved \$55/ton or about 10% of the value.

NO<sub>x</sub> allowance pricing has also been volatile, with prices observed in early 2003 of near \$7,000/ton, but recently within a range of \$2,000 to \$4,000/ton. A NO<sub>x</sub> allowance price of \$4,000/ton would equate to adding a little more than \$3.00/MWh to the variable cost of operating an AEP unit. Exhibit Number 2 provides the dollar per ton at which NO<sub>x</sub> traded from 2000 through 2005 along with the volatility of these prices. Based on a similar mid-October timeframe as the SO<sub>2</sub> example above, NO<sub>x</sub> prices have shown volatility of 39% over a ninety-day period, 50% over a thirty-day period and 105% over a ten-day period.

Q. Will the price of allowances rise or fall based solely on AEP's activity?

A. Price may not necessarily rise or fall based on AEP's activity. However, because the market is illiquid, market players could be influenced if they know AEP's intentions.

## KPCo Allowance Market Discussion

Even though the SO<sub>2</sub> “market” at any point has roughly 15 million allowances (9.2 million EPA issued plus 6 million banked), transactions as small as 10,000 allowances commonly move the price as happens in a typical trading day. The NO<sub>x</sub> market is even more sensitive with only roughly 550,000 allowances able to be traded.

Please note that all outstanding EPA balances need reconciled by 60 days after the end of the relevant period. It is not hard to envision adverse market forces coming to bear as this deadline approaches.

AEP’s comparative level of activity must be also recognized. During the four year period from 2002 through 2005, AEP (East pool companies) bought 3,968,503 allowances compared to EKPC’s 100,457. AEP also sold 1,794,460 allowances versus EKPC’s 37,100. The relative level of transactions easily discerns the differences between the two companies with respect to market impacts and confidentiality concerns.

- Q. What may happen if other market participants (those trading speculatively) gain this longer-term insight?
- A. If other market participants gain access to AEP’s emission allowances status, they will be able to determine if KPCo is in a “long” position or “short” position, i.e. whether KPCo is in a position where it has excess allowances or in a position where it will be required to purchase additional allowances. Access to such information will also be detrimental to KPCo’s ability to freely participate in the emission allowance market since KPCo’s position is now publicly available.

With the limited amount of trading activity, coupled with the knowledge of when a major participant is looking to purchase or sell allowances, there is ample opportunity for astute market participants to extract self-benefiting gains at the expense of a participant like KPCo (AEP). Speculative players could take positions to maximize profits based on the information garnered. Although KPCo’s overall position (total number of allowances) can be determined via the EPA website, the critical information that would be valuable to others is the plans and projections to meet compliance going forward, which is provided in AEP’s forecast.

- Q. Could KPCo be harmed by this activity?
- A. Such information in the hands of a buyer or seller of emission allowances will adversely affect the negotiated price of emission allowances KPCo attempts to purchase or sell because the other participants will know

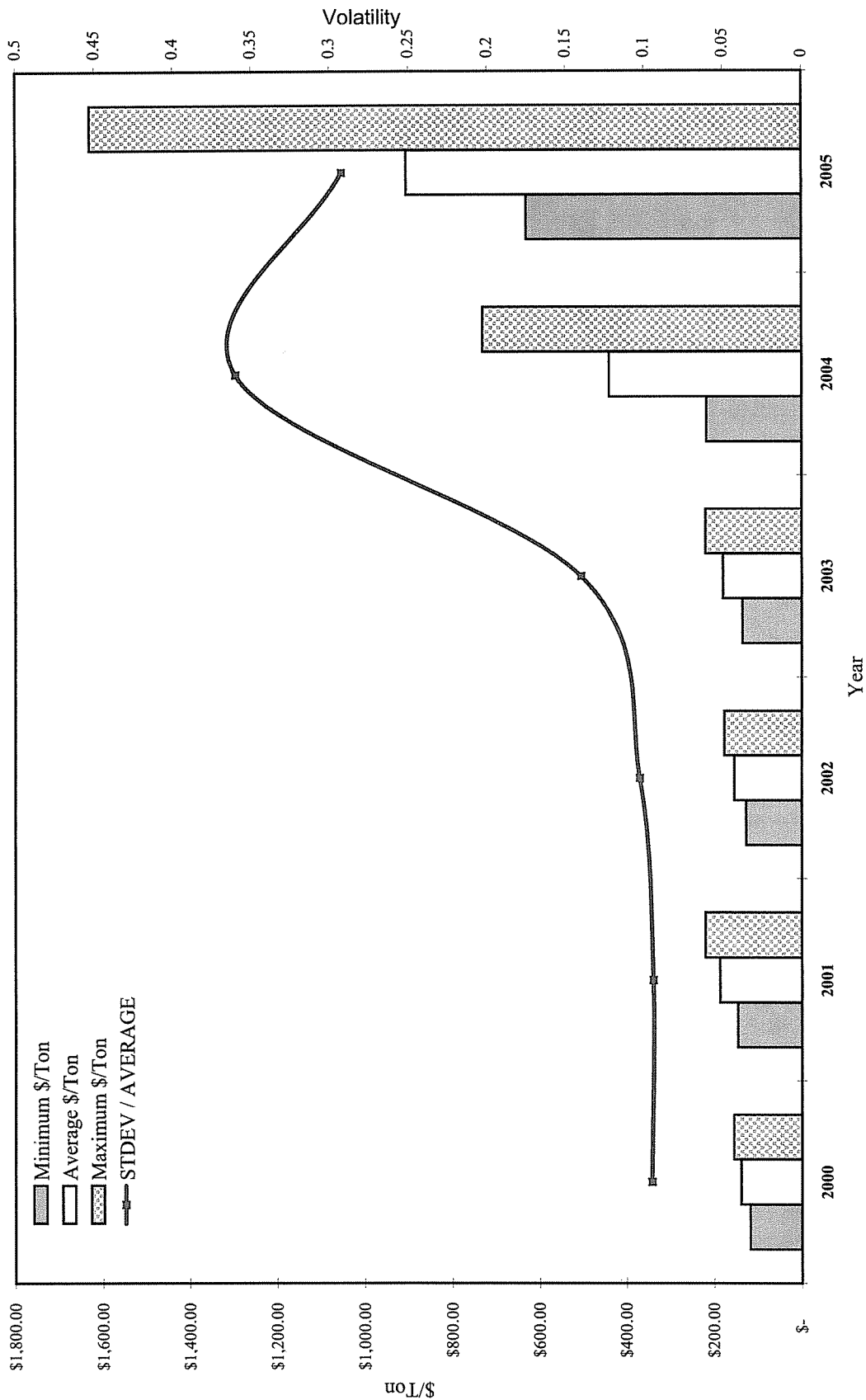
## KPCo Allowance Market Discussion

precisely how important it is for KPCo to purchase or sell the allowances. This pricing effect is likely to unnecessarily increase the cost of electricity for KPCo's customers since any costs incurred, or reduced profits earned, on the purchase or sale of emission allowances flow through the environmental surcharge mechanism.

The harm to KPCo can be easily demonstrated with the following example. For any volume of transactions one wishes to presume, a drop in the allowance sales price from \$700 per allowance to \$500 per allowance requires the sale of an additional 40% of allowances in order to maintain the same sales gain. Conversely, a purchaser such as KPCo facing an increase in the price of an allowance from just \$500 to \$700 will pay an additional 40% more to obtain the same number of needed allowances.

In summary, KPCo is not requesting all data be confidential, rather, any information that will place KPCo at a competitive disadvantage in the highly competitive, but thinly traded, emission allowance market. Based on AEP's active participation and knowledge of the emission market, including the motivation of certain market participants and price volatility exhibited by the market, KPCo believes it would be harmed by the public release of forecasted emission allowance information, ultimately raising the cost of electricity to customers.

**Historical Price of SO2 Allowances and Volatility (2000-2005)**



**Historical Price of NOx Allowances and Volatility (2000-2005)**

