

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

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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.  
2006-00307

**BRIEF OF KENTUCKY POWER COMPANY**

**I.  
INTRODUCTION**

Kentucky Power Company (“Kentucky Power” or the “Company”) seeks recovery in this case of certain environmental costs required by the Federal Clean Air Act (“CAA”) and the Solid Waste Disposal Act (“SWDA”). Kentucky Power seeks recovery of these costs pursuant to KRS 278.183, which provides that a utility is entitled to current recovery of its costs incurred for compliance with the CAA and those federal, state or local environmental requirements which apply to coal combustion and by-products from facilities used to generate electricity from coal. This recovery occurs through imposition of a surcharge. The statute requires the utility to present an environmental compliance plan to the Kentucky Public Service Commission (“Commission”) before imposing the surcharge. KRS 278.183(2). The Commission is required to approve the environmental compliance plan and the proposed surcharge if it finds them to be reasonable and cost-effective. *Id.*

This proceeding is Kentucky Power’s fourth request for approval of the recovery of its environmental costs. The Company has made changes to its original plan as the requirements of the CAA and the various federal, state and local environmental requirements which apply to coal combustion and the by-products from facilities used to generate electricity from coal have been

applied to its operations. The majority of the Company's recoverable environmental costs relate to CAA's Nitrogen Oxide (NO<sub>x</sub>) and Sulfur Dioxide (SO<sub>2</sub>) emission reduction standards for coal-fired power plants, which have been implemented over the course of the last decade.

Kentucky Power is a subsidiary of American Electric Power Company, Inc. ("AEP") and a member, along with four other operating utilities, of the AEP Pool. The AEP Pool was created by the AEP Interconnection Agreement ("Pool Agreement" or "Interconnection Agreement"), which was approved by the Federal Energy Regulatory Commission ("FERC") and which allows the members of the Pool to share capacity and the expenses associated with that shared capacity through FERC-approved rates. As will be set forth in detail below, Kentucky Power does not possess sufficient generating capacity to supply its customers with the power they require during peak demand periods. Consequently, Kentucky Power is classified as a deficit member of the AEP Pool and is assigned capacity from other members that have more capacity than is required to meet their customers' requirements. The rates paid by Kentucky Power for the capacity received from the surplus members of the AEP Pool under the Interconnection Agreement include charges associated with environmental facilities installed at the generating plants of the surplus members. Kentucky Power also receives power from and owns an interest in the Rockport generating plants pursuant to a separate FERC-approved Unit Power Agreement ("Unit Power Agreement").

The costs being sought by Kentucky Power in this proceeding pursuant to the Company's Environmental Compliance Plan are environmental costs incurred by Kentucky Power pursuant to the Interconnection Agreement and the Unit Power Agreement. That is, the costs being sought are costs incurred for environmental compliance by surplus members of the AEP Pool. Kentucky Power is responsible for a portion of these costs pursuant to the Interconnection

Agreement and the Unit Power Agreement, and the Commission has authorized the Company to recover such costs in prior proceedings.

## **II.** **BACKGROUND**

### **A. The AEP Pool**

The AEP Pool consists of five operating utilities: Kentucky Power, Appalachian Power Company (“Appalachian Power”), Columbus Southern Power Company (“Columbus Southern”), Indiana Michigan Power Company (“I&M”), and Ohio Power Company (“Ohio Power”). While each company holds title to its own generating facilities, the AEP Pool is designed, built and operated on an integrated basis. This approach enables Pool members to minimize capacity costs by allowing for larger, more cost-effective units to be constructed with the costs and benefits of those units shared by the Pool members.

Each Pool member’s obligations are specified in the Interconnection Agreement. As explained in detail in the testimony of Mr. Errol K. Wagner, Director of Regulatory Services for Kentucky Power, the Interconnection Agreement requires each operating company in the AEP Pool to provide adequate generating facilities or other sources to meet its internal firm load requirement. Wagner Direct Testimony (“EKW”) at p. 5. Kentucky Power owns two generating units located at Louisa, Kentucky, Big Sandy Unit 1 (260 MW) and Big Sandy Unit 2 (800 MW). Additionally, Kentucky Power has entered into the Unit Power Agreement with AEP Generating Company (“AEG”), which entitles the Company to a share of the generating capacity of the Rockport Units. This arrangement provides Kentucky Power with an additional 390 MW of capacity. Thus, Kentucky Power’s total capacity equals 1450 MW. This amount is some 215 MW less than Kentucky Power’s current internal peak demand (based on the most recent twelve-month period) of 1665 MW.

The Interconnection Agreement allows Kentucky Power to meet its capacity requirements by relying on the AEP Pool. The Interconnection Agreement allocates the total AEP Pool capacity to each member company based on the relative percentage of each member company's highest non-coincident peak demand in the preceding twelve-month period to the total system peak. The ratio of a member company's highest preceding twelve-month non-coincident peak to the total system peak is referred to as the Member Load Ratio ("MLR") for each member company. Each member company is responsible for its MLR share of the total system capacity. This responsibility is referred to as the member company's primary capacity reservation, and it is calculated by multiplying the member company's MLR by the total system capacity. If a member company's primary capacity reservation exceeds its own capacity, the member company is a "deficit" member. Conversely, if a member company's primary capacity reservation is less than its installed capacity, it is a "surplus" member. A deficit member is required to compensate for its shortfall by paying the surplus members a carrying charge based on the average embedded cost of capacity of the surplus companies. This compensation is referred to as a Capacity Settlement Charge.

Because a member company's primary capacity reservation is determined by multiplying the member company's MLR by the total system capacity, the total capacity surplus in any given month will always equal the total capacity deficit for that month. The Capacity Settlement Charge paid by the deficit member companies is a means of equalizing the members' responsibility for the AEP Pool's installed capacity. Without such a mechanism, Kentucky Power would have to either build new generating facilities or purchase power on the open market as additional capacity becomes necessary. The former alternative would require a great expense

from Kentucky Power while the latter alternative would result in increased expenses and an unacceptable risk to the Company's customers.

**B. The CAA Amendments of 1990**

In 1989, President Bush proposed sweeping amendments to the CAA. Congress enacted these changes in 1990. 42 U.S.C. §§ 7401 et seq. Title IV of the 1990 CAA Amendments established a new program that restricted the emission of SO<sub>2</sub> and NO<sub>x</sub> (compounds considered to be precursors to acid rain) from electric utilities' generating facilities. With respect to SO<sub>2</sub> emissions, the CAA Amendments required electric utilities to reduce emission levels by ten million tons from the 1980 levels. CAA § 401(b). This reduction was implemented in two phases. CAA §§ 404, 405. Phase I began on January 1, 1995 and required certain large coal-fired utilities to reduce SO<sub>2</sub> emissions. Phase II began on January 1, 2000. In Phase II, annual SO<sub>2</sub> emission levels were capped at approximately 8.95 million tons for all affected electric utilities. CAA §§ 403(a), 404.

The CAA Amendments used a market-based system of "allowances," each allowance permits the allowance holder to emit one ton of SO<sub>2</sub> in a given year or any subsequent year. CAA § 405. Allowances can be used, banked, traded or sold, and are intended to encourage the most cost-effective SO<sub>2</sub> emission reductions. McManus Direct Testimony ("JMM") at p. 4. The Federal Environmental Protection Agency ("EPA") allocates a finite number of allowances per year. If a utility's actual emissions exceed its allocated allowances, it must take steps to reduce the emissions or purchase additional allowances from utilities whose actual emissions were less than the allowances they received. Utilities that installed SO<sub>2</sub> mitigation technology or otherwise complied with the CAA Amendments early were awarded additional allowances by the EPA.

With respect to NO<sub>x</sub> emissions, the CAA Amendments required a reduction by approximately two million tons from 1980 levels. CAA § 407. Again, these reduction

requirements were implemented in two phases. Phase I became effective in 1996, and imposed annual NO<sub>x</sub> emission rates on certain types of coal-fired generating units. Phase II became effective in 2000 and EPA established allowable NO<sub>x</sub> emission rates for additional types of coal-fired electric utility generating facilities. *Id.* In addition, the rules allow companies to comply with the NO<sub>x</sub> standards by using system-wide averaging plans. JMM at p. 4.

Subsequent to the CAA Amendments, EPA finalized two additional rules governing NO<sub>x</sub> emissions from coal-fired generating units and other sources, to eliminate significant transport of NO<sub>x</sub> emissions from certain regions to downwind ozone non-attainment areas. First, the NO<sub>x</sub> State Implementation Plan (“SIP”) Call Rule requires certain states, including Kentucky, to amend their SIPs to reduce NO<sub>x</sub> emissions during the summer ozone season. (63 FR 5736, October 27, 1998). Second, the Section 126 Rule, promulgated in response to a petition filed by eighteen northeastern States, requires similar NO<sub>x</sub> reductions for upwind States that failed to amend their SIPs to comply with the NO<sub>x</sub> SIP Call Rule. (64 FR 28259, May 25, 1999 and 65 FR 2674, January 18, 2000). (Collectively, the NO<sub>x</sub> SIP Call Rule and the Section 126 Rule will be referred to as the “NO<sub>x</sub> Rules.”)

The NO<sub>x</sub> Rules require emission reductions at all of the coal-fired plants operated by members of the AEP Pool during the summer ozone season that generally runs from May 1 through September 30 each year. Like the Title IV SO<sub>2</sub> program, the NO<sub>x</sub> Rules establish a cap on emissions, and use a market-based allowance system to encourage the most cost-effective reductions. JMM at pp. 4-5.

In 2005, EPA issued the final Clean Air Interstate Rule (CAIR). (70 FR 25161 May 12, 2005). The CAIR calls for significant additional reductions in SO<sub>2</sub> and NO<sub>x</sub> emissions from electric utility generating units within a 28-State region that includes all of the states in which the

AEP Pool facilities are located. The CAIR is intended to help states achieve and maintain compliance with new and stricter air quality standards for ozone and fine particles, and includes three separate market-based emission reduction programs: (1) an ozone season NO<sub>x</sub> program; (2) an annual NO<sub>x</sub> program; and (3) an annual SO<sub>2</sub> program. Each will be implemented in two phases. The seasonal and annual NO<sub>x</sub> programs become effective in 2009 and 2015. The annual SO<sub>2</sub> programs become effective in 2010 and 2015. When fully implemented, the CAIR will cap electric generating unit NO<sub>x</sub> emissions at 1.3 million tons per year, and SO<sub>2</sub> emissions at 2.7 tons per year, achieving significant additional reductions in emissions within the CAIR region. *Id.* The CAA Amendments and subsequent EPA actions have had and will continue to have a dramatic impact on the facilities in the AEP Pool.

**C. KRS 278.183**

KRS 278.183(1) provides that “a utility shall be entitled to the current recovery of its costs of complying with the federal CAA as amended and those federal, state, or local environmental requirements which apply to coal combustion wastes and by products from facilities utilized for production of energy from coal . . .” As Kentucky Power has incurred costs in complying with the CAA and the other federal, state and local environmental requirements specified by KRS 278.183(1), the Company has filed a compliance plan with the Commission and petitioned for recovery of its costs through the rate surcharge mechanism set forth in the Statute.

**D. Kentucky Power’s Previous Surcharge Filings**

Kentucky Power filed its first environmental surcharge case in 1996. The primary components of the 1996 plan included low NO<sub>x</sub> burners for Big Sandy Unit 2; Kentucky Power’s portion of the cost of the scrubbers installed at Ohio Power’s Gavin Plant (as reflected in the capacity charges the Company pays to Ohio Power pursuant to the Interconnection Agreement);

SO<sub>2</sub> allowances purchased by the Company; and continuous emission monitors (“CEMs”) and fees for the Rockport plant. Thus, the original filing included not only costs borne by Kentucky Power for environmental facilities at the Big Sandy Plant, but also included environmental costs incurred by the Company as a result of its membership in the AEP Pool and its participation in three FERC-approved agreements: the Interconnection Agreement and the Unit Power Agreement, discussed in detail above, as well as the Interim Allowance Agreement, which governs the AEP Pool’s allocation of SO<sub>2</sub> allowances. In the Order issued in the 1996 case, the Commission approved Kentucky Power’s recovery of the components of the plan covering the environmental costs incurred through the FERC-approved agreements.

In 2002, Kentucky Power filed a second environmental surcharge case and an Amended Environmental Compliance Plan. *See* Case No. 2002-00169. The primary component of the 2002 case was NO<sub>x</sub> controls at the Big Sandy Plant in compliance with the NO<sub>x</sub> Rules. In support of the filing, Kentucky Power provided detailed testimony concerning the manner in which the AEP Pool was developing a reasonable and cost-effective means for complying with the applicable environmental requirements. The Company explained that AEP uses a production cost model to provide data for an optimization analysis that selects technologies using a least incremental reduction cost method. The analysis performed by AEP demonstrated that, in order to reduce NO<sub>x</sub> emissions as required by the NO<sub>x</sub> Rules, a significant number of the generating facilities in the AEP Pool would require NO<sub>x</sub> emission controls. The determination was made to employ Selective Catalytic Reduction (“SCR”) technology to achieve this reduction because it was the only control technology available that could achieve the required level of NO<sub>x</sub> removal.

In addition to the analysis submitted in support of Kentucky Power’s 2002 environmental case, the Company also provided the Commission with supporting testimony and evidence



establishing that AEP's SCR costs compared favorably to the SCR benchmark costs.

Accordingly, the Commission approved Kentucky Power's recovery of the costs incurred as a result of the installation of the SCR technology at the Big Sandy Plant.

In 2005, Kentucky Power filed a third environmental surcharge case and Amended Environmental Compliance Plan. *See* Case No. 2005-00068. The 2005 case reflected Kentucky Power's MLR share of the environmental requirements for the surplus companies in the AEP Pool, with the primary components of the case being environmental costs incurred by the Company through the Interconnection Agreement and Unit Power Agreement. The specific types of environmental facilities at issue included low-NO<sub>x</sub> burners, over-fire air NO<sub>x</sub> control systems, water injection NO<sub>x</sub> control systems, and SCR systems. The generating plants involved in the 2005 case were owned, in whole or in part, by the two surplus companies in the AEP Pool—i.e., Ohio Power's Amos Plant, Cardinal Plant, Gavin Plant, Mitchell Plant, Kammer Plant, Muskingum River Plant, and Sporn Plant, and I&M's Rockport Plant and Tanners Creek Plant. As was the case in Kentucky Power's previous environmental proceedings, the Commission allowed the Company to recover costs incurred pursuant to the FERC-approved Interconnection Agreement and Unit Power Agreement. This ruling was affirmed by the Franklin Circuit Court in an Opinion and Order issued on October 30, 2006. *Commonwealth of Kentucky, ex rel. Gregory D. Stumbo, Attorney General v. Public Service Commission of Kentucky, et al.*, Civil Action Nos. 05-CI-1534, 05-CI-1534, and 05-CI-1544 ("Franklin Circuit Court Order"). An appeal is pending before the Court of Appeals of Kentucky.

The current filing is the fourth environmental case brought by Kentucky Power, and it reflects the Company's MLR share of the compliance requirements for the surplus companies in the AEP Pool. The primary components of the case include the following: (1) Flue Gas

Desulfurization (“FGD”) projects for reduction of SO<sub>2</sub> emissions at a number of generating facilities, including related projects for balanced draft conversion, coal blending systems, steam generator slag controls, unit controls modernization, FGD purge stream water treatment systems, gypsum handling systems, and a forced draft fan motor replacement; (2) SCR systems for NO<sub>x</sub> control at a number of generating facilities; (3) SO<sub>3</sub> mitigation systems to prevent increases in SO<sub>3</sub> emissions associated with the installation of the SCR and FGD projects and changes in coal sulfur content; (4) the maintenance and improvement of existing environmental facilities, including an upgrade to an electrostatic precipitator control system, replacement of transformer rectifier sets, and replacement of SCR catalysts; and (5) the installation and expansion of solid waste disposal facilities necessary to accommodate by-products from facilities utilized for production of energy from coal. McManus Direct Testimony (“JMM”) at pp. 7-8. These environmental projects are being undertaken at generating facilities owned and operated by surplus members of the AEP Pool. As set forth above, Kentucky Power must carry its portion of the environmental costs incurred for these projects through the Interconnection Agreement and the Unit Power Agreement because the Company relies upon the AEP Pool, and the capacity of the surplus companies, to meet the electricity demands of its Kentucky customers. These costs are what Kentucky Power seeks to have included in its environmental surcharge, as authorized by KRS 278.183.

### **III. ARGUMENT**

KRS 278.183(2) provides that when a utility requests approval of an environmental compliance plan and a rate surcharge, the Commission is required to “[c]onsider and approve the plan and rate surcharge if the Commission finds the plan and rate surcharge reasonable and cost-effective for compliance with the applicable environmental requirements set forth in subsection

(1) of this section.” That is, Kentucky Power must demonstrate (1) that the requested costs are being incurred for compliance with the applicable environmental requirements; and (2) that the environmental compliance plan and rate surcharge are reasonable and cost-effective for such compliance. In this case, the evidence submitted by Kentucky Power in support of its application demonstrates that the Company is statutorily entitled to the current recovery of the environmental compliance costs set forth in the Company’s Environmental Compliance Plan.

**A. Kentucky Power has Satisfied the Requirements of KRS 278.183.**

Kentucky Power presented the testimony of Mr. John M. McManus to demonstrate that the costs at issue are being incurred for compliance with the environmental requirements allowed by KRS 278.183(1). Mr. McManus is the Vice President of the Environmental Services Division of the American Electric Power Service Corporation (“AEPSC”). JMM at p. 1. In this capacity, he is responsible for oversight of environmental support for all AEP generation and energy delivery facilities. JMM at p. 2. Specifically, his responsibilities include working through the Environmental Services Division to develop appropriate, cost-effective and timely compliance solutions and guidance on complex environmental permitting and regulatory issues in the areas of air emissions, water quality and waste management. *Id.* Mr. McManus is also the primary contact with federal, state and local regulatory agency personnel to resolve compliance issues, develop new regulations and prepare and submit permit applications. *Id.*

In his pre-filed testimony, Mr. McManus described the regulatory programs that govern the reduction or control of air emissions related to the operation of the coal-fired generating facilities in the AEP Pool, as well as the regulatory programs related to coal combustion waste and by-products. JMM at pp. 3-7. Mr. McManus described the types of environmental facilities for which cost recovery is sought in this case:

AEP plans to install a number of environmental facilities to maintain compliance with existing CAA requirements, to achieve compliance with future CAA requirements, and to meet its obligations under the [Clean Water Act] and [Solid Waste Disposal Act]. The types of facilities that AEP plans to install to reduce SO<sub>2</sub> emissions are FGD Systems and a Fuel Switch Project. The FGD Systems include related projects for Balanced Draft Conversion, Coal Blending Systems, Steam Generator Slag Controls, Unit Controls Modernization, FGD Purge Stream Water Treatment Systems, Gypsum Material Handling Systems, and a Forced Draft (FD) Fan Motor Replacement. AEP plans to install SCR Systems for NO<sub>x</sub> control. There are also plans to install SO<sub>3</sub> Mitigation Systems to address increases in SO<sub>3</sub> emissions associated with the installation of SCR and FGD Systems and changes in coal sulfur content. Furthermore, additional capital projects are required to improve or maintain the performance of existing environmental controls for particulate matter (PM) and NO<sub>x</sub>. These projects include an Upgrade to an Electrostatic Precipitator (ESP) Control System, Replacement of Transformer Rectifier (T/R) Sets, and Replacement of SCR Catalysts. Finally, to accommodate the solid wastes associated with the new FGD projects and continued operation of existing ESPs, AEP plans to install or expand several Solid Waste Disposal Facilities.

JMM at pp. 8-9. Mr. McManus provided a complete list of the environmental projects in Exhibit Number JMM-1, which was filed with this Commission along with his direct testimony. Mr. McManus' testimony described each of the environmental projects, and explained why these projects satisfy the cost recovery standard set forth in KRS 278.183. As was noted in his testimony, each of the projects was undertaken to satisfy environmental requirements recognized by the applicable statute. In addition, Mr. McManus provided an analysis of how AEP determined that the above noted projects were a reasonable and cost-effective means of satisfying the applicable environmental requirements. JMM at pp. 8-26.

Kentucky Power also presented the testimony of Mr. Errol Wagner. Mr. Wagner is a Certified Public Accountant and the Director of Regulatory Services for Kentucky Power. EKW at p. 2. In his position with Kentucky Power, Mr. Wagner has responsibility for all rate and regulatory matters affecting the Company's Kentucky jurisdiction. *Id.* Mr. Wagner's testimony presented the annual costs expected to be incurred by Kentucky Power as a result of the new

environmental facilities being added to the amended environmental compliance plan. EKW at p. 3. This testimony focused on the manner in which a portion of the cost of these environmental facilities will flow through to Kentucky Power through the Interconnection Agreement and the Unit Power Agreement. *Id.*

Mr. Wagner explained that because Kentucky Power is a deficit member of the AEP Pool—i.e., it does not have sufficient capacity to meet its firm load requirements—it relies upon the generating facilities of the surplus members of the AEP Pool to satisfy its generating capacity obligations. EKW at pp. 4-7. He further explained that this relationship between the deficit and surplus members of the AEP Pool is governed by the FERC-approved Interconnection Agreement. Pursuant to the Interconnection Agreement, the deficit companies must pay a capacity equalization charge to compensate the surplus companies for their investment in the surplus facilities, including the environmental controls placed on those facilities in compliance with the environmental regulations recognized under KRS 278.183(1). *Id.* A summary of the environmental costs at issue in this proceeding and their effect on Kentucky Power through the Interconnection Agreement was filed as Exhibit Number EKW-4 to Mr. Wagner’s direct testimony.

Mr. Wagner also explained the nature of Kentucky Power’s interest in the Rockport Units pursuant to the Unit Power Agreement, and how a portion of the cost of the landfill expansion at both Rockport Unit 1 and Unit 2 will flow through the Unit Power Agreement to the Company. EKW at pp. 10-12.

Finally, Mr. Wagner testified that Kentucky Power is not requesting a rate of return on the capital expenditures incurred by the surplus companies, but is seeking only the recovery of the new environmental costs it will incur pursuant to the FERC-approved Interconnection

Agreement and Unit Power Agreement. EKW at p. 11. The annual retail effect of the proposed changes to the environmental surcharge tariff is estimated to be \$8,346,134.<sup>1</sup> *Id.* The effect of these costs on a residential customer using an average of 1,353 kWh per month will be an increase to the monthly bill of approximately \$1.77, which amounts to a 2.05% increase. However, Kentucky Power's retail customers will not experience the full increase immediately following a determination by the Commission that the Company is entitled to recover its costs at issue in this proceeding. Rather, the impact will be more gradual as the environmental facilities at issue will be phased into service over the next three years. EKW at pp. 11-12.

**B. The Amended Environmental Compliance Plan and Rate Surcharge are Reasonable and Cost-Effective.**

The Commission has consistently recognized that federal preemption requires acceptance of environmental costs as reasonable to the extent those costs are allocated to Kentucky Power under the terms of FERC-approved agreements. The Commission first articulated this position in Kentucky Power's 1996 environmental surcharge case, finding as follows:

The Commission finds that federal preemption mandates our acceptance of the FERC jurisdictional agreements as reasonable. To the extent that environmental costs are part of the total costs Kentucky Power is allocated under the terms of these agreements, the costs must be accepted as reasonable. Contrary to KIUC's position, federal preemption is applicable and controls in this instance, not only for the allowance purchases required under the IAA, but also for the costs Kentucky Power is required to pay under the terms of the Rockport Unit Power Agreement and the Interconnection Agreement. Due to the application of federal preemption, the Commission is required to accept as reasonable the costs incurred under these FERC agreements. Consequently, all of the arguments presented by the AG and KIUC in opposition to the reasonableness of such costs are not appropriate for consideration by this Commission.

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<sup>1</sup> This amount could be reduced because of (1) retirements associated with some of the facilities, which will reduce the amount of the environmental investments; and (2) the deferred federal income tax benefit with respect to Kentucky Power's share of the Rockport generating facilities, which will reduce the annualized revenue requirement. EKW at pp. 11-12.

Order of May 27, 1997, p. 16, Case No. 96-489 (“1997 Order”). The Commission has consistently rejected invitations to look behind the reasonableness of environmental costs incurred by Kentucky Power through FERC-approved agreements. In Kentucky Power’s 2005 environmental case, the Commission addressed the issue of the Company’s recovery of environmental costs incurred through the Interconnection Agreement and found as follows:

In this case, Kentucky Power is proposing to amend its compliance plan to include the costs of the environmental projects that Kentucky Power is required to pay under the AEP Interconnection Agreement. Since that agreement is a FERC-approved rate, the judicial doctrine of federal preemption forecloses any inquiry here into the reasonableness of that rate or the costs recovered through that rate.

Order of September 7, 2005, p. 10, Case No. 05-00068 (“2005 Order”).

In the 2005 Order, the Commission distinguished between a finding that the FERC-approved costs are “reasonable” and a finding that the costs are “both reasonable and cost effective for complying with the environmental requirements listed in KRS 278.183.” *Id.* at p. 11. Accordingly, the Commission determined that “Kentucky Power must carry its burden to prove that a FERC-approved rate qualifies for environmental surcharge recovery [as cost-effective].” *Id.*

In this proceeding, Kentucky Power has presented evidence showing that the measures taken by AEP to ensure that the environmental projects at issue were undertaken in a cost-effective manner. To this end, Mr. McManus testified about AEP’s use of the state-of-the-art multi-emissions compliance optimization model (“MECO model”) to arrive at the least-cost compliance plan for AEP on a system-wide basis. JMM at pp. 8-9. Additionally, Kentucky Power provided the Commission with the least-cost compliance plan, compliance costs, and projected emissions generated by the MECO model, and the modeling that supported the projects at issue in this proceeding. *See* Response to Item No. 3 of the Commission Staff’s First Set of

Data Requests. Kentucky Power also presented all the capital improvement requests (“CIs”) for approval of each of the environmental projects at issue. These CIs are the written evaluation made by American Electric Power Service Corporation (“AEPSC”) in support of each project, after consideration of the MECO model analysis. Kentucky Power has presented this information to assure the Commission and its Staff that AEP has undertaken appropriate measures to ensure both the reasonableness and cost-effectiveness of the environmental control projects at issue in this proceeding.

C. **Kentucky Power is Entitled to Recover the Portion of its Capacity Charges Attributable to the Cost of Environmental Compliance Facilities Owned and Operated by the Surplus Companies.**

Kentucky Power anticipates that the Attorney General (“AG”) and the Kentucky Industrial Utilities Customers, Inc. (“KIUC”) will argue that the Company should not be permitted to recover its portion of environmental costs incurred by the surplus companies. However, the Commission rejected this argument in Kentucky Power’s 2005 environmental case, expressing the following rationale for its decision:

The environmental surcharge statute expressly authorizes a utility to recover by surcharge its costs of complying with specified environmental requirements. The statute does not restrict surcharge recovery to costs incurred at facilities owned by the utility or at facilities located in Kentucky. The language of the statute is unambiguous, and neither KIUC nor the AG have raised a claim to the contrary. Under these circumstances, it is not the Commission’s role to determine legislative intent for purposes of interpreting an unambiguous statute.

Kentucky Power has identified the environmental compliance costs for the 2005 Plan projects charged to it under the provisions of the FERC-approved AEP Interconnection Agreement and Rockport Agreement. These are the costs for the 2005 Plan projects that Kentucky Power proposes to recover through its environmental surcharge. The Gavin scrubber costs, the Rockport CEMs, and Indiana air emission fees in the original environmental surcharge case were handled in the same manner. The costs identified here by Kentucky Power are eligible for surcharge recovery if they are shown to be reasonable and cost effective for complying with the environmental requirements specified in KRS 278.183.



2005 Order at p. 16. That is, the Commission determined that Kentucky Power has a statutory right to recover the environmental compliance costs it is responsible for through the FERC-approved Interconnection Agreement and Unit Power Agreement, even though the environmental compliance projects are carried out by other companies within the AEP Pool at generating facilities located outside the State.

On appeal, the AG and KIUC presented the Franklin Circuit Court with four arguments in support of their contention that the Commission's ruling on this issue should be overturned: (1) the costs incurred by Kentucky Power were not "its costs," within the meaning of KRS 278.183; (2) the statute only contemplates cost recovery for environmental facilities either located in Kentucky, or owned or controlled by Kentucky electric utilities; (3) the statute only allows cost recovery for environmental facilities over which the Commission has jurisdictional oversight; and (4) allowing Kentucky Power cost recovery for the facilities in question would conflict with the legislative intent of KRS 278.183. The court rejected each of these arguments, reasoning as follows:

KRS 278.183 is not ambiguous, it allows a utility to recover its costs for environmental compliance equipment. In the case at bar, Kentucky Power incurs costs on a monthly basis for environmental facilities at electric generating plants of the AEP surplus companies. These costs directly benefit Kentucky Power and its Kentucky customers. The fact that another AEP utility first makes the capital investment for the environmental projects does not defeat the applicability of the statute. Kentucky Power enjoys significant benefits because of its membership in the AEP Pool. Along with these benefits comes the obligation to comply with the AEP Pool Agreement, including payment for the benefits received thereunder. The capacity payments made to I&M and Ohio Power are properly Kentucky Power's costs, since Kentucky Power gets both the energy from the AEP system, and the corresponding capacity obligation under the Pool Agreement. Nothing in KRS 278.183 limits cost recovery to only those environmental projects owned and operated by the affected electric utility—and this Court will not read such a limitation into the statute. If the AG and KIUC have concerns over the language of the statute, those concerns should be directed to the General Assembly.

Franklin Circuit Court Order, pp. 5-6. The court having affirmed the Commission's ruling on Kentucky Power's right to recover its environmental compliance costs incurred pursuant to the Interconnection Agreement and the Unit Power Agreement, the Commission should reach the same decision if the AG and KIUC seek another bite at the apple in this proceeding.

**D. Kentucky Power has Satisfied the Requirements of KRS 278.183(1) with Respect to the Specific Issues Raised by the Commission Staff.**

Neither of the intervenors in this case, the Attorney General ("AG") and the Kentucky Industrial Utilities Customers, Inc. ("KIUC"), has challenged the reasonableness or the cost-effectiveness of any of the projects included in Kentucky Power's application in this case. However, the Commission Staff has raised questions about two of the projects: (1) the Coal Blending Projects being undertaken at Tanners Creek Unit 4, Amos Unit 3 and Mitchell Units 1 and 2; and (2) the SO<sub>3</sub> Mitigation Projects being constructed at Ohio Power's Amos Unit 3, Cardinal Unit 1, and Mitchell Units 1 and 2. Through the testimony of Mr. McManus and Mr. Wagner, and the documents provided to the Commission in support of its application, Kentucky Power submits that it has satisfied its burden under KRS 278.183(1) with respect to both the coal blending and SO<sub>3</sub> mitigation projects. The evidence presented by Kentucky Power in support of its recovery of the costs associated with these projects is undisputed.

**1. The Coal Blending Projects**

Kentucky Power has provided the Commission with evidence that the coal blending projects at issue in this case are being undertaken as part of the Company's obligation to comply with current and future regulations under the CAA Amendments and the CAIR in the most cost-effective manner. *See* Responses to Item Nos. 6 and 7 of the Commission Staff's First Set of Data Requests. With respect to the project at Tanners Creek Unit 4, there is no question but that the coal blending facility is required for compliance with the CAA and the Clean Air

Interstate Rule. Under AEP's compliance plan, scrubbers are not being installed at Tanners Creek. Instead, Mr. McManus explained that SO<sub>2</sub> and NO<sub>x</sub> limits will be met at this facility by modifying the unit and the coal blending equipment in order to allow AEP to burn a "much higher percentage of lower-sulfur Powder River Basin coal." Transcript of Evidence from November 28, 2006 Hearing ("TE") at p. 15. In other words, the coal blending project at Tanners Creek is the primary vehicle for achieving compliance at that plant.

The remaining coal blending projects play a key role in an individual facility's overall compliance plan. Through the testimony of Mr. McManus, Kentucky Power has shown that the coal blending projects play a critical role in AEP's emission compliance strategy in at least two ways. The first is set forth in the pre-filed testimony of Mr. McManus when he states as follows:

The installation of FGD technology allows greater flexibility in the range of coal quality that can be used at a controlled unit. In order to take advantage of this flexibility, and to achieve subsequent savings in fuel cost, improvements to the current coal handling systems are needed at some units. The savings associated with the wider range of lower priced coals have been analyzed as part of the economic justification for the FGD projects.

JMM at p. 12. This testimony shows that AEP relied upon the availability of the coal blending facilities in developing its least-compliance emission compliance plan. That is, the savings associated with the coal blending facilities factored into the least-cost compliance plan generated by the MECO model, was included in the overall analysis, and should not be separated from the overall FGD plan.

Mr. McManus provided further justification for the coal blending projects in the testimony he offered on cross-examination at the hearing on this matter. In describing the need for coal blending capabilities following the installation of FGD technology, Mr. McManus stated as follows:

The boilers would be able to burn a higher sulfur content coal, but the operating conditions in the boiler would not be optimal and the reliability of the unit, because of slagging conditions, things like that, would not be optimized. You know, one key part of the compliance plan for the units that we're investing in is to install pollution control equipment and achieve significant emission reductions. The compliance plan really needs those units to be available and reliable and to operate at the highest capacity factors that we can. If those units are not operating, it means that generation will move to units that do not have controls that have higher emission rates and therefore will have higher emissions. So the compliance plan, as it looks at installing pollution control equipment, factors in what other equipment is needed at the plant at those units to ensure that, once we complete this investment, would bring this equipment on line, the units are available and they're reliable.

TE at pp. 16-17. Thus, the coal blending projects play an essential and integral role in ensuring that generating facilities within the AEP Pool that have been outfitted with pollution control equipment continue to perform at an optimum level. Such performance is critical to AEP's system-wide emissions compliance plan.

As Mr. McManus' testimony demonstrates, the coal blending projects are an important part of AEP's system-wide plan for compliance with the CAA in the most cost-effective manner. The coal blending facilities are not stand-alone projects that can simply be eliminated from the overall compliance plan, for to do so would cause a ripple effect that would have far-reaching impacts on AEP's emission control plan.

## **2. The SO<sub>3</sub> Mitigation Projects are Necessary for Compliance with the CAA**

As with the coal blending projects, Kentucky Power offered undisputed evidence that the installation of the SCR and FGD systems at Ohio Power's Amos, Cardinal, and Mitchell plants would result in an unacceptable increase in the formation of SO<sub>3</sub>, and that the installation of SO<sub>3</sub> mitigation technology at these facilities is necessary to comply with the CAA. Through the testimony of Mr. McManus, Kentucky Power provided the Commission with two reasons why the Company would not be in compliance with the CAA in the absence of the SO<sub>3</sub> mitigation technology.

First, Mr. McManus described the prospect that installation of the SCR and FGD projects in the absence of the SO<sub>3</sub> mitigation technology could trigger the Federal New Source Review requirements under Title I of the CAA, which could necessitate additional permits and emission control equipment. JMM at p. 20. This issue arose for Kentucky Power and other similarly situated electric utilities in 2005. *Id.* For many years, EPA excluded pollution control projects such as the installation of FGD and SCR systems from any Title I New Source Review Program preconstruction review under a regulatory exclusion known as the pollution control project exclusion. *Id.* All of AEP's SCR and FGD projects commenced prior to 2005 relied upon this exclusion. *Id.* In June of 2005, the United States Court of Appeals for the District of Columbia Circuit vacated this exclusion, and held that any significant emission increases associated with a pollution control project should be subject to New Source Review requirements. *See New York v. United States EPA*, 413 F.3d 3 (D.C. Cir. 2005).

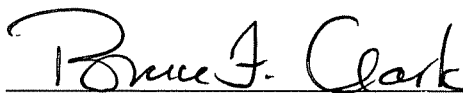
Kentucky Power has offered undisputed evidence that the installation of the SCR systems at issue in this case increase SO<sub>3</sub> emissions in the absence of the SO<sub>3</sub> mitigation technology. When SO<sub>3</sub> is combined with water in saturated flue gas from an FGD, H<sub>2</sub>SO<sub>4</sub>, a regulated pollutant is produced. JMM at p. 19. Thus, Mr. McManus explained that the installation of the SO<sub>3</sub> mitigation technology will reduce the resulting H<sub>2</sub>SO<sub>4</sub> emissions and will allow the Company to avoid the risk of triggering New Source Review requirements that might require installation of more costly pollution control equipment (such as a wet electrostatic precipitator). TE at p. 25. This evidence demonstrates that the SO<sub>3</sub> mitigation technology included in Kentucky Power's Environmental Compliance Plan is essential to, and an integral part of, the Company's reasonable and cost-effective plan for complying with the CAA.

Further, Kentucky Power showed that the SO<sub>3</sub>/H<sub>2</sub>SO<sub>4</sub> levels present at Ohio Power's Gavin Plant prior to the installation of the SO<sub>3</sub> mitigation technology at that facility resulted in the EPA issuing a Notice of Violation ("NOV") to Ohio Power pursuant to the CAA. *Id.* at p. 25. The experience at the Gavin Plant led AEP to conclude that, in the absence of SO<sub>3</sub> mitigation technology, the installation of equipment similar to that installed at the Gavin Plant at other facilities within the AEP Pool could lead to similar enforcement actions concerning those facilities. *Id.* The testimony provided by Mr. McManus on this issue confirms that the SO<sub>3</sub> mitigation technology expenses were incurred to comply with the CAA.

#### **IV.** **CONCLUSION**

The evidence presented by Kentucky Power in this proceeding demonstrates: (1) that the environmental control projects included in the Company's Third Amended Plan are necessary for compliance with the CAA and those federal, state, or local environmental requirements which apply to coal combustion wastes and by products from facilities utilized for production of energy from coal; (2) that the projects are a part of the AEP system-wide plan designed to achieve environmental compliance and constitute reasonable and cost-effective means of compliance with the applicable environmental requirements; and (3) that all the projects included in this proceeding, including the coal blending and SO<sub>3</sub> mitigation technology projects, play a critical role in the operation of that system-wide plan. Thus, Kentucky Power has met its burden under KRS 278.183, and the Commission is respectfully requested to include these costs in the Company's Environmental Compliance Plan and the corresponding surcharge.

Respectfully submitted,



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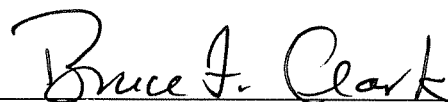
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**CERTIFICATE OF SERVICE**

I hereby certify that the foregoing Brief was mailed to the following parties of record, this 21st day of December, 2006:

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