

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

**IN THE MATTER OF: THE APPLICATION OF KENTUCKY :  
POWER COMPANY FOR APPROVAL OF ITS 2011 :  
ENVIRONMENTAL COMPLIANCE PLAN, FOR APPROVAL :  
OF ITS AMENDED ENVIRONMENTAL COST RECOVERY :  
SURCHARGE TARIFF, AND FOR THE GRANT OF A :  
CERTIFICATE OF PUBLIC CONVENIENCE AND :  
NECESSITY FOR THE CONSTRUCTION AND :  
ACQUISITION OF RELATED FACILITIES :**

Case No. 2011-00401

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1. Refer to page 3, beginning at line 18, of the Direct Testimony of Stephen G. Hill. It states, “the Companies have ignored the fact that the return recovery method utilized in the environmental surcharge mechanism, which allows recovery of costs during construction only two months after those costs are incurred, represents a very low-risk alternative to the normal used-and-useful regulatory paradigm.”
  - a. Identify the “Companies” referenced in the above quote.
  - b. Clarify whether it is Mr. Hill’s understanding that Kentucky Power Company (“Kentucky Power”) is requesting to recover costs incurred during construction within two months after those costs are incurred.
  - c. Identify where in its application Kentucky Power indicates that it is requesting to recover costs incurred during construction within two months after those costs are incurred.
  - d. Explain whether it is Mr. Hill’s understanding that Kentucky Power earns a cash return on Construction Work In Progress (“CWIP”) in base rate and environmental cost proceedings.
  - e. Explain whether it is Mr. Hill’s position, if Kentucky Power does not earn a cash return on CWIP in base rate and environmental proceedings, that the allowed return should be set at the higher end of a reasonable range to recognize the higher-risk nature of environmental construction cost recovery.

**RESPONSE**

- a.) The word “Companies” is a typographical error and should be “Company.” The Company referenced is Kentucky Power Company.
- b.) It is Mr. Hill’s understanding that the Kentucky environmental surcharge statute allows a company to request recovery of carrying costs during construction of environmental-related utility plant. Kentucky

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Power has not taken advantage of that beneficial provision, and instead has proposed to capitalize carrying costs during construction as AFUDC. Regardless of whether AFUDC or recovery of carrying costs on CWIP during construction is utilized, the environmental surcharge stature is inherently less risky than traditional base rate recovery.

- c.) The Company did not request recovery of carrying costs during construction in its application.
  
- d.) Mr. Hill's testimony is limited to the appropriate return on equity that should be awarded in this proceeding.

However, the environmental surcharge mechanism is a much lower-risk regulatory mechanism than is normal rate-base-rate-of-return regulation. That is because, as set out in Section 278.138 of the Kentucky Code the Company is able to recover all of its costs of complying with environmental requirements (capital costs, operating expenses, equipment, property, taxes, overheads, depreciation) "in the second month following the month in which costs are incurred." While those costs are, of course, subject to periodic review by the Commission for accuracy, that mechanism represents a very reliable and timely recovery of all costs of operation. Also those costs are not subject to re-setting through a "rate case" type of structure, the costs are what they are and the Company is entitled to recover them—including the allowed rate of return. This is true whether carrying costs during construction are capitalized (AFUDC) or recovered on a current basis (CWIP). With a normal rate proceeding, the utility's overall costs are included in the rates they are allowed to charge. If sales or costs differ from expectations, the return

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earned by the Company and its investors can vary—and the point here is that the variance of the return earned in a normal rate base proceeding, which does not allow on-going, very rapid recovery of actual costs, would be far greater than those earned in an environmental surcharge proceeding such as this.

- e.) The question is not clear. However, in the event that the Company were unable to recover a return on its investment during construction of environmental plant, the environmental surcharge mechanism and the return allowed under it should be lower than that utilized in a normal base rate proceeding for the reasons set out above in the response to subpart d) of this question. The environmental surcharge is simply a lower-risk regulatory mechanism.

If the Company were unable to earn a return on CWIP in either its environmental surcharge or its normal utility operations, an appropriate return would be in the middle of the range because, in Mr. Hill's experience, traditional regulation does not allow a return on plant that is not "used and useful," i.e., plant under construction. Thus, without the ability to recover a return on CWIP the Company would be considered average risk.

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2. Refer to page 6, starting at line 7, of the Direct Testimony of Stephen J. Baron (“Baron Testimony”). It states:

*“[t]he Commission should modify the ECR rate recovery mechanism among all other rate classes (primarily, business customers) such that the ECR recovery factor for these rate schedules is determined by recovering the ECR revenue requirement on the basis of non-fuel base revenues. The ECR recovery factor should be calculated for these nonresidential rates using a ratio of the allocated ECR revenue requirement to non-fuel base revenues. Because the environmental costs at issue in this case are primarily demand-related there is no basis to allocate those costs to non-residential customers based on their fuel usage. Using a ‘non-fuel base revenue’ ECR recovery factor will also enhance the competitiveness of the Company’s largest, high load factor manufacturing customers who must compete on a national and international basis.”*

- a. Explain whether Mr. Baron believes that there is a relationship between energy consumed and emissions caused by the generation of that energy.
- b. Explain whether Mr. Baron believes that, due to the type of fuel consumed at the Big Sandy plant, the installation of a Flue Gas Desulfurization (“FGD”) is required due to the Clean Air Act if the plant is to continue to operate.
- c. Is it correct that, under Mr. Baron’s allocation proposal, the industrial or commercial customers using the greatest amounts of energy will be allocated a lesser amount of environmental costs on a percentage basis than the customers using the least amount of energy?
- d. If Mr. Baron’s proposed allocation methodology will enhance the competitiveness of Kentucky Power’s largest, high load factor manufacturing customers, who must compete on a national and

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international basis, identify the customers for whom this methodology will have a detrimental effect and explain why it will have such an effect.

- e. Explain whether it is correct that, under Mr. Baron’s proposed allocation methodology, the level of emissions, which is what Kentucky Power is seeking to control, and which is a direct result of the amount of electricity generated, will not impact the allocation of environmental costs to the non-residential rate classes.
- f. Explain whether the statement, “[t]he Commission should modify the ECR rate recovery mechanism among all other rate classes (primarily, business customers) such that the ECR recovery factor for these rate schedules is determined by recovering the ECR revenue requirement on the basis of non-fuel base revenue” means that Mr. Baron is recommending that the ECR recovery factor for non-residential customers should be based on base revenues, and exclude both base fuel revenues and fuel adjustment clause revenues.
- g. Explain why the “non-fuel revenue” ECR allocation methodology proposed by Baron will apply only to the non-residential classes and not the residential class

**RESPONSE:**

- a. Mr. Baron agrees that the total amount of emissions produced by generators is a function of the number of hours that the generator operates, and therefore the mWh generated. Notwithstanding this, emission control fixed costs are allocated in the KPCo class cost of service study (and, in most class cost of service methodologies that Mr. Baron is familiar with, such as LGE/KU’s class cost of service methodology,

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classifies fixed environmental costs that associated with production facilities as demand related, in the same manner as any other fixed production investment (e.g., feed water pumps, boilers, etc.).

- b. Mr. Baron believes that the premise of this question is true.
- c. Mr. Baron's proposal is to replace the current total revenue allocation factor for non-residential customers with a non-fuel base revenue allocation factor. For the most part, the difference between the two allocation factors is that fuel expenses (fuel revenues) are excluded from Mr. Baron's proposed allocation factor. Neither Mr. Baron's proposal, nor the existing total revenue allocation factor, specifically include kWh energy as an allocator. All else being equal, for any level of fuel costs per kWh, a higher energy use customer will have a higher level of fuel revenues included in the current allocator than a lower kWh use customer. Following this logic, removing fuel revenues from the allocator would benefit higher load factor (energy intensive) customers, compared to lower load factor customers.
- d. Mr. Baron has not performed a specific analysis addressing the requested information. However, it is Mr. Baron's experience that lower load factor non-residential customers tend to be commercial customers that do not compete nationally and internationally, but rather compete locally. Since fuel revenue would be removed from the proposed allocation factor under Mr. Baron's recommended methodology, lower load

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factor customers, who Mr. Baron believes are primarily commercial customers, would pay higher ECR charges than under the current methodology (generally, customers on the smaller general service rates).

This is shown on a rate class basis in Mr. Baron's Exhibit \_\_ (SJB-4).

- e. The level of emissions caused by any individual customer's usage of electricity is not a factor in either Mr. Baron's proposed allocation methodology or the current methodology, as-filed by KPCo.
- f. Yes, Mr. Baron's proposed ECR allocation methodology is a two-step method. First, allocate ECR revenue requirements between residential and non-residential rate classes using the Company's total revenue methodology, which includes base fuel revenues and fuel adjustment revenues, as well as other adjustment clause revenues (other than the ECR). Step-two would then determine the non-residential ECR factor by dividing the allocated non-residential ECR revenue requirement by non-fuel base revenues (base revenues less base fuel, excluding the fuel adjustment charge and all other riders).
- g. While Mr. Baron believes that it would be appropriate to apply a non-fuel base revenue allocation method to all rate classes, he is not proposing any change to the residential class ECR allocation methodology in order to mitigate the impact of the change and apply it only to business customers. This is consistent with the Commission approved methodology (per a Stipulation among the parties) for LGE/KU.

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3. Refer to page 6, starting at line 21, of the Baron Testimony. It states:

*“[t]he modified two-step ECR rate recovery mechanism should also apply to the recovery of costs from all current ECR projects that are subject to ECR surcharge recovery. Also, in any subsequent roll-in of ECR costs to base rates, the roll-in should reflect separate residential and nonresidential adjustments to base rates following the two-step allocation methodology recommended by KIUC. Residential base rates would be adjusted using the current methodology; non-residential rates would be adjusted on a non-fuel base rate basis.”*

- a. Explain whether Mr. Baron believes that the best method to roll environmental costs into base rates is through a base rate case.
- b. Explain whether it is Mr. Baron’s understanding that, historically, Kentucky Power has rolled environmental costs into base rates only as part of a base rate case
- c. Explain whether Mr. Baron believes that rolling environmental costs into base rates at the time of a base rate case assists the Commission with consistent application of cost-of-service and cost causation principles.

**RESPONSE:**

- a. Generally, Mr. Baron believes that a roll-in at the time of a base rate case would permit the inclusion of the rolled-in ECR costs in the base rate class cost of service analysis. This would permit traditional cost



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of service treatment to these ECR costs. However, in the event that a roll-in occurs without a concurrent base rate case, Mr. Baron's recommendation is to follow the allocation discussed on page 6 of his testimony.

- b. It is Mr. Baron's understanding that there can be ECR roll-ins every two years during the two year review proceeding. There does not have to be a rate case for a roll in.
- c. Yes, as discussed in response to part (a) of this question, a roll-in at the time of a base rate case permits a full cost of service allocation of ECR costs, consistent with cost of service principles and methodologies.

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4. Refer to page 3, starting at line 21 and continuing to page 4, of the Direct Testimony of Lane Kollen (“Kollen Testimony”) which states, “[t]he Company has not demonstrated that the BS2 retrofit projects are reasonable and cost-effective, the standard set forth in KRS 278.183.” Explain how Mr. Kollen determined that Kentucky Power has not demonstrated that the proposed projects are reasonable and cost effective.

RESPONSE

The Company’s own studies demonstrate that it is cheaper for the Company to purchase energy and capacity from PJM for ten years. This option is the least cost option on a cumulative net present value basis of the options actually studied by the Company. This option will save customers hundreds of millions of dollars compared to the Company’s proposal and will result in a rate increase in 2016 that is less than a third of the Company’s proposed increase.

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5. Refer to page 9, starting at line 13, of the Kollen Testimony. It states, "I estimate that this will increase the Company's revenue requirement by another 10% to 15%." Provide all calculations that support this conclusion.

RESPONSE

If the Rockport units are retrofitted with environmental compliance equipment, then the Company will incur its share of those costs as well. Mr. Kollen estimates that this will increase the Company's revenue requirement by another approximately \$80 million, or 14%, in addition to the effects of the BS2 projects. Although the Company would not provide the estimated cost of these retrofits in response to KIUC 1-18, it was willing to provide a combined estimate for [REDACTED]

The cost for the Rockport units is [REDACTED] based on the midpoint of this estimate and scaling the estimate for the Rockport mW capacity to exclude Tanner's Creek. If the Company's proposed cost of the BS2 retrofits is scaled for the Rockport units, which only reflects the DFGD and not the SCR, then the cost for the Rockport units is \$3,102 million. In addition, there will be significant operating costs for

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the Rockport DFGDs and SCRs, likely more than \$200 million, again based on scaling the BS2 retrofit projects for the DFGD and then rounding upward for the effects of the SCR.

Mr. Kollen used this information to roughly estimate the effect on the Company's revenue requirement (ECR and base) from the Rockport environmental upgrades in 2017 and 2019. To make this estimate, Mr. Kollen assumed that the cost for the Rockport units would be \$2,163 million at a grossed-up return of 11% and depreciation rate of 4% as well as \$200 million in O&M expenses. On this basis, Mr. Kollen estimated the total revenue requirement for the Rockport units at \$524 million, of which the Company's share is 15%, or roughly \$80 million. This is equivalent to rate increases (ECR and base) of 14% in addition to the rate increases for the proposed BS2 retrofit projects (ECR and base).

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6. Refer to pages 32-34 of the Kollen Testimony which address the allocation of short-term debt to Kentucky Power's environmental cost recovery based on CWIP rather than on rate base.
- a. Under Mr. Kollen's recommended allocation, a greater percentage of short-term debt will be allocated to environmental cost recovery. Is it correct that this will result in decreasing the percentage of short-term debt allocated to base rates?
  - b. Explain whether this allocation approach will reduce a utility's total revenue requirement or if it results in shifting the reduction in the environmental revenue requirement to the base rate revenue requirement.

**RESPONSE**

- a. No. Mr. Kollen cannot confirm that the relationship set forth in the question always will be true, although there likely will be a greater percentage of short-term debt allocated to the ECR at least during the latter years of the BS2 retrofit construction. Mr. Kollen is unable to make an assessment as to whether the statement in the question is likely to be true after the BS2 retrofit is placed in service. In addition, it isn't necessarily true that a greater allocation of short-term debt to the ECR will result in a lesser allocation to base rates.

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- b. The use of greater amounts of short-term debt during the BS2 retrofit construction will result in a lower revenue requirement on a total Company basis and in the ECR compared to the use of lower amounts of short-term debt, all else equal. The issue then becomes one of allocation between the ECR and base rates. In between base rate cases, the only place that the greater amount of short-term debt can and will be reflected in the revenue requirement is through the ECR, which essentially is a real-time ratemaking recovery mechanism (although it is lagged by two months). Between base rate cases, even with Mr. Kollen's recommendation, a portion of the savings from a greater amount of short-term debt is flowed through to customers through the ECR, but the remaining amount of the savings is retained by the Company unless and until there is a base rate case. In short, ratemaking is not a closed loop and there may be more or less short-term debt allocated to base rates depending on the timing of the base rate case proceeding, the test year

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7. Refer to pages 35-40 of the Kollen Testimony which address the use of “Mirror CWIP” as a means of mitigating the revenue requirement in the early years after the Big Sandy 2 scrubber is placed in service.
- a. Identify the state utility regulatory commissions of which Mr. Kollen is aware that use, or have used, Mirror CWIP in the manner he describes.
  - b. Provide the three most recent orders from these commissions in which the use of Mirror CWIP was required.

RESPONSE

- a. Mr. Kollen is aware that Texas and Ohio have used mirror CWIP from his regulatory experience in those states. There may be other jurisdictions that also use this form of CWIP in rate base.
- b. Mr. Kollen has identified the following orders where the Ohio and Texas Commissions have discussed or mentioned the use of Mirror CWIP:
  - Public Utilities Commission of Ohio:
    - Case No. 86-2025-EL-AIR, *Re Cleveland Electric Illuminating Company*, Order (Dec. 16, 1987).
    - Case No. 88-170-EL-AIR, *Re Cleveland Electric Illuminating Company*, Opinion and Order (Jan. 31, 1989)
  - Public Utility Commission of Texas:

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- Docket No. 21528, *Application of Central Power and Light Company for Financing Order to Securitize Regulatory Assets and Other Qualified Costs*, Financing Order (March 27, 2000) (listing Mirror CWIP in assets to be securitized)
- Docket No. 14965 , *Application of Central Power and Light Company for Authority to Change Rates*, Second Order on Rehearing (Oct. 16, 1997)

The depth of discussion of Mirror CWIP varies in the orders. Mr. Kollen has not verified whether these are the most recent orders requiring the use of Mirror CWIP. Additionally, Ohio has a statute requiring the use of Mirror CWIP - R.C. 4909.15(A). Ohio also requires certain utilities to file information related to Mirror CWIP pursuant to Ohio Adm. Code 4901-7-01 (Standard Filing Requirements).



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8. Refer to pages 47-48 of the Kollen Testimony which address the cost of \$15.2 million incurred by Kentucky Power in 2004-2006 for preliminary investigation and evaluation of wet scrubber technologies.
- a. Kentucky Power's response to Item 18 of Commission Staffs First Information Request identifies \$1.65 million of these costs as "FGD Landfill" costs that "[c]an and will be used with the proposed DFGD technology." If the Commission were to approve Kentucky Power's proposed scrubber project, explain why it would not be appropriate to permit recovery of a portion of the cost related to the landfill.
  - b. Mr. Kollen cites Commission decisions in Case Nos. 2010-00523 and 2011-00036 as support for his recommendation that Kentucky Power be denied recovery of the preliminary investigation costs. [Footnote omitted]. Explain whether Mr. Kollen is aware that in both cited cases the utility had not deferred the costs in question but had charged them to expense in the year in which they were incurred and then presented a proposal seeking Commission approval to retroactively defer the costs.

**RESPONSE**

- a. Mr. Kollen agrees that at least the land component of the landfill costs should be allowed recovery because the cost of land is a physical asset and normally is accounted for in the plant accounts, not as a regulatory asset. Please refer to Mr. Kollen's recommendation on page 48 lines 3-8 of his testimony.

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- b. Yes. In this case, the utility unilaterally deferred the expenses without Commission authorization, which is substantively the same as the other cited cases. That is because in this case and the others cited, the Commission would be required to approve the deferrals retroactively so that the utility can recover the costs prospectively.

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9. Refer to page 4, lines 8-9, of the Kollen Testimony. Specify the options that Mr. Kollen believes “were not fully evaluated by the Company.” Provide any analysis that Mr. Kollen has performed relative to these options.

RESPONSE

Mr. Kollen specifically identifies four options that were not fully evaluated by the Company on page 24 line 16 through page 27 line 21 and describes the analysis that he performed. Mr. Kollen recommends that these four options as well as other options be considered in a separate proceeding to develop a least cost resource plan for the future. Mr. Kollen has not performed any independent quantitative analyses of these four options.

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10. Refer to pages 10-11 of the Kollen Testimony, which describe the two purchase power alternatives Kentucky Power used in its analysis. Indicate whether Mr. Kollen agrees or disagrees with the capacity and energy prices used in the analysis. If he disagrees, provide his proposed alternative prices.

RESPONSE

Mr. Kollen has not performed an independent assessment of the capacity and energy prices used in the analysis other than to review the Company's analyses and data sources.

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11. Refer to page 19 of the Kollen Testimony. Mr. Kollen suggests that gas price projections are below Kentucky Power's base case natural gas price forecast. Which gas price projections or range of gas price projections would Mr. Kollen recommend for use in the analysis?

RESPONSE

Mr. Kollen would use a lower natural gas price forecast than the Company's lower band, perhaps starting with \$2.50/mmBtu, in order to bound the upside of potential savings under options that rely on natural gas generation or purchases that reflect natural gas pricing compared to the Company's proposed BS2 retrofit option and to assess the full range of the risk from proceeding with the BS2 retrofit option.

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12. Refer to page 24, lines 6-14, of the Kollen Testimony. Mr. Kollen proposes a separate proceeding *to* develop a least-cost option. Expand on this proposal and delineate the likely parties, the role of the parties, and potential schedule.

RESPONSE

The purpose of such a proceeding would be to consider on a comprehensive basis the supply and demand side options available to the Company to meet its resource requirements on a least cost basis going forward and with consideration of other factors such as fuel diversity, future regulatory compliance requirements, and customer impacts. The likely participants in such a proceeding are the Company, the Staff, and the active intervenors in this proceeding.

In such a proceeding, the working group would develop the framework for a base case against which to compare available options. This would include the future of the AEP pool agreement and the disposition of the Ohio generating capacity, among other issues. The working group would develop a list of possible options for assessment. The working group would decide on the appropriate range of assumptions to reflect in the base case and for the options as well as the sensitivities on those assumptions. The Company would perform the analyses and the working group would review the analyses. This likely would involve study iterations and refinement. The working group would attempt to reach a consensus on the resource plan and then support the plan in related regulatory proceedings.

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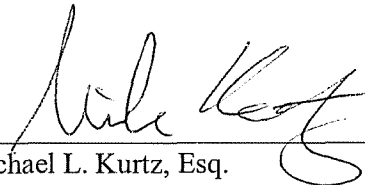
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Respectfully submitted,

 4/12

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April 2, 2012

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