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

KENTUCKY POWER COMPANY'S RESPONSE TO JOINT PETITION FOR REHEARING OF THE ATTORNEY GENERAL AND KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

INTRODUCTION

Kentucky Power Company ("KPCo" or "the Company") files this response to the Joint Petition for Rehearing filed by the Kentucky Attorney General ("AG") and Kentucky Industrial Utility Customers, Inc. ("KIUC") (collectively "the Intervenors"). The Petition should be denied because each of the issues presented has already been raised several times by the Intervenors, and correctly rejected by the Commission.

The Commission in this case was asked by KPCo to apply the environmental cost recovery (ECR) mechanism to environmental costs it pays to surplus members of the AEP Pool under the monthly capacity charges. Because these costs are being incurred pursuant to the FERC-approved AEP Interconnection Agreement, they are presumed to be both required and reasonable – and, contrary to the Intervenors' unsupported declaration, the costs are indeed KPCo's costs. This Commission's Order properly found that, as such, the costs are entitled to be recovered through the ECR surcharge, as follows:

Based on the evidence of record and being otherwise sufficiently advised, the Commission finds that, with the exception of the SO_3 projects discussed below, Kentucky Power has submitted an environmental compliance plan that conforms to KRS 278.183. As a member of the AEP Pool, Kentucky Power purchases energy from the other pool members under the terms of the AEP Interconnection Agreement. Under the terms of that agreement, Kentucky Power is required to pay its member load ratio share of the cost of environmental projects installed by the surplus members of the AEP Pool.

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.

However, while Kentucky Power's costs under the AEP Interconnection Agreement must be accepted as reasonable for rate-making purposes, that does not mean that such costs must be accepted for recovery by environmental surcharge under KRS 278.183. To qualify under KRS 278.190 and 278.192 for rate recovery in a base or general rate case, a cost must be reasonable, and any cost incurred pursuant to a FERC rate is presumed to be reasonable. Thus, a FERC-approved rate cannot be disallowed as unreasonable. But to qualify under the restrictive provisions of KRS 278.183 for environmental surcharge recovery, a cost must be "reasonable and cost-effective for compliance with the applicable environmental requirements." Thus, even though a FERC-approved rate is presumed to be reasonable, there is no presumption that such a rate is both reasonable and cost effective for complying with the environmental requirements listed in KRS 278.183. Kentucky Power must carry its burden to prove that a FERC-approved rate qualifies for environmental surcharge recovery.

> The Commission has reviewed the information provided by Kentucky Power that addresses the need for the projects. Seven of the projects involved the installation of CEMs at various locations, and the documentation demonstrates that CEMs were the only alternative to comply with the CAA. One project involved the upgrade of the electrostatic precipitator controls at Tanners Creek Unit 4, and the evidence shows that no other feasible option was available for the Tanners Creek project. For the remaining projects, it appears that AEP does conduct some optimization modeling of compliance options, but does not document the results of that modeling in a manner similar to previous analyses Kentucky Power has filed with this Commission. A review of the CIs submitted for the projects does reveal that compliance alternatives have been noted by AEP's engineering staff. While the documented evaluation of the reasonableness and cost effectiveness of the projects in this case does not match the analyses Kentucky Power provided in its certificate application for a SCR at Big Sandy, the documentation does support a finding that the projects are reasonable and cost-effective means of controlling SO_2, SO_3, and NOx emissions.

September 7, 2005 Order ("Order") at pp. 10 -11.

This passage from the Order shows that the Commission thoroughly considered, and accepted, the Company's compliance plan[1] (with the noted exceptions) in their Order and found it to comply with the statutory requirements.

I. THE LEGISLATIVE INTENT OF KRS 278.183 DOES NOT PRECLUDE RECOVERY OF KPCO'S REQUESTED ENVIRONMENTAL COMPLIANCE COSTS.

The Intervenors seek rehearing on their "legislative intent" argument on the erroneous basis that, in holding against them, "the Commission found that as the AG and KIUC had not specifically alleged that KRS 278.183 is ambiguous, the Commission could not look at legislative intent to determine the scope of the statute." Intervenors' Petition at p.2. The Intervenors, however, have mischaracterized the language of the Commission. The Order does not say that the Commission could not look at the legislative intent because the AG and KIUC

[1] See the compliance plan filed as Exhibit 1 to the Company's March 8, 2005 application.

had not alleged the statute to be ambiguous. Rather, the Order specifically states: "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." Order at p.15. Thus the Commission clearly held the statute was unambiguous so that it is not necessary to look beyond the clear language of the statute in order to effectuate legislative intent. None of the Intervenors' arguments on rehearing succeed in establishing any ambiguity in the statute. Nor do the Intervenors present any evidence or proof that the Commission's Order is inconsistent with legislative intent.

The Intervenors' argument is that the legislative purpose behind KRS 278.183 somehow precludes KPCo's recovery in this case. This position (which was fully presented previously at pp. 9-10 of the KIUC Brief, filed August 19, 2005) is built around the 1998 Kentucky Supreme Court case of *Kentucky Industrial Utility Customers, Inc. v. Kentucky Utilities Co.*, 983 S.W.2d 493 (Ky. 1998). The Intervenors note that this case emphasized that the purpose of KRS 278.183 was "to incentivize the use of high-sulfur, Western Kentucky coal" (Intervenors' Petition at p. 2) – a fact with which KPCo generally agrees.[2] They then argue that the Commission's application of KRS 278.183 should be guided by legislative intent. Assuming arguendo that legislative intent were a proper consideration for the Commission in this instance, its decision is certainly consistent with an intent to" incentivize" the use of Kentucky coal, including high sulfur Western Kentucky coal. By allowing KPCo to recover the costs it incurs under the Pool Agreement for air pollution control projects at its surplus AEP sister companies,

[2] The preamble to SB341 (i.e. KRS 278.183) described the purpose as being "to foster and encourage the continued use of Kentucky coal by electric utilities serving the Commonwealth." The Court opinion noted that this intent was focused primarily on high sulfur coal—which is located primarily in Western Kentucky.

the Commission gives those companies an incentive to retain and develop coal as a fuel source, including high sulfur Western Kentucky coal. As the Commission noted, the "statute does not restrict surcharge recovery to costs incurred at facilities owned by the utility or at facilities located in Kentucky." Order at p.16.

A further flaw in the Intervenors' position is not in the recitation of the principles found in *Kentucky Industrial Utility Customers, Inc.*, *supra*, but in the application of these principles to the very different facts and circumstances of this case. In *Kentucky Industrial Utility Customers, Inc.*, *supra*, Kentucky Utilities had sought recovery of costs via the environmental surcharge which had been incurred prior to January 1, 1993 – the effective date of KRS 278.183 (the environmental surcharge statute). The Court succinctly framed the issue: "[W]hether KRS 278.183 . . . permits a surcharge for those projects built before the statute was enacted." *Id.* at 496. In answering this issue in the negative, the Court noted that many of the costs for which Kentucky Utilities was seeking recovery were incurred well before 1990, the date of the Federal Clean Air Act – the federal statute that required the scrubbers and other environmental investment. These new requirements are what formed the basis for the "legislative intent" of KRS 278.183 – which was to promote Kentucky coal by allowing prompt recovery of new costs incurred as a result of the Act. In rejecting KU's argument that KRS 278.183 should be applied retroactively to capture environmental investment incurred prior to the passage of KRS 278.183, the Court simply declined to impose such retroactivity without a clear and expressed legislative directive to do so. *Id.* at 500. Rather, the Court held that the statute "was only intended to apply to the Utility's future obligations to comply with new environmental laws." *Id.* In the case currently before this Commission, all of the projects included in KPCo's compliance plan were constructed in 1993 or thereafter to comply with the requirements of the Federal Clean Air Act.

Therefore, the reasoning of the *Kentucky Industrial Utility Customers* case supports the Company's position, not the Intervenors'. Moreover, this argument should be rejected for rehearing, because it has been made and rejected by this Commission from the very first surcharge case. See Order of May 27, 1997, Case No. 96-489 at p. 8 ("[T]he Commission has not based its finding on the AG's argument that compliance projects are eligible for surcharge recovery only if they have been reviewed and approved by the Commission prior to being undertaken by the utility.")

It should be further noted that the legislative intent of KRS 278.183 cannot be read quite as narrowly as the Intervenors suggest. The expressed goal of the statute was surely to protect and promote the use of Kentucky coal – but the legislative means chosen to achieve that goal are equally significant. Here, the "surcharge" mechanism promoted coal consumption by assuring electric utility companies that they would receive direct and prompt recovery of their environmental costs – without the timely and expensive process of a base rate proceeding. The Act was thus telling utilities that if you choose to comply with the Clean Air Act by adding environmental equipment to your generating plants, we will assure you prompt and full recovery of the costs associated with such investment. The Intervenors' position ignores this essential and fundamental "implementation" aspect of the "legislative intent" of KRS 278.183.

Finally, legislative intent must be construed so as to not conflict with significant constitutional principles. In this case, a Commission application of KRS 278.183 only to in-state environmental equipment would run the risk of violating the Commerce Clause of the United States Constitution. This Clause prohibits states from passing favorable in-state legislation which imposes an "undue burden" on interstate commerce. 15A Am. Jur.2d Commerce § 100. Certainly the electric utility industry in general, and the AEP System in particular, constitutes

interstate commerce. *FERC v, Mississippi*, 456 U.S. 742 (1982). And certainly the restricted interpretation of KRS 278.183 sought by the Petitioners would adversely affect such commerce. Such an interpretation would result in the disparate treatment of environmental costs incurred for the benefit of KPCo's ratepayers based solely on the interstate character of these costs. Put another way, without full cost recovery for all projects, wherever located, KPCo's interstate environmental costs would be discriminated against (as compared to utilities whose facilities are fully in-state) – a circumstance which would encourage the Company either (1) to leave the AEP System and secure power from another Kentucky utility; or (2) to build all of its generation (and environmental) needs in Kentucky. Neither of these options would be in the best interest of the Company or its customers. Manifestly, the purpose of the Commerce Clause is to prevent such interference with interstate business operations – and, in this case, KRS 278.183 should be interpreted and applied to avoid such an unconstitutional result.

II. THE PETITION FOR REHEARING RAISES THREE JURISDICTIONAL ARGUMENTS THAT HAVE BEEN, AND SHOULD CONTINUE TO BE, REJECTED.

The Intervenors' Petition, recognizing that the Order considered and rejected each of the arguments raised on the merits, again maintains that the PSC simply does not have the authority to order recovery of KPCo's environmental costs incurred via the capacity charge. This position is based on three erroneous positions, which were initially set forth at pages 7-9 of the KIUC brief.

First, the Intervenors continue to maintain that the Commission should not have approved the Company's proposed compliance plan because the PSC "has no jurisdiction over facilities located outside the Commonwealth." Petition, p. 5. This argument misses the point. The PSC has jurisdiction over a utility's rates and service (KRS Chapter 278), including the recovery of reasonably incurred environmental costs. The Commission's language quoted at pp. 2-3 herein

properly reflects the statutorily mandated inquiry: Are the projects reasonable and cost-effective? The statute simply does not require that the PSC have initial approval jurisdiction of the projects – and the Intervenors cannot, by *ipse dixit*, make the statute impose such a standard.

The Intervenors next argue that the costs which KPCo seeks to recover through the ECR mechanism are not "its costs," which they read as requiring the actual investment to have been made by KPCo, rather than its sister companies. This argument is simply too simplistic. The AEP System is designed, built and operated as a single tility system – a system which has produced enormous efficiencies and benefits both for the Company and its customers. The heart of this relationship is the AEP Interconnection Agreement, which provides the mechanism (*i.e.*, the capacity charge) under which the AEP member receiving the benefit incurs the cost of that benefit. This "cost" is mandated by federal law – and, indeed, the cost is incurred by KPCo when it pays its FERC-determined capacity charge. At the time of this transaction, the "cost" is incurred by KPCo, and the surplus company is relieved of the burden of carrying this cost. The standards of KRS 278.183 are thus satisfied.

Finally, the Intervenors maintain that the Commission cannot assume jurisdiction over the Company's environmental compliance plan because KPCo did not offer a "reasonable rate of return" for the projects included. (Petition at p. 6.) To the contrary, the Company explained to the Commission (as recognized in the Intervenors' Petition) (1) that it was seeking recovery of an expense incurred under the capacity charge, (2) that the capacity charge includes the rate of return established by FERC; and (3) that the doctrine of federal preemption requires acceptance of the rate (and hence the rate of return). The Commission has properly recognized that it cannot go behind the FERC rate; nor can the state legislature attempt to pass legislation that conflicts with federal law. In this case, there is no conflict between KRS 278.183, which requires proof

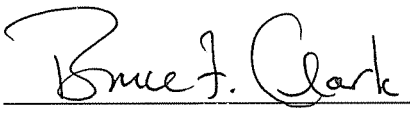
and a determination of a reasonable rate of return, and the fact that this rate has already been established by FERC – a determination which must be accepted as reasonable. But if a conflict were to exist, the doctrine of federal preemption would necessarily prevail.

The AG and KIUC have failed to recognize that KPCo is asking for a recovery of operating expenses as permitted by the statute, not a return on facility costs, when it seeks recovery of the costs incurred through the Pool Agreement. The Company is asking for current recovery of these environmental operating expenses as recorded in the FERC Chart of Accounts No. 555. The Commission properly determined that they are recoverable pursuant to KRS 278.183.

CONCLUSION

For the reasons set forth herein, the arguments set forth in the Petition for Rehearing filed by the Intervenors must be rejected.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I hereby certify that a true and accurate copy of the foregoing Response to Joint Petition for Rehearing was served via United States Postal Service, First Class Mail, postage prepaid, upon:

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on this the 6th day of October, 2005.

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