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Via Hand Delivery

August 19, 2005

Beth A. O'Donnell, Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

Re: Case No. 2005-00068

Dear Ms. O'Donnell:

Please find enclosed the original and twelve (12) copies of the Main Brief of The Kentucky Industrial Utility Customers, Inc. filed in the above-referenced matter. By copy of this letter, all parties listed on the Certificate of Service have been served.

Please place this document of file.

Very Truly Yours,

Michael L. Kurtz, Esq.
BOEHM, KURTZ & LOWRY

MLKkew
Attachment
cc: Certificate of Service

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served by mailing a true and correct copy, by electronic mail and first-class postage prepaid mail, unless otherwise noted, to all parties on the 19th day of August, 2005.

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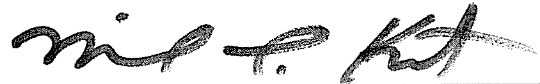

Michael L. Kurtz, Esq.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

RECEIVED
AUG 1 9 2005
PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

KENTUCKY POWER COMPANY'S SECOND AMENDED ENVIRONMENTAL COMPLIANCE PLAN AND SECOND REVISED TARIFF	)))	**CASE NO. 2005-00068**

BRIEF OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

I. INTRODUCTION

Kentucky Power Company ("Kentucky Power" or "the Company") generates its own power and also receives power from American Electric Power Company ("AEP") sister-companies through the FERC-approved AEP Interconnection Agreement.[1] The Interconnection Agreement equalizes capacity costs among the AEP affiliates that are surplus through payments from affiliates that are deficit. The Interconnection Agreement does not contain separate line items for environmental and non-environmental costs within the capacity equalization payment. Kentucky Power is also subject to the AEP System Interim Allowance Agreement[2] which pertains only to environmental compliance costs. The Interim Allowance Agreement allocates the costs and benefits of environmental compliance among the AEP operating companies with a specific emphasis on the treatment of emission allowances

[1] KIUC Cross Examination Exhibit 5.
[2] KIUC Cross Examination Exhibit 1.

produced at Ohio Power Company's ("Ohio Power") Gavin facility. Both the Interconnection Agreement and the Interim Allowance Agreement were approved by the FERC and carry with them the weight of federal preemption under the filed rate doctrine.

On May 27, 1997 the Kentucky Public Service Commission ("Commission" or "KPSC") issued its final Order in Case No. 96-489, holding that Kentucky Power could recover its share of the cost of a scrubber installed at Ohio Power's Gavin facility through Kentucky's environmental surcharge statute (KRS 278.183) pursuant to both the Interconnection Agreement and the Interim Allowance Agreement.

On March 8, 2005 Kentucky Power filed its Application in the above-captioned matter requesting Commission approval to amend its environmental surcharge tariff. The Company requests surcharge recovery of environmental costs incurred at the facilities of the surplus AEP operating companies. These out of state environmental costs are not specified in the Interconnection Agreement but are one of a number of costs that make up the capacity equalization charge. Nor are these out of state environmental costs specified in the Interim Allowance Agreement. The environmental projects for which recovery is sought were put in service between 1993 and 2005 at the following facilities owned by Ohio Power or Indiana & Michigan Electric Company ("Indiana & Michigan") and are listed below:[3]

- Amos Plant (West Virginia)
- Cardinal Plant (Ohio)
- Gavin Plant (Ohio)
- Kammer Plant (West Virginia)
- Mitchell Plant (West Virginia)
- Muskingum Plant (Ohio)
- Philip Sporn Plant (West Virginia)
- Rockport Plant (Indiana)
- Tanners Creek Plant (Indiana)

[3] Kentucky Power Exhibit JMM-2.

The Kentucky Industrial Utilities Customers, Inc. ("KIUC") intervened in this case and submitted the testimony of its expert witness Lane Kollen. For the reasons set forth below KIUC recommends that the Company's Application be denied. KIUC further recommends that the Commission: 1) enforce its previous determination that all SO2 emission allowance margins allocated to Kentucky Power under the Interim Allowance Agreement be used to prospectively reduce the surcharge and require refunds of past overcharges; 2) enforce its previous determination that all NOx emission allowance margins used to supply power to off-system sales be used to prospectively reduce the surcharge and require refunds of past overcharges; and 3) reflect the federal and state tax law changes in the surcharge revenue requirement.

II. ARGUMENT

1. The Company's Share Of The Environmental Compliance Costs Of Ohio Power And Indiana & Michigan Are Properly Recovered Through A Base Rate Case, Not The Environmental Surcharge.

a. The Requirements Of KRS 278.183 Have Not Been Met.

It is well settled that federal preemption requires state courts and regulatory bodies to allow a utility subject to their jurisdiction to recover the cost of purchasing wholesale power when such costs are contained in a FERC-approved rate (the "filed rate doctrine"). It is also well settled that a utility which seeks the recovery of a FERC-approved rate through a state court or agency must petition to recover the costs associated with the federal rate in accordance with state regulatory law and procedures. The Commission is bound by preemption and the filed rate doctrine to allow Kentucky Power to recover the costs it incurs through the FERC-approved Interconnection Agreement. However, the Commission is not required to, and it would be a violation of Kentucky law for the Commission to allow the recovery of these costs through the environmental surcharge because the plain language of the environmental surcharge statute does not provide for the recovery of such costs. Nor would recovery of such costs be appropriate in the fuel adjustment clause or DSM surcharge. The proper recovery mechanism for Kentucky Power's costs associated with the Interconnection Agreement is a base rate case.

The United States Supreme Court has held that FERC-approved rates must be passed through to ratepayers without interference by state courts or regulators. In Mississippi Power & Light Co. v. Mississippi Ex Rel. Moore, 487 U.S. 354, 372 (1987) the Supreme Court held:

> "*When FERC sets a rate between a seller of power and a wholesaler-as-buyer, a State may not exercise its undoubted jurisdiction over retail sales to prevent the wholesaler-as-seller from recovering the costs of paying the FERC-approved rate.*" citing Nantahala Power and Light Company v. Thornburg, 476 US 953, 106 S. Ct. 2349 (1986).

Under the filed rate doctrine the KPSC must allow the Company to recover the costs associated with the Interconnection Agreement as they are FERC-approved rates. The KPSC does not have jurisdiction to question the reasonableness of and disallow the recovery of any portion of these federal rates.

Although it is undisputed that the Company is entitled to recover its costs incurred pursuant to the Interconnection Agreement, the state Commission retains the discretion to determine the appropriate retail recovery mechanism and the timing of recovery in accordance with that retail recovery mechanism. The existence of a federal rate does not entitle the utility to pick and choose the retail recovery mechanism that provides the earliest recovery, to force immediate retail rate recovery, or to otherwise circumvent the established retail rate recovery procedure. To the contrary, the state Commission must determine the appropriate retail recovery mechanism and the timing of that recovery. The discretion of state Commissions in this respect was decided in Arkansas Power & Light v. Missouri Public Service Commission, 829 F.2d 1444 (8th Cir. 1987). In that case, the Eight Circuit Court of Appeals was presented with the question of:

> "*whether MPSC* [the Missouri Public Service Commission], *which concededly must ultimately recognize as reasonable the costs of capacity imposed on AP&L* [Arkansas Power & Light] by FERC, *is also obliged, by the preemptive force of the Federal Power Act, to allow immediate pass-through of these costs, without regard to the ordinary process of suspension and investigation provided by state law*."(Id. p. 1450)

The Court agreed with the MPSC that:

> "*local commissions, although they must treat federally ordered costs as reasonable, may consider those costs under the ordinary rate-making procedures applicable to rate filings generally. One such procedure, of course, is the local rate-making authority's ability to suspend rates and allow them to go into effect only after the expiration of a period set by statute for investigation and hearing*." (Id. p. 1451)

The Court further explained that:

> *"Although the FERC order clearly contemplates that costs will have to be passed on to retail customers, it also 'clearly recognize[s] the role of the States in regulating retail electric rates and the need to balance overlapping State and Federal electric jurisdiction'... No one claims that the FERC order in express words commands an immediate pass-through or purports to override ordinary state suspension and investigation procedures, nor is there any language in the Federal Power Act that would indicate that Congress had any such intention*" Id. at 1451.

In Arkansas Power & Light the Court determined that although FERC-approved rates must be recoverable at the state level, state commissions should treat these cost within the framework of ordinary rate-making procedures. Preemption does not require that FERC-approved rates are immediately recoverable or that they are recoverable through a state tracker that was designed to pass through entirely different types of costs than the costs associated with the FERC-approved rate.

The same conclusion was reached by other courts deciding this issue. In Narragansett Electric Co. v. Burke, 119 R.I. 559, 381 A.2d 1358 (R.I., 1977) the Court stated:

> "*The* [Rhode Island] *commission ... may treat the* [increase in FERC-approved wholesale rates] *as it treats other filings ... and investigate the overall financial structure of* [the power company] *to determine whether the company has experienced savings in other areas which might offset the increased price.*" (Id. p. 1363)

Additionally, in Public Service Co. of Colorado v. Public Utilities Comm'n, 644 P.2d 933 (Colo.1982) the Court determined that:

> "[The Colorado commission] *may treat* [a proposed rate increase pursuant to a federal rate] *as it treats other filings for proposed rate increases ...* [and] *investigate whether* [either of the utilities] *has experienced savings in other areas which might offset the increased price for natural gas to consumers*". (Id. at 941)

A FERC-approved rate with preemptive effect does not give a utility license to recover its costs associated with that rate in any way the utility sees fit irregardless of state law or procedures. Utilities must recover these costs through the proper channel. The proper channel for recovery of Kentucky Power's fixed costs incurred pursuant to the Interconnection Agreement is a base rate case, not the Kentucky environmental surcharge statute. The Company's Application for recovery of these costs through KRS 278.183 fails to meet the requirements of the statute in several respects.

First, KRS 278.183(1) requires that the Commission "*consider*" and "*approve*" a compliance plan "*if the Commission finds the plan... reasonable and cost-effective for compliance with the applicable environmental requirements...*" Kentucky Power fails this most basic requirement of the statute by not submitting a compliance plan for Commission approval of Ohio Power's and Indiana & Michigan's environmental costs incurred in Ohio, West Virginia and Indiana. The omission of a compliance plan alone is grounds for denial of the Company's Application.

The capacity equalization provision of the Interconnection Agreement does not in any way establish an environmental compliance plan. The Interconnection Agreement merely requires deficit companies to pay surplus companies an amount to equalize the investment between the companies. It is an untenable proposition to request this Commission to approve an alleged environmental compliance plan based solely on purchased power costs incurred by Kentucky Power through a capacity equalization charge.

Had the Company submitted an environmental compliance plan the Commission would be unable to take the next step required by the statute of approving or disapproving the plan or the costs associated with the plan because the Commission has no jurisdiction over facilities located outside the Commonwealth. The Commission would have no authority to consider and approve any compliance plan that includes environmental costs from Ohio, Indiana and West Virginia. The proposed recovery of

environmental costs incurred by Kentucky Power's out-of-state sister AEP companies does not fit within the framework of Kentucky's environmental surcharge statute. Recovery of these costs through an environmental surcharge, rather than through a base-rate case, violates Kentucky law.

Next, 278.183(2)(b) requires the KPSC to "[e]*stablish a reasonable rate of return on compliance-related capital expenditures*..." The Company has not proposed that the KPSC set a rate of return for these costs because the rate of return has already been set by the FERC.[4] If the Commission is not able to engage in the necessary step of determining the reasonable rate of return on compliance related expenditures, then Kentucky Power's proposed costs cannot be the subject of an environmental surcharge according to KRS 278.183. Again, Kentucky's environmental surcharge is simply the wrong avenue for recovery of Ohio Power and Indiana & Michigan's environmental compliance costs.

KRS 278.183(1) also contains clear language that a surcharge will be approved for the recovery of the applicant's environmental compliance costs and not the environmental compliance costs of another utility. 278.183(1) states that "*a utility shall be entitled to the current recovery of its cost of complying with the Federal Clean Air Act... and those federal, state, or local environmental requirements which apply to coal combustion wastes*..." (emphasis added). Kentucky Power's Application does not seek to recover "*its*" environmental compliance costs, but requests that the Commission adopt a surcharge which is comprised of the portion of the Company's capacity equalization payments that are attributable to the environmental compliance costs of out-of-state utilities. KRS 278.183 requires that costs to be recovered through an environmental surcharge be the utility's own costs. Kentucky Power does not meet this standard.

The reason the Company's Application so glaringly fails to meet the requirements of KRS 278.183 is that the statute was never intended to be used to recover the environmental costs of a utility

[4] Direct Testimony Errol K. Wagner p. 12 lines 6-10.

outside the Commonwealth. It is clear from the language of that statute as well as a Kentucky Supreme Court's discussion of KRS 278.183 that the Legislature authorized the preferred ratemaking treatment of surcharge recovery for reasons very different than those presented here. The intent of the Legislature in providing for the preferred ratemaking treatment of an environmental surcharge was to level the playing field between high sulfur Western Kentucky coal, which generally requires a scrubber, and low sulfur Eastern Kentucky coal which requires no scrubber. The intent was not to allow utilities to pass environmental compliance costs incurred outside the Commonwealth on a real-time basis through a Kentucky tracker. These costs should only be recoverable in a base rate case.

The Kentucky Supreme Court sheds light on the legislative intent of 278.183. In Kentucky Industrial Utility Customers, Inc. v. Kentucky Utilities Co., Ky., 983 S.W.2d 493 (1998) the Court explained that 278.183 was enacted in order to encourage utilities to build scrubbers to use the high sulfur coal found in Western Kentucky. This was seen as leveling the playing field with low sulfur Eastern Kentucky Coal, the cost of which is immediately recoverable in the fuel adjustment clause. The Court wrote:

> "*The legislative intent of* [KRS 278.183] *was to promote the use of high sulfur Kentucky coal by permitting utilities to surcharge their customers for the cost of a scrubber which is part of a power plant that cleans high sulfur coal in order to meet the acid rain provisions of the Federal Clean Air Act amendments of 1990. This Court recognizes that both high sulfur and low sulfur coal are mined in Kentucky. The high sulfur coal is mined primarily in Western Kentucky whereas low sulfur coal is mined primarily in Eastern Kentucky. The legislature believed that some Kentucky coal was in a disfavored position because high sulfur coal was the product that required pollution control devices. In order to balance the preference for coal produced in the western part of the United States, regulations were enacted which allowed utilities to immediately recover fuel cost increases due to the use of coal produced in the western part of the United States. Prior to 1992, a utility could increase its rates only pursuant to the Fuel Adjustment Clause or as a general rate case. A general rate case pursuant to KRS 278.190 is a lengthy procedure in which a new base rate is approved only after thorough examination of all operations and costs by*

> *the PSC. In 1992, the General Assembly enacted the statute involved in this case which allows utilities to use Kentucky coal and collect the costs of cleaning high sulfur coal. The effect is that the statute provides an alternate procedure to increasing the base rate by allowing utilities to recover the costs of environmental compliance by means of a surcharge rather than by opening a general rate case.*" (Id. p. 496-497)

The Legislature never envisioned this statute being used to allow a utility to institute an environmental surcharge ultimately based on environmental facilities located outside of Kentucky. Given the fact that 278.183 was not intended to be used to allow the type of costs contained in the Company's Application to be included in the environmental surcharge it is not surprising that the Company's Application so thoroughly fails to meet the requirements of 278.183.

The Company has pulled out the environmental components of its costs of taking power from out-of-state utilities in an attempt to fit a square peg (capacity equalization payments) into the round hole that is KRS 278.183. The Commission is required to allow the recovery of the Company's FERC-approved costs, but the Commission is not required to order their recovery through the environmental surcharge. Federal law is clear that although state regulators are preempted from disallowing the recovery of FERC-approved costs the recovery of these costs must be achieved in accordance with state law and ordinary rate making procedures. The Commission should deny the Company's proposal to recover out-of-state environmental costs embedded in the Interconnection Agreement because the Company has failed to meet the requirements of KRS 278.183.

b. The Company's Proposal To Change The Interconnection Agreement Capacity Equalization Charge Is Barred By The Filed Rate Doctrine And Federal Preemption.

As discussed above, the filed rate doctrine requires that state courts and agencies allow the recovery of FERC-approved costs. Under this principle the KPSC cannot change or deviate from the rates established in the AEP Interconnection Agreement. However, Kentucky Power requests deviation

from the federal rate by seeking to pull out the environmental components embedded in the FERC-approved rate in order to separately recover these costs through the environmental surcharge. The Company has disaggregated the federal rate and invented new rates for ostensibly environmental components and new rates for non-environmental components. Such modification of a federal rate is preempted.

In Arkansas Louisiana Gas Company v. Hall, 101 S.Ct. 2925 (1981) the US Supreme Court stated:

> "*Except when the* [FERC] *permits a waiver, no regulated seller of natural gas may collect a rate other than the one filed with the* [FERC]... *the 'filed rate doctrine' forbids a regulated entity* [from charging] *rates for its services other than those properly filed with the appropriate federal regulatory authority.*" (Id. p. 2930)

In Entergy Louisiana, Inc. v. Louisiana Public Service Commission, 123 S.Ct. 2050, 2056 (2003) the Supreme Court held:

> "*The filed rate doctrine requires 'that interstate power rates filed with FERC or fixed by FERC must be given binding effect by state utility commissions determining intrastate rates.*'"

In Gulf States Utilities CO. v. Alabama Power Co., 824 F.2d 1465 (5th Cir. 1987), the Fifth Circuit Court of Appeals explained the proscription against changing a federal rate. The Court stated:

> "*Through the* [Federal Power Act], *Congress preempted states, state courts, and even federal courts form acting in areas reserved exclusively for the FERC... the FPA forbids a state or state agency to impose a rate different from the filed rate ...*"

Perhaps the strongest language concerning the inability of a state court or agency from changing or deviating from a federal rate is contained in the Ninth Circuit Court of Appeals case California v. Lockyer (9th Cir.) Case No. 02-73093, at 5 (2004). The Lockyer Court states that:

> *"The rate filed by the wholesale seller of electricity or fixed by FERC is the only lawful charge and '[d]eviation from it is not permitted upon any pretext.'"* (Emphasis added) quoting AT&T v. Central Office Telephone, Inc., 524 U.S. 214, 222; 118 S.Ct. 1956 (1986).

The Company's Application violates the filed rate doctrine by deviating from a FERC-approved rate. The FERC-approved rate in question is the AEP Interconnection Agreement. The capacity equalization charge of the Interconnection Agreement is a total rate that includes numerous costs items – some of which are related to environmental compliance and some of which are not. This rate does not itemize environmental and non-environmental costs separately.

The Company has gone to great lengths to disaggregate the FERC-approved rate into 21 separately computed and hypothetical environmental rates based on dozens of environmental cost components.[5] As a result the Company has essentially broken the FERC-approved rate into two categories; one of which contains costs the Company deems to be environmental and the other which contains costs the Company deems to be non-environmental. The Company proposes that these remnants of the original FERC-approved rate receive very different retail ratemaking treatment. Per the Company's proposal, environmental components derived from the federal rate will be recovered immediately through the surcharge, while the non-environmental components of the federal rate will presumably be recovered through the Company's next rate case.

These separate rates authored by the Company are not the federal rate. The Commission is barred by the filed rate doctrine from deviating from the federal rate. Separating the capacity equalization charge of the Interconnection Agreement into hypothetical categories for the purposes of recovering some costs immediately through the environmental surcharge while recovering other costs in a base rate proceeding is precluded by federal law.

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[5] Direct Testimony of Lane Kollen p. 13.

c. **In Case No 96-489 The Commission Allowed The Company To Recover Its Costs Associated With The Gavin Scrubber In Order To Give Effect To Both The FERC-Approved Interim Allowance Agreement And Interconnection Agreement. The Commission Did Not Hold That All Environmental Costs Embedded In The Interconnection Agreement Are Recoverable Through The Environmental Surcharge.**

In its May 27, 1997 Order in Case No. 96-489 the Commission acknowledged that federal preemption "*mandates* [Commission] *acceptance of the FERC jurisdictional agreements as reasonable*" (Id. p. 16). This conclusion applied to both the FERC-approved Interconnection Agreement and Interim Allowance Agreement. Clearly, Kentucky Power is entitled to full recovery of its costs pursuant to the Interconnection Agreement. However, the Company is mistaken that Case No. 96-489 stands for the proposition that the Commission must allow any environmental cost embedded in the Interconnection Agreement to be recovered through the environmental surcharge. To the contrary, the Commission recognized that the unique nature of Gavin scrubber costs specifically addressed in the Interim Allowance Agreement made division of the federal rate under the Interconnection Agreement appropriate in order to give effect to the terms of the Interim Allowance Agreement.

In Case No. 96-489 the Commission allowed the costs of the Gavin scrubber, which was given separate treatment by the Interim Allowance Agreement, to be recovered through the environmental surcharge. The Interim Allowance Agreement required the reallocation of Gavin SO2 emission allowances to deficit member companies at zero cost consistent with the obligation of the deficit members to pay Gavin scrubber costs through the AEP Pool capacity equalization rates. The Gavin costs were given unique treatment by the Interim Allowance Agreement as demonstrated by the fact that Gavin is referenced 30 times throughout the Interim Allowance Agreement whereas the other facilities which the Company now seeks cost recovery for through the environmental surcharge are not referenced

at all. The Commission determined that it was appropriate *"in this instance"*[6] to include the costs paid by the Company through the AEP capacity equalization charge for the Gavin scrubber in the environmental surcharge. In Case No. 96-489, the Commission adopted only a limited disaggregation of the capacity equalization charge because that computation was required to fully incorporate the effects of the Interim Allowance Agreement. Case No. 96-489 dealt with a specific circumstance in which the Interim Allowance Agreement's treatment of Gavin environmental compliance costs made it necessary for the Commission to pass these costs through the environmental surcharge.

The Commission should reject the Company's attempt to reinterpret this "Gavin exception" established in Case No. 96-489 to a broad rule that it can recover any and all environmental costs incurred pursuant to the capacity equalization provisions of the Interconnection Agreement through the environmental surcharge. The component of Case No. 96-489 that made recovery of Gavin scrubber costs through the environmental surcharge necessary was the Interim Allowance Agreement, which exclusively pertains to environmental costs and specifically to the scrubber at Gavin. That component is missing in this case. The exception articulated in 96-489 should not be turned into the rule.

2. Under The Case No. 96-489 Order And The Filed Rate Doctrine The Company Must Include Margins Allocated To It Under The Interim Allowance Agreement For The Utilization Of SO_2 Emission Allowances To Make Off-System Sales As A Credit Against The Environmental Surcharge.

Kentucky Power earns margins as the result of several types of SO_2 emission allowance sales. Kentucky Power properly accounts for some of these margins by using them to reduce its monthly environmental surcharge revenue requirement, but fails to properly account for the margins (market value of allowances less inventory cost) it is allocated under the Interim Allowance Agreement for allowances utilized to supply power for off-system sales. The Commission should direct the Company

[6] KPSC Case No. 96-489 (Order of May 27, 1997) p. 16.

to reduce its environmental surcharge revenue requirement by the amount of these margins. The Commission required the Company to include all such margins as a reduction to the environmental surcharge revenue requirement in its Case No. 96-489 Order, and should ensure that its prior ruling is followed in this case.

In its May 27, 1997 Order in Case No. 96-489, the Commission unequivocally mandated that margins allocated to Kentucky Power pursuant to the Interim Allowance Agreement be used to reduce the revenue requirement in the environmental surcharge. The Commission articulated this rule three times in this Order. First, the Commission stated that:

> "*The monthly current period revenue requirement will be composed of the following components…*
> *1…*
> *2…*
> *3…*
> *4. The net gain or net loss from emission allowance sales, either from the annual EPA auctions or those amounts allocated to Kentucky Power under the terms of the Interim Allowance Agreement.*"[7]

Second, the Commission stated:

> "*any EPA auction proceeds and any net gains or net losses allocated to Kentucky under the Interim Allowance Agreement will be included as offsets to the current period revenue requirement in the month received by Kentucky Power.*"[8]

Third, the Commission clarified that the margins on utilization of allowances should be incorporated into the Company's revenue requirement through reference to an appendix to the Order. The Commission stated, "[t]*he reporting formats included in Appendix B shall be used, as specified therein, for each monthly filing.*"[9] Appendix B reflects the schedules and the formulas that implement

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[7] KPSC Case No. 96-489 (Order of May 27, 1997) pp. 26-27.
[8] Id. pp. 27-28.
[9] Id. p. 35.

the Commission's Order. The Current Period Revenue Requirement requires that the revenue requirement be reduced by the term AS, which the schedule defines as "*Net Gain or Net Loss from the Emission Allowance Sales*... [from either] *EPA Auctions Proceeds received during Expense Month*...[or] *Net Gain or Net Loss from Allowance Sales, in compliance with the AEP Interim Allowances Agreement received during Expense Month*..."[10]

At hearing, KIUC questioned Company witness Errol Wagner on how Kentucky Power can reconcile the fact that it was allocated gains under the Interim Allowance Agreement yet did not credit those gains against the environmental surcharge revenue requirement as required by the above-quoted language from the Commission's 1997 Order. KIUC asked Mr. Wagner:

> "[The Commission's Order in Case No. 96-489] *says '...any gains or losses allocated to Kentucky Power under the IAA...' You were allocated $824,505 under the IAA in March 2005; weren't you*?"

Mr. Wagner answered:

> "*I was allocated dollars, that's correct, but it was not a sale of an allowance.*"

KIUC asked:

> "*That's not what the Commission's Order says; does it? It says if you were allocated any net gains.*"

Mr. Wagner answered:

> "*I was allocated a gain...*"[11]

Further, in the same line of questioning, KIUC asked Mr. Wagner:

> "*and its your position that these revenues that you are allocated under the Interim Allowance Agreement don't belong in the environmental surcharge as an offset? That's your position*?

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[10] Id., Appendix B, ES Form 3.0.
[11] Transcript of Evidence p. 60 lines 7-14.

Mr. Wagner answered:

"*That's the company's position.*"[12]

The Company's position is wrong. It is at odds with the 1997 Order of this Commission. Because ratepayers are required to pay all costs under the Interim Allowance Agreement, they are entitled to all revenue as well. This is just as true today as it was in 1997.

In addition to Commission precedent, the Interim Allowance Agreement also provides instructions on how margins must be allocated and accounted for. Paragraph 4.3 entitled "Allowances Consumed for Power Sales to Foreign Companies" requires that the revenues received be allocated on member load ratio and that the consumed cost of the allowances be allocated on member load ratio. The net of these two amounts is the margin. This paragraph of the AEP Interim Allowance Agreement specifically states:

> "*When allowances are consumed for power sales to foreign companies, the customer has the option of reimbursing the supplying company with allowances in kind, or paying cash for the allowances at the current market rate. If the customer reimburses in kind, the allowances shall be retained by the supplying Member (Member company that generated the energy and consumed the allowances); and a cash settlement shall be made to each Member based on its MLR-share of the current value of the allowances received. If cash is received, in lieu of allowances, it shall be shared by each member based on its current MLR. The supplying Member's consumed cost of allowance for sale to foreign companies shall be allocated to each Member based on its current MLR.*" (Paragraph 4.3).

As explained above, the Commission cannot change or deviate from the rates established in the Interim Allowance Agreement. The Commission is bound by the filed rate doctrine to account for the Company's margins from SO_2 emission allowances used to supply off-system sales per the terms of the Interim Allowance Agreement, a FERC-approved rate. (See Entergy Louisiana, Inc. v. Louisiana Public Service Commission, 123 S.Ct. 2050, 2056 (2003); Gulf States Utilities CO. v. Alabama Power Co., 824

[12] Id. p. 61 lines 17-21.

F.2d 1465 (1987); Arkansas Louisiana Gas Company v. Hall, 101 S.Ct. 2925 (1981); Nantahala Power and Light Company v. Thornburg, 476 US 953, 106 S. Ct. 2349 (1986)). On cross examination Company witness, Errol Wagner conceded that under federal preemption the Commission cannot deviate from the above-quoted language from the Interim Allowance Agreement. In response to questioning from KIUC, Mr. Wagner answered:

> "*The Interim Allowance Agreement is a federal agreement; that's correct.*"

KIUC asked:

> "*And it has preemptive effect on this Commission?*"

Mr. Wagner answered:

> "*That's correct.*"

KIUC asked:

> "*Okay, and the Commission is required to follow all aspects of the federal preemptive rate?*"

Mr. Wagner answered:

> "*That's correct.*"[13]

The record could not be any clearer. Margins from SO2 emission allowances used in off-system sales must be credited against the surcharge revenue requirement per the Commission's Orders in Case No. 96-489, and the Interim Allowance Agreement. The Company is bound by the Commission's rulings on this issue and the KPSC is preempted from deviating from the language in the Interim Allowance Agreement.

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[13] Transcript of Evidence p. 63 lines 5-13.

If the margins on the utilization of allowances for off-system sales by the AEP System are properly incorporated in the environmental surcharge, then they should not also be available for sharing through the System Sales Clause. This adjustment is necessary to ensure that the Company is not required to include and share the same margins a second time through the System Sales Clause. That result can be achieved by properly incorporating the margins on the utilization of these allowances in the environmental surcharge and not the System Sales Clause.[14]

The effect of properly including the margins in the environmental surcharge would have reduced the Kentucky retail revenue requirement on a net basis by $2,614,431 for the twelve months ending March 2005, consisting of a reduction in the Kentucky retail environmental surcharge revenue requirement of $5,228,862 ($7,838,118 total margins on utilization of allowances times 66.71% Kentucky retail jurisdictional factor) and an increase in the Kentucky retail System Sales Clause revenue requirement of $2,614,431 ($5,228,862 times 50%).[15]

Kentucky Power has been in violation of the orders of this Commission since May 27, 1997. Therefore, refunds are appropriate. Environmental surcharge cost recovery is not final until the Commission completes the two-year review case required by KRS 278.183(3). Since the last two year review case was completed, all margins allocated to Kentucky Power under the Interim Allowance Agreement should be refunded to ratepayers.

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[14] Id. p. 28 lines 1-13.
[15] Exhibit___(LK-3)

3. Under The Commission's Order In Case No. 2002-00169 The Company Must Include Margins Allocated To It For The Utilization Of NOx Emission Allowances To Make Off-System Sales As A Credit Against Any Environmental Surcharge.

In addition to the Company's responsibility to credit the margins from SO_2 allowances used to supply power to off-system sales against the environmental surcharge revenue requirement the Company is also required to credit the margins from NOx emissions allowances. Although these NOx allowances are not referenced in the Interim Allowance Agreement, as the SO_2 allowances are, and therefore there is no federal preemption issue with respect to NOx allowances, Commission precedent dictates that the Company's revenues from NOx allowances used in off-system sales must be reflected in the surcharge revenue requirement.

In the Commission's Order in Case No. 2002-00169, the Commission states that:

> "*The net proceeds from any sale or transfer of NOx allowances should be included in the appropriate environmental surcharge monthly report as an offset to that month's current period revenue requirement.*" (Id. p. 14)

The Commission requires that revenues from the sale of all emission allowances, NOx and SO_2, used to supply power off-system be credited against the environmental surcharge revenue requirement. Just as they have not properly accounted for revenues from SO_2 allowances, the Company likewise has not credited revenues from NOx allowances against the surcharge revenue requirement.[16] This should be fixed prospectively. Also, the Commission should Order that the Company refund all margins from NOx emission allowances allocated since the last two year review case was completed.

[16] See Direct Testimony of Lane Kollen pp. 18-22.

4. **A Change In The Internal Revenues Code, Which Effectively Reduces The Federal Tax Rate On Utility Production Taxable Income, And A Reduction In The State Income Tax Rate Should Be Reflected In The Company's Environmental Surcharge Filing.**

KIUC recommends that a new §199 in the Internal Revenue Code, which authorizes a 9% deduction against qualified domestic production taxable income, and the state tax law changes contained in Kentucky House Bill 272 (signed into law on March 18, 2005), which adopted the §199 of the Internal Revenue Code as of December 31, 2004 for Kentucky state income tax purposes should be reflected in the Companies' filing.[17] Additionally, Kentucky House Bill 272, which reduced the Kentucky state income tax rate from 8.25% to 7.0% effective January 1, 2005 and reduced it further to 6.0% effective January 1, 2007, should be reflected in the Company's filing. The reduction in the Kentucky state income tax rate applies to all taxable income, not just qualified production activities income.[18]

All three changes have the effect of reducing the Company's environmental surcharge revenue requirement. The §199 deduction reduces the Company's environmental surcharge revenue requirement by effectively reducing the federal and state corporate income tax rates and the related income tax gross-up on the equity components of the overall rate of return applied to the Big Sandy and Rockport environmental surcharge rate base investment. The reduction in the state corporate income tax rate reduces the income tax gross-up on the equity component of the overall rate of return applied to the Big Sandy environmental surcharge rate base investment.[19]

For the Big Sandy return, the income conversion factor (1 minus the combined federal and state income tax rate), used to gross-up the equity return component, will be increased from 59.52% to 61.63% on January 1, 2005, to 63.38% on January 1, 2007, and to 64.48% on January 1, 2010. For the

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[17] Direct Testimony of Lane Kollen p. 31 lines 6-15, p. 32 lines 1-4.
[18] Id. p. 32 lines 9-12.
[19] Id. p. 32 lines 17-20, p. 33 lines 1-6.

Rockport return, the income conversion factor will be increased from 59.48% to 60.44% on January 1, 2005, to 61.40% on January 1, 2007, and to 62.36% on January 1, 2010.[20] The income tax changes will reduce the Company's environmental surcharge revenue requirement by $368,689 based on the Company's environmental surcharge filing for the March 2005 expense month. In addition, the income tax changes will reduce the Company's environmental surcharge revenue requirement by $6,142 for its share of the Rockport low NOx project pursuant to the Rockport UPA.[21] These calculations are explained in detail on pages 31-35 of Mr. Kollen's Direct Testimony.

Kentucky Power disputes the validity of these adjustments despite the fact that this exact same issue was raised by KIUC in the Louisville Gas & Electric Company/Kentucky Utilities Company ("LG&E/KU") recent environmental surcharge case (Case Nos. 2004-00421, 00426) just a few months ago and the Commission held that KIUC was correct that these adjustments must be reflected in environmental surcharge filings. In that case LG&E/KU conceded that KIUC was correct in its treatment of these tax law changes. The Commission agreed with both KIUC and LG&E/KU and incorporated the effects of these federal and state tax law changes in its final Order of June 20, 2005.[22] Kentucky Power counsel's attempt at the hearing to characterize the Commission's unambiguous holding with respect to these tax adjustments as not binding because the Commission's holding in that case was "*an acknowledgement or an agreement by the parties*"[23] is simply false. The LG&E/KU environmental surcharge case was not settled. The Commission decided that case on the merits and held that the tax adjustments recommended by KIUC must be taken into account in LG&E/KU's environmental surcharge Application.

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[20] See KIUC Exhibit___(LK-4).
[21] Direct Testimony of Lane Kollen p. 35 lines 14-20, p. 36 lines 1-4.
[22] KPSC Case Nos. 2004-00421 and 00426, p. 28.
[23] Transcript of Evidence p. 109 lines 4-9.

Kentucky Power's rebuttal of KIUC misses the mark by a wide margin. First, Kentucky Power witness Michael J. Kelley argues that the Commission cannot consider Kentucky Power or the environmental surcharge on a standalone basis and that the Commission must consider the tax effects of its affiliate AEP companies.[24] In his Rebuttal Testimony Mr. Kelley states that: "*The actual Kentucky Power Company effective state income tax rate should be used to compute gross-up factors employed in determining the Company's effective rate of return.*"[25] Although Mr. Kelley raises the issue of an AEP consolidated tax return in a half-hearted attempt to convince the Commission to disregard the stand alone tax savings available to Kentucky Power as a result of the recent federal and state tax reductions, Mr. Kelley has not developed a proposal for reflecting AEP consolidated taxes in the Company's environmental surcharge revenue requirement. Nor did Mr. Kelly provide any evidence that would lead to a determination of how this tax consolidation affects the environmental surcharge revenue requirement. Mr. Kelley abandoned his position during cross examination.

On cross, KIUC asked Mr. Kelley if it was his "*position that the Commission should take into account the actual taxes paid by AEP on a consolidated basis rather than to compute the Kentucky Power income tax expense on a stand-alone basis*?"[26] Mr. Kelley backed off of his stance answering:

> "*I offer no opinion on that one way or another. I'm simply here to testify as to how this deduction is calculated.*"[27]

If Kentucky Power is truly proposing that the Commission consider the consolidated taxes of all AEP companies it should submit a concrete proposal and provide some evidence of how this affects the environmental surcharge revenue requirement. We would welcome such a proposal. This is due to the fact that the standalone separate tax return methodology employed by the Commission for each investor

[24] Rebuttal Testimony Michael Kelley p. 6 lines 12-22, p. 7 lines 1-7.
[25] Id. p. 11 lines 5-7.
[26] Transcript of Evidence p. 111 lines 3-7.
[27] Id. p. 111 lines 8-10.

owned electric utility in Kentucky results in the highest possible income tax expense, and therefore the highest possible revenue requirement regardless of whether there are any consolidated tax savings.

Although Mr. Kelley tried to raise some red flags in his Rebuttal Testimony regarding the Commission's treatment of the tax rate reductions contained in §199 of the Internal Revenue Code and Kentucky House Bill 272 he has apparently backed off of whatever position he took in his Rebuttal Testimony. The Company has offered no counter-proposal in response to Mr. Kollen's recommendation. KIUC recommends that the Commission follow the precedent set in the Case Nos. 2004-00421 and 2004-00426 and reduce the Company's revenue requirement in order to reflect these tax rate reductions. A calculation of the Company's tax savings is included on pages 31-35 of Mr. Kollen's Direct Testimony.

III. CONCLUSION

WHEREFORE, for the reasons set forth above, this Honorable Commission should: 1) deny surcharge recovery of the environmental costs incurred by Kentucky Power's out of state affiliates; 2) enforce its previous determination that all SO2 emission allowance margins allocated to Kentucky Power under the Interim Allowance Agreement be used to prospectively reduce the surcharge revenue requirement and require refunds of past overcharges; 3) enforce its previous determination that all NOx emission allowance margins used to supply power to off-system sales be used to prospectively reduce the surcharge revenue requirement and require refunds of past overcharges; and 4) reflect the federal and state tax law changes in the surcharge revenue requirement.

Respectfully submitted,

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