

ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

IN THE MATTER OF THE VERIFIED PETITION OF)
 INDIANA MICHIGAN POWER COMPANY FOR)
 APPROVAL OF AN ADJUSTMENT TO ITS RATES)
 THROUGH ITS ENVIRONMENTAL COMPLIANCE) CAUSE NO. 43992 S1
 COST RIDER ADJUSTMENT COMMENCING WITH)
 THE BILLING MONTH OF APRIL 2011 PURSUANT TO)
 THE COMMISSION'S ORDER IN CAUSE NO. 43306)
 AND 43856.)

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ORDER OF THE COMMISSION

Presiding Officers:

Kari A. E. Bennett, Commissioner

Loraine L. Seyfried, Chief Administrative Law Judge

On June 22, 2011, the Indiana Utility Regulatory Commission ("Commission") issued its order in the underlying Cause No. 43992 ("43992 Order"). The 43992 Order created a subdocket ("Subdocket") to further explore through submission of additional evidence the request of Indiana Michigan Power Company ("Petitioner", "Company" or "I&M") to recover emission allowance surrender costs incurred under certain provisions of an October 9, 2007 Consent Decree in I&M's Environmental Compliance Cost Rider ("ECCR") should be approved. The 43992 Order also approved use of a standard docketing convention for the next and subsequent annual ECCR filings.

Pursuant to a prehearing conference order dated August 3, 2011, I&M filed its direct testimony and exhibits in the Subdocket on September 30, 2011. On December 13, 2011, I&M filed a request for administrative notice of the record in Cause No. 43992, which request was granted by docket entry dated February 2, 2012. On December 15, 2011, the Indiana Office of Utility Consumer Counselor ("OUCC") filed its direct testimony and exhibits. The OUCC filed its workpapers on December 20, 2011 and filed corrections to its exhibits and workpapers on January 5 and 10, 2012. In accordance with a docket entry dated January 18, 2012, I&M filed its rebuttal testimony on March 16, 2012.

On February 2, 2012, I&M filed a Petition in Cause No. 43992 ECCR1 (“ECCR1”) for an ECCR adjustment to be effective with the first billing cycle for the billing month of April 2012 or the first full billing month following a Commission Order, pursuant to the Commission’s Orders in Cause Nos. 43306 and 43856. I&M filed its direct testimony and exhibits on February 2, 2012. Pursuant to an extension of time granted by docket entry dated March 21, 2012, the OUCC prefiled its direct testimony and exhibits on March 22, 2012, and I&M filed its rebuttal testimony and exhibits on April 13, 2012.

By joint motions filed on April 18 and 20, 2012, I&M and the OUCC requested the Commission continue the hearing in the Subdocket, grant leave for the parties to submit a settlement agreement resolving all disputed issues in the Subdocket and ECCR 1 and to consolidate these two proceedings pursuant to 170 IAC 1-1.1-19 because these proceedings have common issues of fact and law. The stipulation and settlement agreement (“Settlement Agreement”) was filed with the Commission on April 20, 2012. The parties’ motions were granted by docket entries dated April 18 and 26, 2012. Testimony in support of the Settlement Agreement was filed on April 26, 2012. By docket entry dated May 1, 2012, the presiding officer issued two questions to which I&M and the OUCC responded in writing on May 4, 2012.

Pursuant to notice given and published as required by law, proof of which was incorporated into the record of this Cause by reference and placed in the official files of the Commission, a public hearing was held on May 4, 2012, at 1:30 p.m. EDT in Room 224, PNC Center, 101 W. Washington Street, Indianapolis, Indiana. Petitioner and the OUCC participated in the hearing. No members of the general public appeared. At the hearing, Petitioner and the OUCC offered their respective prefiled testimony and exhibits, which were admitted into evidence without objection.

The Commission, based upon the applicable law and the evidence presented herein, now finds as follows:

1. **Notice and Jurisdiction.** Proper notice of the public hearing in this Cause was published as provided by law. Petitioner is a public electric generating utility and is subject to the jurisdiction of the Commission. This Commission has jurisdiction over Petitioner and the subject matter of this proceeding in the manner and to the extent provided by the laws of the State of Indiana.

2. **Petitioner’s Organization and Business.** I&M, a wholly-owned subsidiary of American Electric Power Company, Inc. (“AEP”), is a corporation organized and existing under the laws of the State of Indiana, with its principal offices at One Summit Square, Fort Wayne, Indiana. I&M is engaged in rendering electric service in the State of Indiana and owns, operates, manages and controls plant and equipment within the State of Indiana that are used for the generation, transmission, distribution and furnishing of such service to the public.

3. **Background.** Petitioner’s annual adjustment to its ECCR factors in Cause No. 43992 included certain emission allowance costs incurred under the above referenced Consent Decree entered into between the AEP Eastern operating companies, including I&M, the U.S. Department of Justice, the U.S. Environmental Protection Agency (“EPA”) and other entities in 2007. As noted above, the Subdocket was convened to explore disputed issues regarding the surrender of emission

allowances under Section IV and V of the Consent Decree. I&M's ECCR 1 filing sought to include the emission allowance surrender costs incurred during the period relevant to the filing subject to refund pending the outcome of the Subdocket. As noted below, the OUCC questioned this approach and raised certain other issues regarding the ECCR 1 filing. Following the pre-filing of evidence, the Parties reached a Settlement Agreement which reflects a compromise and resolves all disputed matters pending in these two dockets. The summary of the evidence below outlines the disputed issues and is followed by a discussion of the Settlement Agreement and supporting testimony.

4. Subdocket Evidence.

a. Petitioner's Direct Testimony. I&M supplemented the Cause No. 43992 record in this Subdocket with the direct testimony and exhibits of Mr. John M. McManus, Vice President of the Environmental Services Division of the American Electric Power Service Corporation ("AEPSC") and Mr. Marc E. Lewis, I&M's Vice President of External Relations.

Mr. McManus described the background of the New Source Review ("NSR") litigation that resulted in the Consent Decree and the relevant provisions of the Consent Decree. I&M Exhibit G, at 3, 5-12. Mr. McManus explained that at the time the AEP companies entered into the Consent Decree in October 2007, there had been no judicial determination of liability. *Id.* at 6. Mr. McManus explained that AEP was planning to install or had installed very efficient sulfur dioxide ("SO₂") and/or nitrogen oxides ("NO_x") controls on a number of units to comply with the Clean Air Act ("CAA") and was able to include the installation of controls on additional units in the Consent Decree that did not accelerate existing plans and removed the risk of an adverse outcome in litigation. *Id.* He also testified that the Consent Decree incorporated a system-wide emissions cap that afforded the companies a great degree of flexibility in designing and implementing additional measures to further reduce SO₂ and NO_x emissions to meet the requirements of the Clean Air Implementation [*sic*¹] Rule ("CAIR"), which was scheduled to take effect in 2009 for NO_x and 2010 for SO₂. *Id.* Mr. McManus added that AEP was also able to obtain a release of claims from all parties and a covenant not to sue from the EPA and DOJ, removing the risk of future litigation for units included in the settlement, including I&M's units. *Id.*

Mr. McManus discussed the alternatives AEP considered prior to entering into the Consent Decree. He stated that the alternatives available to the AEP companies at the time were to settle on acceptable terms or continue litigation. *Id.* at 7. He testified that by the time the settlement was finalized, the litigation had been pending for more than eight years. He explained that none of the pending cases had progressed all the way to a final remedy at that time and that regardless of the outcome, appeals were likely. *Id.* Mr. McManus testified that continuing to litigate would have consumed substantial additional company resources with an uncertain outcome at best. *Id.* He testified that under the circumstances and given the flexibility of the terms of the Consent Decree and the consistency of such terms with compliance plans already in place, settlement was determined to be the reasonable and prudent option. *Id.* Mr. McManus testified that the Consent Decree ended years of litigation, avoided the costs and uncertainty associated with continued litigation and provided I&M a measure of protection against future NSR claims. *Id.* He added that the AEP companies admitted no violations of law and all claims against them were released. *Id.*

¹ "Implementation" should be "Interstate."

Mr. McManus summarized the Consent Decree provisions relevant to the challenged emission allowance costs. He explained that the calculation regarding NO_x allowances is somewhat complex and provides for a number of offsets. He produced the calculation of this value for calendar year 2010 in I&M Exhibit JMM-2. *Id.* at 8. Mr. McManus explained that the AEP East Operating Companies calculate the number of Restricted NO_x allowances potentially subject to surrender each year, and each company's share of those allowances is accrued on the books at the end of the calendar year. *Id.* With regard to the surrender of SO₂ allowances, Mr. McManus explained that, because CAIR used increased allowance surrender ratios as a means of further restricting SO₂ emissions beginning in 2010, the first year this provision was effective, the allowance surrender requirement accounts for the CAIR allowance ratio. *Id.* at 9. He presented the calculation for calendar year 2010 on Exhibit JMM-2 and showed a surrender obligation of zero SO₂ allowances. *Id.* Mr. McManus described the measures in the Consent Decree to minimize the number of NO_x and SO₂ allowances subject to surrender. *Id.* at 10-11.

Mr. McManus discussed the status of CAIR. He explained that while EPA was required to rewrite CAIR to address the deficiencies identified by the Court, at the time I&M prefiled its direct testimony, the rule remained in effect until replaced by the Cross-State Air Pollution Rule ("CSAPR") on January 1, 2012.² *Id.* at 12. Mr. McManus described the impact the change from CAIR to CSAPR would have on the number of SO₂ and NO_x allowances that are potentially subject to surrender under the Consent Decree. *Id.* at 12-13. Mr. McManus testified that, because the NO_x allowance surrender obligation is calculated based on the difference between NO_x CAIR allocations and the AEP Eastern System NO_x cap, and the NO_x CAIR allowances will become zero when CSAPR replaces CAIR, there would be no additional NO_x allowances potentially subject to surrender under the Consent Decree after calendar year 2011. *Id.* at 13. He explained that although the offsets for generation from renewable and natural gas-fired resources and new generating facilities could, under the terms of the Consent Decree, continue to accrue through 2015, AEP assumes that all remaining CAIR NO_x allowances will be removed from compliance accounts within a brief period after the final compliance reports are submitted for 2011. *Id.* Mr. McManus explained that as shown in Exhibit JMM-4, during 2010-2020, due to the replacement of CAIR by CSAPR, an SO₂ allowance that would have been surrendered to comply with CAIR will now be surrendered under the Consent Decree. *Id.*

Mr. McManus also discussed how I&M's customers benefitted from AEP entering into the Consent Decree. *Id.* He stated that entering into the Consent Decree avoided substantial costs and significant uncertainty associated with continued litigation and provided I&M a measure of protection against future NSR claims. *Id.* He testified that at the time AEP signed the agreement, it reflected AEP's fleet environmental compliance plan under the known CAA regulations which would have resulted in an insignificant number of SO₂ and NO_x allowances being surrendered. *Id.* at 13-14. He testified that these Consent Decree provisions incorporated all information AEP and I&M knew or should have reasonably known. *Id.* at 14. He explained that the number of surrendered NO_x allowances for which I&M is seeking cost recovery is not material and will cease once CAIR is replaced with CSAPR. He explained that no SO₂ allowances have yet been subject to surrender, but

² As discussed below, on December 30, 2011, the U.S. Court of Appeals for the D.C. Circuit stayed CSAPR pending judicial review.

going forward the number of SO₂ allowances that will be transferred for compliance with the acid rain program and Consent Decree will be less than the number of allowances that would have been consumed had CAIR remained in effect. *Id.* Mr. McManus opined that resolving the NSR litigation by entering into the Consent Decree was reasonable and prudent based upon all that AEP and I&M knew or should have reasonably known, and the allowance surrender provisions impose minimal compliance costs upon the AEP East Operating Companies that are parties to the Consent Decree. *Id.*

Mr. Marc E. Lewis, Vice President of External Relations for I&M, explained why from a regulatory policy perspective it is reasonable to recognize the challenged emission allowance costs for ratemaking purposes through I&M's ECCR. I&M Exhibit H, at 4. He discussed how prudence should be determined from a regulatory policy perspective. He testified that I&M acted reasonably and prudently in all relevant respects in entering into the Consent Decree. He also testified that the Consent Decree is a legally binding document that was determined to be in the public interest by the court. *Id.* He testified that the challenged emission allowance costs were prudently incurred and are reasonable and necessary costs of providing utility service. He stated that as reasonable and necessary costs of providing service, the challenged emission allowance costs are recognizable for ratemaking purposes, in this case through the ECCR that was established to address emission allowance costs. *Id.*

Mr. Lewis also explained that the Consent Decree serves the public interest and is consistent with public policy that discourages litigation and encourages negotiation and settlement of disputes. *Id.* at 5-6. Mr. Lewis concluded that the challenged emission allowance costs are reasonable in the context of the entire Consent Decree and the benefits it achieved for I&M and its customers. *Id.* Finally, Mr. Lewis explained that that the Commission has repeatedly concluded that costs incurred under a consent decree or otherwise required by a government agency may be recognized for ratemaking purposes and recommended the Commission follow this practice. *Id.* at 7.

b. OUCC Testimony. The OUCC offered the testimony of Cynthia M. Armstrong, a Utility Analyst in its Electric Division. Ms. Armstrong presented the OUCC's position that I&M has not satisfied standards the Commission set forth in Cause No. 43392 to demonstrate that the emission allowance surrender costs associated with the Consent Decree should be recognized for ratemaking purposes. OUCC's Exhibit No. 4, at 2-3. Ms. Armstrong stated that Mr. McManus testified that the flexibility of the terms of the Consent Decree, the consistency of the Consent Decree terms with AEP's compliance plans already in place, and the costs and uncertainty associated with continued litigation led AEP's leadership to conclude that settlement was the reasonable and prudent option. *Id.* at 3. Ms. Armstrong noted that Mr. McManus did not quantify the continued costs of litigation or the known costs of the Consent Decree so that they may be compared. *Id.* at 4. She also stated that I&M has not attempted to quantify the ratepayer benefits provided by the Consent Decree. *Id.* Ms. Armstrong testified that an estimate of these costs is needed for the Commission to determine whether it was prudent for AEP to enter into the Consent Decree. *Id.*

Ms. Armstrong attempted to quantify the costs of the Consent Decree based on information that she testified would have been available to AEP when it entered into the Consent Decree in 2007. She estimated the total expected cost of the Consent Decree, including the challenged emission allowance costs, is approximately \$104.7 million in 2007 dollars. *Id.* at 4; Attachment CMA-1. In her opinion, the continued litigation costs would have to exceed \$100 million for the Consent Decree

to be considered the more prudent option. *Id.* at 4-5. Ms. Armstrong testified that even if the Commission accepted that it was prudent to enter into the Consent Decree, it does not mean the challenged emission allowance costs should be included in rates through the ECCR. *Id.* at 5.

Ms. Armstrong stated that it is likely that the company settled because it felt that it was likely to be found responsible for committing the violations the EPA alleged against it. She stated that if any of I&M's generating units were judged to be liable of violating the NSR or Prevention of Significant Deterioration ("PSD") provisions of the Clean Air Act, it is unlikely the Commission would have allowed the Company to recover any penalties or emission allowance surrenders associated with the remedy the court imposed. It is also likely that consumer parties would strongly challenge the recovery of penalties, emission allowance surrender costs, and the additional fuel, purchased power, and capacity costs incurred by the Company to cover the lost energy and capacity from immediately shutting down units. She stated that by signing the Consent Decree, AEP was given the opportunity to end litigation without admitting any guilt for the violations alleged against the Company. Therefore, in her view, the Company had a strong incentive to settle for its own benefit, not necessarily for the benefits of its ratepayers. *Id.* at 5-6.

Ms. Armstrong also stated that it is necessary to review the Company's actions at the time it undertook the projects that triggered the EPA's allegations against I&M and the other generating units in the AEP Eastern System. *Id.* at 6. She stated that based on the evidence submitted by I&M in this case, she was not able to make this determination and therefore stated that the determination of whether or not I&M violated the NSR or PSD provisions of the CAA is not an issue for the Commission to decide. *Id.* She stated that I&M knew that the PSD and NSR provisions of the CAA could apply to its generating facilities and opined that a prudent utility would have policies and procedures in place to evaluate each project to determine if either the NSR or PSD preconstruction review would be triggered by the project. Ms. Armstrong noted that when asked in discovery, I&M responded that it did not have any non-privileged documents showing that such a review took place. *Id.* at 7.

Ms. Armstrong testified that any company that has a question regarding the applicability of NSR or PSD to a particular project can ask the EPA to evaluate the project and make a determination whether or not NSR or PSD would apply. *Id.* at 7. She stated that if I&M had made such a request, I&M would have a signed document from the EPA declaring the project to be exempt from NSR and would have assurance that it could complete the projects without needing a pre-construction permit to do so. She stated that I&M did not seek an NSR applicability determination from the EPA for the Tanners Creek projects identified in the NSR litigation.

Ms. Armstrong noted that the OUCC has supported capital and operation and maintenance ("O&M") costs of installing and operating pollution control equipment because of a Consent Decree with the EPA. She explained that the OUCC has supported these kinds of costs because the projects were necessary to meet other environmental regulations to produce electricity, in addition to meeting the mandates imposed by a Consent Decree. *Id.* 7-8. She stated that the OUCC believes that there is a sufficient nexus between these projects and the provision of electric service to customers. *Id.* Ms. Armstrong stated that the OUCC finds two faults with allowing utilities to recover the costs incurred for environmental mitigation projects and emission allowance surrenders. The first reason the OUCC opposes these costs, she explained, is because the OUCC views them to be a form of a penalty for a

company's alleged environmental violations. She explained that environmental mitigation projects and allowance surrenders generally serve as remedial measures to rectify the harm caused by the company's excess emissions, and such emissions occur because the company did not obtain a pre-construction permit under the NSR and PSD provisions of the Clean Air Act and did not install the appropriate pollution controls required by such permits. *Id.* at 8-9. She explained that while allowance surrenders are not specifically referred to as a penalty in the consent decrees, the OUCC's position is that remedial measures such as these constitute a penalty for past wrongdoing that should not be charged to ratepayers. *Id.* at 9. She opined that such projects are meant to counterbalance past damage to the environment, but their large funding requirements (often several million dollars) also serve to discourage future violations. *Id.* She testified that allowing a utility to recover the cost of the emission allowance surrenders acts to nullify that incentive. *Id.*

Ms. Armstrong agreed with Mr. McManus that the concept of surrendering emission allowances is embedded in federal environmental regulation as a means to achieve emission reductions, but noted that surrenders can also be imposed as a penalty for failure to comply with regulations. *Id.*

Ms. Armstrong stated that the second reason the OUCC opposes environmental mitigation costs and allowance surrender costs stemming from a Consent Decree is that the OUCC does not view these costs to be relevant or necessary to the provision of electric service to customers. With regard to emission allowance surrenders, she explained that consuming emission allowances in the past would have been associated with the production of more power for customers or the generation of additional revenues through off-system sales. She also stated that when an incremental amount of emission allowances ("EAs") allocated to a generating unit were available as a result of new pollution control equipment installed on the unit, the net proceeds from the sale of those allowances were passed back to ratepayers in order to offset the cost of pollution controls. She explained that these allowances must now be surrendered and recorded as consumed without being available for the provision of additional electric service, off-system sales, or to counterbalance the cost of pollution control equipment. She reasoned that if these allowances were permitted to be recovered through rates, I&M customers would be charged more without the corresponding benefit for the allowance surrender. She stated the only reason that ratepayers would need to incur these additional EA costs is because AEP and I&M entered into the Consent Decree with the EPA to settle allegations that the Company violated environmental law. Under normal operating conditions, the Company would not be required to make these additional EA surrenders. *Id.* at 9-10.

Ms. Armstrong stated that the OUCC is concerned that if the Commission were to approve recovery of the challenged emission allowance costs, then the OUCC would be disadvantaged in arguing for mitigation of the amount of these costs passed onto ratepayers because the OUCC's ability to take part in settlement negotiations that lead to a Consent Decree may be limited, if not precluded entirely. *Id.* at 11. She added that if Indiana electric investor-owned utilities know that they are able to pass such costs onto ratepayers they will have more incentive to negotiate greater allowance surrenders and more expensive mitigation projects in exchange for lower civil penalties. She viewed this as providing utilities less incentive to keep all compliance costs resulting from such settlements as low as possible. *Id.* Ms. Armstrong also argued that allowing utilities to pass onto ratepayers the cost of consent decree emission allowance surrenders could lead to the undermining of the federal environmental laws the consent decrees are designed to enforce and protect. *Id.* at 12. In

her view, if utilities know they can pass most of the costs of a consent decree onto ratepayers, then they have little incentive to comply with environmental regulations in the future. *Id.* Therefore, Ms. Armstrong concluded that I&M should not be allowed to pass the emission allowance costs associated with the Consent Decree onto its ratepayers.

c. **Petitioner's Rebuttal.** I&M witnesses McManus and Lewis, as well as I&M witness Timothy M. Dooley, AEPSC Director of Energy Accounting and Reporting, presented rebuttal testimony.

Mr. McManus replied to Ms. Armstrong's claim that the surrender of emission allowances is a penalty-type cost. I&M Exhibit J, at 3. Mr. McManus explained that the OUCC position is a mischaracterization of fact. *Id.* He testified that there was no liability finding against AEP and I&M and therefore the surrendered allowances are not a penalty. *Id.* Mr. McManus also stated that the existence of an allegation of wrongdoing does not change this conclusion. *Id.* He said, this distinction – no liability – separates I&M's case from the Commission's decision in Cause No. 43956, in which the Commission denied Duke Indiana's request to include emission allowance surrender costs incurred under Duke Indiana's consent decree. *Id.* Mr. McManus explained that the Order in the Duke proceeding notes that Duke Indiana had been found guilty of violating EPA regulations. *Id.* Mr. McManus stated that the Order in Cause No. 43956 reflects that Ms. Armstrong argued that Duke Indiana's request for recovery of its emission allowance surrender costs was unreasonable because the "courts have already decided this issue" and the "Commission should not be required to make a finding that is contrary to a determination by the federal agency in charge of enforcing federal environmental law." Mr. McManus explained that in I&M's case, no court found the Company legally culpable for any violation of law. *Id.* He further testified that the EPA, the DOJ, Citizens Action Coalition of Indiana ("CAC"), and 21 other entities, acknowledged in the Consent Decree that AEP has denied and continues to deny the violations alleged in the complaints and notices of violation, maintained that they have been and remain in compliance with the Act and are not liable for civil penalties or injunctive relief, and stated that they are agreeing to the obligations imposed by this Consent Decree solely to avoid the costs and uncertainties of litigation and to improve the environment. *Id.* at 4. Mr. McManus added that the parties to the Consent Decree further agreed that the Consent Decree is in the public interest, it was entered into "without any admission by Defendants, and without any adjudication of the violations alleged in the complaints or the NOV's." *Id.* Mr. McManus stated that a federal court approved the entire settlement without change. *Id.*

Mr. McManus discussed the evidence presented by I&M in light of the requirements in the 43992 Order. *Id.* at 4. Mr. McManus noted that Ms. Armstrong did not show any imprudence. *Id.* at 5. He also testified that Ms. Armstrong's unfounded characterization of the emission allowance surrender provisions ignores the actual language of the AEP Consent Decree and is based almost entirely on speculation. *Id.* Mr. McManus concluded that the Commission should accept the conclusion reached by the entities responsible for enforcing environmental law, treat the emission allowance surrenders as a reasonable cost of compliance, and reject Ms. Armstrong's baseless opposition. *Id.* Mr. McManus explained that Ms. Armstrong's analysis does not consider the offsets set forth in the Consent Decree or recognize that AEP and I&M will not know the extent to which these NO_x surrenders are actually made until after 2016 and that the SO₂ allowance surrenders are minimized by recognizing the surrender ratios used in CAIR. *Id.* at 6.

Mr. McManus testified that the Duke consent decree at issue in Cause No. 43956 is very different from the AEP Consent Decree, and includes a specific requirement to surrender several tens of thousands of allowances to mitigate past “excess emissions,” as well as an annual allowance surrender obligation based on the difference between the allowances allocated to one or more units and the unit’s compliance obligation under the settlement. *Id.* at 6. He stated that there is no surrender of allowances tied to past “excess emissions” in the AEP Consent Decree. *Id.* at 7. Rather, it is a forward-looking provision that restricts the transfer of that portion of allowance allocations that exceeds the system caps in the Consent Decree. *Id.* He added that AEP’s Consent Decree was the first to include both Restricted and Unrestricted Allowances, and to provide for offsets (credits) to the allowance surrender obligation. *Id.* at 7. Mr. McManus testified that he disagrees that the terms negotiated by AEP regarding emission allowance surrenders should be ignored. *Id.* Mr. McManus explained that these terms minimize the ultimate cost of the emission allowance surrenders, achieve the beneficial policy of reducing emissions, and create a forward-looking incentive for the Company to undertake initiatives beneficial to the environment and its customers. *Id.*

Mr. McManus testified that as a result of EPA’s adoption of CSAPR, and that rule being stayed on December 30, 2011, by the U.S. Court of Appeals for the District of Columbia, the number of allowances subject to surrender under the requirements of the AEP Consent Decree will be impacted. *Id.* at 8. Mr. McManus explained that until the Court rules, CAIR remains in effect as follows: for every ton of SO₂ emissions from the AEP units covered by the Consent Decree, two Title IV SO₂ allowances will be required to be surrendered for compliance purposes, and the surrender obligation calculated in Exhibit JMM-4 of his direct testimony will not take effect. *Id.* Instead, under CAIR, Mr. McManus explained, the surrender obligation remains zero until 2018. *Id.* The only obligation will be to surrender NO_x allowances per the requirements of Section IV, Paragraphs 70 through 80 of the Consent Decree. Mr. McManus testified that Ms. Armstrong’s analysis does not reflect this. *Id.*

Mr. McManus explained that the disagreement between I&M and the OUCC concerns the nature of the emission allowance surrender provisions at issue in this Cause. He stated that I&M views the emission allowance surrender provisions in paragraphs 70 through 80 and 93 through 97 of the AEP Consent Decree as a reasonable means to achieve environmental goals, to achieve emission reductions and to bring the protracted litigation to an end in accordance with the public policy favoring settlement. *Id.* at 9. Mr. McManus explained that I&M’s view is based on the plain language of the Consent Decree (which excludes the emission allowance surrender requirements from the Stipulated Penalties provisions in Paragraph 150 of the Consent Decree), the reasonableness of these specific costs particularly when viewed in the light of what AEP knew or reasonably should have known at the time it made the decision to incur these costs, and the public policy goals favoring settlement discussed by Mr. Lewis. *Id.*

Mr. McManus also responded to Ms. Armstrong’s criticism that he did not “quantify” the continued costs of litigation, the known costs of the Consent Decree or the benefits provided for ratepayers. *Id.* at 9-10. He explained his view that Ms. Armstrong oversimplified the presentation in his direct testimony, particularly when she suggested that all of the costs and benefits he outlined are reasonably subject to precise quantification when they are not. *Id.* at 10. He further noted that the only specific cost Ms. Armstrong attempted to calculate is an estimated cost of the emission allowance surrenders and that I&M witness Dooley discusses why Ms. Armstrong’s calculation is

unreliable. *Id.* He reiterated that the litigation had been pending for over eight years by the time the settlement was finalized, and absent settlement, the litigation was expected to continue for many more years. *Id.* He explained that AEP was able to terminate this litigation on terms that were consistent with its own projected compliance plans and the settlement agreement removed compliance uncertainty. *Id.* In particular, the settlement provided a great degree of flexibility in designing and implementing additional measures to further reduce SO₂ and NO_x emissions under CAIR requirements scheduled to take effect in 2009 and 2010. *Id.* He stated that based on AEP's analysis at the time it entered into the Consent Decree, the number of allowances that would have been subject to surrender was projected to be negligible under the provisions of CAIR. *Id.* He explained that the settlement includes a release of claims from all parties and a covenant to not sue from EPA and DOJ that removed the risk of future litigation for all units included in the settlement, including I&M's units. *Id.* Mr. McManus testified that this too was a significant benefit; yet it is one that is difficult to quantify. *Id.* at 10-11.

Mr. McManus explained that Ms. Armstrong's analysis cumulates the costs of the civil penalty, the environmental mitigation projects, and the emission allowance surrenders and claims that for the settlement to be reasonable, "continued litigation costs" must have exceeded \$100 million. *Id.* at 11. Mr. McManus testified that her calculation inflates the "costs" of the settlement that have a direct impact on customers, and ignores the benefits of greater certainty, increased flexibility, and future releases noted above, which are admittedly difficult to quantify. *Id.* He explained that the \$15 million civil penalty is not an incremental cost of the settlement for I&M's customers (or any other customers), who could not be and have not been requested to pay rates for service that reflect any portion of it. *Id.*

Mr. McManus stated that what is relevant in assessing the prudence of settling the NSR litigation for I&M's customers is a comparison of the costs for the environmental mitigation projects and emission allowance surrenders to the estimated cost of an unfavorable outcome on even one unit if the litigation continued. *Id.* at 11. Mr. McManus explained that in the NSR litigation, plaintiffs were seeking an order mandating the retrofit of best available control technology ("BACT") for SO₂, NO_x, and/or particulate matter at each unit as quickly as possible. *Id.* at 11-12. For illustrative purposes, Mr. McManus compared the costs of settling the NSR litigation to the potential cost of retrofitting I&M's Tanners Creek Unit 4 with Flue Gas Desulfurization ("FGD") and Selective Catalytic Reduction ("SCR") technologies, to understand whether I&M's customers have benefited from the NSR agreement. *Id.* at 12. He stated that of the \$60 million AEP committed to complete environmental mitigation projects, I&M's Member Load Ratio ("MLR") share for Indiana (requested and partially approved for recovery in Cause No. 43306) was approximately \$7.2 million. *Id.* He noted that the cost of all surrendered allowances has been estimated by Ms. Armstrong to be \$29.7 million and that I&M witness Dooley provides a more accurate and significantly lower accounting of this cost component in his rebuttal testimony. *Id.* But, for comparison purposes, Mr. McManus testified that he used Ms. Armstrong's estimate as an upper bound on the total "cost to compare," of which I&M's MLR share for Indiana would be \$3.56 million. *Id.* He stated that combined, these two amounts total \$10.76 million. *Id.* Mr. McManus testified that using Ms. Armstrong's approach, for I&M to be in favor of AEP settling the NSR litigation, the impact on rates of the cost of retrofitting a FGD and SCR on Tanners Creek 4 would have to exceed this amount. *Id.*

Mr. McManus testified that using costs that would have been available to I&M at the time the NSR litigation was settled, it is estimated that the capital cost of installing BACT controls on Tanners Creek Unit 4 would have been approximately \$300 million with 65% of this cost, or \$195 million, allocable to I&M's Indiana jurisdiction. *Id.* He added that operation of an FGD and SCR would require incremental fixed O&M for routine equipment maintenance and staffing as well as variable O&M for consumables (*e.g.*, limestone and urea) to operate these technologies. *Id.* at 13. Considering only the capital cost avoided, Mr. McManus explained, the benefit to I&M's customers from AEP's prudent settling of the NSR litigation is evident as the impact to rates from a \$195 million addition to rate base is greater than both the approximate \$1 million in expense of surrendered emission allowances as calculated by Company witness Dooley (shown in Exhibit TMD-R1) and Ms. Armstrong's approximate \$100 million total expected cost of the Consent Decree. *Id.*

With respect to customer benefits, Mr. McManus testified that Ms. Armstrong presents no facts to suggest that the Company did not consider customer benefits. *Id.* Mr. McManus testified that the Company took into consideration its obligation to provide adequate and reliable service and to keep rates for that service reasonably low for the benefit of customers. *Id.* Mr. McManus explained that at the time the Consent Decree was signed, the negotiated settlement not only mitigated the uncertainties and commitment of resources associated with continued litigation but allowed all of the units at Tanners Creek (which were named in the original complaints filed in these cases) to continue operating as configured with their existing fuel supplies. *Id.* He pointed out that none of these units were required to change fuel supplies or install additional controls to comply with the terms of the Consent Decree. *Id.* at 13-14. He stated that although the Rockport units were not named in the lawsuit, the settlement also resolved any potential NSR claims for Rockport Units 1 and 2, and established a deadline for equipping these units with FGD and SCR controls in 2017 and 2019, respectively. *Id.* at 14. He stated that installing controls within this time frame was thought to be a likely scenario for compliance with existing and/or anticipated environmental requirements due to the more stringent requirements that would take effect in Phase 2 of CAIR and the proposals to increase the stringency of the ambient air quality standards for both ozone and fine particulate matter. *Id.*

Mr. McManus stated that in his opinion, this expectation regarding the need to install controls proved to be a prudent determination. *Id.* He stated that the subsequent CSAPR and Mercury and Air Toxics Standards ("MATS") issued by the EPA accelerated the need to retrofit environmental controls at the Rockport Plant and are the subject of Cause No. 44033. He added that the inclusion of a commitment to install these controls at Rockport as part of the NSR settlement also provided I&M some measure of protection from future NSR claims by the federal government. *Id.*

Mr. McManus disagreed with Ms. Armstrong's position regarding procedures a prudent utility would have had in place to evaluate projects to determine whether the NSR or PSD review would be triggered by the project. *Id.* at 14-15. He explained that the permitting requirements under the NSR/PSD program do not apply to every "major capital improvement," as Ms. Armstrong suggests, but only to "major modifications" that result in a "significant net increase" in emissions. He added that there are a number of well-recognized exceptions to the definition of "major modification," including "routine maintenance, repair and replacement" and "increases in production rate or hours of operation" that are not prohibited by a previously issued permit. *Id.* at 15. Mr.

McManus testified that absent a change in law or regulation, conducting activities that are accepted by an industry and state environmental agencies as routine maintenance that require a capital investment does not call for each activity to be scrutinized each and every time it is conducted. *Id.* Mr. McManus stated that doing so would require additional administrative resources, consume precious lead time for ordering equipment, and could ultimately be judged an imprudent practice due to the additional costs. *Id.* Mr. McManus further testified that AEP and I&M had no reason to believe that NSR/PSD requirements would be triggered based on what each knew or reasonably should have known at the time the projects at issue were undertaken. *Id.* He explained that standard industry practices were being followed at the time the decisions were made to proceed with each of the three projects at Tanners Creek that were not dismissed from the NSR litigation. *Id.* He added that Ms. Armstrong did not identify any specific information in her testimony that shows the Company should have known that NSR/PSD applied. *Id.*

Mr. McManus disagreed with Ms. Armstrong's position that recovery of emission allowance surrender costs is unreasonable even if it was prudent for AEP to enter the Consent Decree. *Id.* at 15-16. He stated that Ms. Armstrong argues that AEP must have settled the litigation because it had violated the CAA. *Id.* at 16. Yet she admitted that she cannot determine whether or not the Company should have expected to obtain a permit for the projects cited in the complaints, and that the determination of whether or not I&M violated the NSR or PSD provisions of the CAA is not an issue for the Commission to decide. *Id.* Mr. McManus stated that it is not necessary for the Commission to determine the merits of the underlying case in order to conclude that the costs of the settlement are reasonable compared to the risks of continued litigation. *Id.* He explained that there was no determination of liability in these cases, and based on the estimates provided by Company witness Dooley, the costs to I&M's customers of the emission allowance surrenders are reasonable. *Id.*

Mr. McManus testified that requesting a review of maintenance activities by an environmental agency to seek a "sort of insurance policy" as Ms. Armstrong contended would not have been reasonable or prudent. *Id.* at 16-17. He stated that Ms. Armstrong has the benefit of hindsight in making this determination, basically saying that I&M should have sought permission rather than relying on what was standard practice in the industry to determine that these activities were routine maintenance, repair and replacement ("RMRR") activities. *Id.* at 17. As Mr. McManus testified, seeking an NSR applicability determination prior to commencing construction would have not provided any insurance against an enforcement action being taken against I&M. *Id.* Mr. McManus showed that this position is supported by the NSR complaint against SIGECO. *U.S. v. S. Ind. Gas & Elec. Co.*, 2002 U.S. Dist. LEXIS 14039 (S.D. Ind. 2001). In this instance, a RMRR review was requested and the agency determined that the proposed activities were RMRR. Nonetheless, this project was subsequently included in the enforcement action against the utility. *Id.* Thus, seeking pre-approval provided no insurance against the EPA's allegation that SIGECO violated the Clean Air Act. *Id.*

Mr. McManus responded to Ms. Armstrong's contention that the emission allowance surrenders were intended to counterbalance past excess emissions while I&M operated "out of compliance" and testified this was not the case. *Id.* at 17. As Mr. McManus explained, I&M's Rockport and Tanners Creek units operated within the emission limitations of each plant's Title V permit and therefore the emission allowance surrender is not related to a past compliance issue. *Id.* He further testified that allowance surrenders are merely another compliance provision in the

Consent Decree, no different than the provisions requiring installation and operation of pollution controls. *Id.* at 17-18. Surrendering allowances that exceed the caps on AEP Eastern System emissions simply assure that future emissions, in the form of allowances, are not just transferred to units outside of AEP's Eastern System. *Id.* at 18.

Mr. McManus also disagreed with Ms. Armstrong's view that allowing utilities to recognize in ratemaking the cost of emission allowance surrenders made under the Consent Decree "could" lead to the undermining of federal environmental laws the consent decrees are designed to enforce and protect and that utilities will have little incentive to ensure compliance. *Id.* at 18. He stated that the environmental statutes covering emissions to air, water, and land from which regulations are derived, and on which compliance requirements are based, do not broadly use allowances for compliance so allowing state regulatory commissions such as the Commission to recognize emission allowance surrenders would have a low potential to undermine federal (or state) environmental laws. *Id.* He stated that negligent non-compliance with environmental laws subjects offenders to potential severe civil and criminal penalties. *Id.* Mr. McManus explained that Ms. Armstrong provides no factual support for her supposition that utilities will have little incentive to comply with environmental regulations in the future if they can pass the costs of a consent decree onto ratepayers. *Id.* Mr. McManus stated the potential penalties from violating environmental laws serve to incent compliance and do so with or without recovery of prudent costs of compliance like the surrender of emission allowances. *Id.* at 18-19. Mr. McManus concluded that I&M has demonstrated that incurring the cost of the emission allowance surrenders under the Consent Decree was prudent and reasonable and summarized why this is the correct conclusion. *Id.* at 19.

I&M witness Mr. Dooley addressed Ms. Armstrong's calculation of AEP's expected allowance surrender costs and supported the inclusion of challenged emission allowance costs in the ECCR. Mr. Dooley stated that incorrect assumptions used by Ms. Armstrong caused her analysis to significantly overstate I&M's Indiana share of actual and estimated cost of complying with the allowance surrender provisions contained in the Consent Decree. I&M Exhibit I, at 3. For example, Ms. Armstrong's analysis assumed that CAIR is in effect for 2012 and remains in effect through at least 2020. Mr. Dooley explained that the more likely assumption is that CAIR will continue to be in effect for the years 2012 and possibly 2013, and that CSAPR will be in effect beginning in 2014. *Id.* He stated that this distinction is important because the EPA regulation in effect at the time impacts the number of allowances that would be expected to be surrendered under the Consent Decree. *Id.* When CSAPR is in place, the number of NOx allowances to be surrendered would be zero. *Id.* Under CAIR, a number of NOx allowances are expected to be surrendered. *Id.* Regarding SO₂ allowances, under CAIR there are no expected surrenders under the Consent Decree until 2018 because of the 2 for 1, and 2.86 for 1 consumption rates. Under CSAPR, there are some number of SO₂ allowances expected to be surrendered in those years because of the 1 for 1 consumption rate that would be in place. *Id.* at 4.

Mr. Dooley stated that the OUCC's assumptions or estimates for the number of allowances and cost per allowance to be surrendered are not correct. *Id.* In addition, the OUCC's calculation of AEP allowance surrender costs significantly overstates and misrepresents the true cost to I&M and the Indiana jurisdictional portion thereof that would be recovered through the ECCR. *Id.* Mr. Dooley provided the actual total company and Indiana jurisdictional allowance surrender costs and explained why the values used by the Company to calculate the challenged emission allowance costs are

appropriate. *Id.* at 4-5. He explained that the appropriate cost method to use in calculating the cost of surrendered allowances is I&M's actual Weighted Average Inventory ("WAI") cost. *Id.* at 5. This is the methodology described in the Federal Energy Regulatory Commission's ("FERC") Uniform System of Accounts ("USOA"), and used to comply with FERC Form 1 reporting requirements and the annual reporting provisions included in the Consent Decree. *Id.* He stated that Ms. Armstrong's estimates for WAI cost per NO_x allowance are in excess of I&M's actual cost per NO_x allowance. *Id.* In addition, Ms. Armstrong's estimates for WAI for cost per SO₂ allowances are overstated and not indicative of actual I&M SO₂ allowance WAI cost. *Id.*

Mr. Dooley testified that if Ms. Armstrong's calculations were corrected, the total AEP cost of allowance surrenders under the Consent Decree are actually \$6.1 million – not \$29.7 million as asserted by the OUCC. *Id.* Because the \$6.1 million represents a total AEP level, additional adjustments are required to determine the Indiana jurisdictional cost that is at issue in this proceeding. *Id.* He stated that I&M's Indiana jurisdictional allowance surrender cost is approximately \$1 million total for all years presented. *Id.* Mr. Dooley compared the NO_x cost per allowance reflected in his exhibit to that presented by the OUCC and showed that his amount is over 21% lower than the cost utilized by Ms. Armstrong. *Id.* at 5-6. He stated that Ms. Armstrong incorrectly assumes a NO_x per allowance price of \$300 for years 2012-2020. *Id.* at 6. He explained that when the correct cost per NO_x allowance of \$0 is used for the 2014-2020 period, regardless of the volume, the cost of surrendered NO_x allowances is \$0. *Id.* Thus, Ms. Armstrong's estimated pricing valuation, just for the estimated NO_x surrender costs for 2014-2020, over-estimates AEP cost by more than \$5 million dollars. *Id.* Mr. Dooley noted that for 2012 and 2013 there is a separate but associated impact to the NO_x allowance compliance expense associated with the then current WAI. *Id.* He stated that the Company estimates that a small number of NO_x allowances would likely need to be purchased from the market and expensed in both 2012 and 2013 to meet compliance in those years and for remittance to the EPA. *Id.* He said the average of bid and ask prices for CAIR Annual NO_x allowances from Argus Air Daily (published by Argus Media, Inc.) on March 14, 2012 is \$35/allowance. *Id.*

Mr. Dooley also compared the volumes of surrendered NO_x allowances in his analysis to those presented by Ms. Armstrong. *Id.* at 7. He testified that the actual volumes he used for 2009, 2010 and 2011 were roughly 23% fewer than what Ms. Armstrong used for the same period. He explained that for 2012 and 2013, the Company estimates that approximately 1,000 allowances may need to be surrendered by I&M each year for a total of 2,000 – significantly fewer than the 13,682 estimated by Ms. Armstrong for the same period. *Id.* He testified that an apparent reason for the 2009-2011 volume discrepancy between the Company and Ms. Armstrong can be found in the Consent Decree provisions related to allowance offsets. *Id.* He stated that Ms. Armstrong appears to omit any volume reductions related to offsets, while the Company's analysis of NO_x allowance surrendered costs incorporates this provision of the Consent Decree. *Id.* Mr. Dooley stated that with the appropriate corrections, the net impact to the cost of AEP's surrendered NO_x allowances (in 2007 dollars) is a reduction from the \$9.5 million dollar amount presented by Ms. Armstrong to \$257,276 as presented in Exhibit TMD-R1. *Id.* He added that when the relevant I&M Indiana jurisdictional amount is calculated, the relevant cost drops even further to \$91,725. Mr. Dooley also compared the I&M cost per allowance values reflected in his analysis to the cost of surrendered SO₂ allowances in Ms. Armstrong's analysis. *Id.* at 8. He explained that the appropriate value for surrendered SO₂ allowances is I&M's WAI cost. *Id.* The WAI cost of SO₂ allowances for the year 2014 is \$54.90. *Id.* The WAI cost of SO₂ allowances for 2015 (and each year thereafter) is \$0. He

added that these WAI values are reported by I&M in its FERC Form 1. *Id.* He explained that Ms. Armstrong incorrectly assumed some Interim Allowance Agreement (“IAA”) based cost per SO₂ allowance which overstated and misrepresented estimated AEP SO₂ allowance surrender costs. *Id.* He stated that when the appropriate cost per SO₂ allowance of \$0 is used for the 2015-2020 period, regardless of the volume, the cost of surrendered SO₂ allowances is \$0. *Id.*

Mr. Dooley also described the volume corrections he made to Ms. Armstrong’s analysis of the number of SO₂ allowances to be surrendered. *Id.* He said that currently in 2012, the governing EPA regulation is CAIR, which is assumed to remain in force through the end of 2013. *Id.* Under CAIR, the Company would not surrender any SO₂ allowances until 2018. *Id.* Thus, for the years 2009-2013, the appropriate volume of surrendered SO₂ allowances is zero. *Id.* He further explained that beginning in 2014, it is assumed that CAIR regulations will be replaced by CSAPR. *Id.* at 9. He said that under CSAPR, the Company estimates that it will need to surrender some number of SO₂ allowances as per the terms of the Consent Decree. *Id.* He showed that the expected volume of surrendered SO₂ allowances is significantly lower than estimated by Ms. Armstrong. *Id.* He testified if CSAPR was to be effective for 2013, then the estimated Indiana jurisdictional SO₂ surrender expense for that year would increase by \$482,944. *Id.* He concluded that Ms. Armstrong incorrectly used prices and volumes that grossly overestimated AEP’s SO₂ allowance surrender costs by \$14.2 million (in 2007 dollars). *Id.* Mr. Dooley showed that when appropriate I&M pricing is used, the I&M Indiana jurisdictional amount is estimated to be \$823,057. *Id.*

Mr. Dooley recommended the Commission reject Ms. Armstrong’s calculations of emission surrender costs as they are not accurate, they are significantly overstated, and they simply misrepresent I&M Indiana’s actual and estimated allowance surrender costs. *Id.* He showed that the actual amounts of NO_x and SO₂ emission allowance surrender costs for 2009-2011 for I&M’s Indiana jurisdictional share are in fact actual costs that should be considered by the Commission. He explained that the estimated amounts for NO_x and SO₂ emission allowance surrender costs for the years 2012 -2020 are based on the Company’s actual WAI cost, and the best estimates of applicable volumes of the Company pertaining to when CAIR and CSAPR will be in effect. He stated that for the years 2009 through 2011, I&M has recorded the identified NO_x allowance surrender expenses, along with all other appropriate emission allowance compliance expenses. He added that these expenses were not recorded as penalties but were properly recorded as allowance expense.

I&M witness Mr. Lewis presented his view that Ms. Armstrong opines on the ultimate issue pending before the Commission without providing a sufficient factual and analytical foundation to aid the Commission in reaching a decision in this matter. I&M Exhibit K, at 3-16. Mr. Lewis discussed flaws in Ms. Armstrong’s contention that the standard set forth in the 43992 Order is not satisfied. *Id.* at 5. In his view, Ms. Armstrong first altered the standard set by the Commission and then concluded that it has not been met without presenting a sound factual or analytical foundation to support this ultimate conclusion. *Id.* Mr. Lewis also responded to Ms. Armstrong’s contention that it is necessary to review the Company’s action at the time it undertook the projects triggering the EPA’s allegation. *Id.* at 7. He testified that this position is contrary to the plain language of the 43992 Order, which points only to the prudence of the decision to incur the emission allowance surrender costs under the Consent Decree. He stated that even assuming *arguendo* that the prudence question should stretch back in time, Ms. Armstrong has not shown that I&M or AEP reasonably should have known that the challenged projects were subject to the NSR or PSD review. *Id.* at 7. Mr. Lewis

added that Ms. Armstrong's reasoning is circular and illogical. *Id.* He noted that Ms. Armstrong concedes that the determination of whether or not I&M violated the NSR or PSD provisions of the Clean Air Act is not an issue for the Commission to decide. *Id.* Yet, Mr. Lewis noted, she also argues that the Commission must review the prudence of the Company's actions (in 1987, 1988 and 1989) at the time the Company undertook the projects that were identified in the EPA's complaint against the Company many years later.³ *Id.* As Mr. Lewis testified, the question whether the Company knew or reasonably should have known that the identified projects triggered the NSR and PSD requirements necessarily requires a legal determination that is not an issue for the Commission to decide. *Id.* Mr. Lewis also explained that it would also require the litigation of the very matters the Consent Decree was expressly designed to bring to an end without adjudication. *Id.* at 7-8. That is why Mr. Lewis believes the 43992 Order expressly tied the prudence review to the decision in 2007 to incur the emission allowance surrender costs. *Id.* at 8.

Mr. Lewis also presented support for his view that Ms. Armstrong's contentions lack adequate foundation. For example, he pointed to Ms. Armstrong's position that costs of environmental mitigation projects and emission allowance surrenders resulting from a consent decree are a "form of penalty" "for past wrongdoings." *Id.* at 10. He explained that Ms. Armstrong claims this to be the case even though: 1) such costs are not identified as such in the Consent Decree; and 2) neither I&M nor AEP have been found by a court of competent jurisdiction to have engaged in past wrongdoing. *Id.*

Mr. Lewis also explained why in his opinion Ms. Armstrong has failed to provide a sound basis for the OUCC's policy position that the emission allowance surrender costs incurred under Sections IV and V of the Consent Decree are a penalty for past wrongdoing. *Id.* at 11. He explained that the parties to the Consent Decree excluded the Section IV and V emission allowance surrenders from the civil penalty provisions of the Consent Decree. *Id.* at 12. In his view this shows that when the parties to the Consent Decree and the Court that approved the Consent Decree wanted to identify penalties, they knew how to do so. *Id.* at 12. Furthermore, Mr. Lewis noted that there is no finding of past wrongdoing. *Id.* He explained that the Consent Decree makes clear that "Defendants [including AEP and I&M] have denied and continue to deny the violations alleged in the complaints and the [notice of violations], maintain that they have been and remain in compliance with the Act and are not liable for civil penalties or injunctive relief, and state that they are agreeing to the obligations imposed by this Consent Decree solely to avoid the costs and uncertainties of litigation and to improve the environment." *Id.*

Mr. Lewis also explained that the parties to the Consent Decree and the reviewing Court found that the Consent Decree was negotiated in good faith and at arm's length, that its terms are fair, reasonable, and in the public interest and consistent with the goals of the Clean Air Act, and that entry of the Consent Decree "without further litigation" and "without adjudication of the alleged violations" was the most appropriate means of resolving this matter. *Id.* He noted that this language reinforces the view that the emission allowance surrender provisions in Sections IV and V were part of the overall compromise; these provisions are not a penalty. *Id.*

³ As shown by page 5 of Petitioner's Exhibit JMM-1 in Cause No. 43992 S1, the EPA filed initial complaints on November 3, 1999 and April 8, 2005, and amended complaints on March 3, 2000 and September 17, 2004.

Mr. Lewis pointed out that in Cause No. 43956, Ms. Armstrong argued that Duke Indiana's request for recovery of its emission allowance surrender costs was unreasonable because the "courts have already decided this issue" and the "Commission should not be required to make a finding that is contrary to a determination by the federal agency in charge of enforcing federal environmental law." *Id.* at 13. He stated that in I&M's case, Ms. Armstrong urges the opposite. She asks the Commission to reject the conclusion of the EPA – the federal agency in charge of enforcing federal environmental law – as well as the DOJ, CAC and the other parties to the Consent Decree, as well as the decision of the federal court. *Id.* Mr. Lewis testified that in this regard, Ms. Armstrong's policy appears oriented to achieving a pre-conceived and arbitrary result and is not grounded in fact, analysis or public policy. *Id.* at 13.

Mr. Lewis also explained through the presentation of specific examples how Ms. Armstrong's policy position is at odds with other Commission decisions and OUCC positions. *Id.* He added that both the OUCC and the Commission have recognized that the ratemaking process should recognize the cost of negotiated settlement agreements without modification or full litigation of the underlying issues, particularly where, as here, the overall agreement is shown to be reasonable. *Id.* at 14. Mr. Lewis explained that one key reason why parties negotiate settlement agreements is that doing so provides certainty about the terms and conditions to which they have agreed. *Id.* Mr. Lewis also noted that this has been recognized by this Commission, courts and others. *Id.* 14-15. He explained that settlements are the result of give and take, with the end result being a compromise of the parties to the settlement agreement. *Id.* at 15. He stated that the desire to achieve certainty with respect to an outcome is an important goal of the settling parties in entering into the compromise. *Id.* Whether certainty is, or can be, achieved often rests on certainty with respect to monetary risks and rewards. *Id.* He explained that if the costs of a settlement that serves the public interest cannot be recognized for ratemaking purposes, the utility can be disincented from entering into settlement agreements and unintended adverse consequences might also result. *Id.* In his view, Ms. Armstrong urges the Commission to endorse a blanket rejection of emission allowance surrender costs regardless of the overall circumstances. *Id.* She also urges the rejection of such costs for ratemaking purposes notwithstanding the evidence showing that the decision to incur such costs as part of an overall agreement was reasonable and, as discussed by Mr. McManus, permitted a designated emission level to be achieved at an overall cost that is lower than the cost of achieving the same level of emission reductions within the specified time frame via the use of pollution control equipment. *Id.*

Mr. Lewis explained that essentially Ms. Armstrong asks the Commission to modify the NSR settlement agreement. *Id.* He testified that in doing so, she overlooks the well-established aspects of the settlement process and instead presents her personal view that focuses almost exclusively on the notion that if a party decides to settle, it must have done something wrong. *Id.* at 15-16. Mr. Lewis testified that this view does not accurately reflect the reasons why parties enter into settlement agreements, particularly in a regulatory forum. *Id.* at 16. Mr. Lewis urged the Commission to refrain from second-guessing the judgment of those who negotiated the Consent Decree and to also refrain from re-writing the settlement agreement, particularly when the parties to the settlement agreement include the federal agency with jurisdiction over the subject matter. *Id.*

Mr. Lewis summarized the reasons supporting his opinion that the inclusion of the emission allowance surrender costs in the ECCR is just and reasonable. He further testified that the OUCC does not challenge Mr. McManus's testimony but rests its opposition on a blanket policy position

that lacks a sound foundation and contravenes the well-established policy favoring settlement. *Id.* He noted that while the decision to enter into the Consent Decree was voluntary on I&M's part, it was also voluntary on the part of the EPA and other parties to the agreement as well as the reviewing federal court that found the agreement to be fair, reasonable, in the public interest and consistent with the goals of the underlying federal law and regulation. *Id.* Therefore, Mr. Lewis testified, the challenged emission allowance costs are a reasonable and necessary cost of providing utility service. Lewis Rebuttal, at 16-17. Mr. Lewis added that the recovery of the emission allowance surrender costs is reasonable because costs reasonably incurred to provide utility service are properly recognized in the ratemaking process. *Id.* at 17. Furthermore, the OUCC was keenly aware of the Consent Decree requirements at the time it agreed (without limitation) that the Commission should permit I&M's emission allowance costs to be recognized through the ECCR. *Id.*

5. ECCR 1.

a. **Petitioner's Case-In-Chief.** In its Verified Petition, I&M requested Commission approval for an ECCR Adjustment commencing with the billing month of April 2012 or the first full billing month following a Commission Order. This is I&M's third annual ECCR Adjustment petition and includes the reconciliation of actual costs for December 1, 2010 through November 30, 2011 and a projection of emission allowance costs for a forecast period of April 1, 2012 through March 31, 2013.

I&M Witness Scott Krawec, Director of Regulatory Services for I&M, testified that the current ECCR was designed to recover approximately \$11.7 million of Indiana jurisdictional annual environmental compliance costs. I&M Exhibit C, at 4. He explained that the first component of the ECCR is a projection of environmental compliance costs for the forecast period. The second component is the cumulative under-recovery of ECCR costs as of November 30, 2011, which includes the over-recovery of actual jurisdictional emission allowance costs to actual billing under the ECCR for the period December 1, 2010 through November 30, 2011 (the "reconciliation period"). *Id.* at 5. Mr. Krawec stated that the reconciliation component of the ECCR adjusts for the difference between the amount recovered during the months in which the ECCR factor was in effect and the actual costs incurred during that time period. *Id.*

Mr. Krawec testified that beginning March 23, 2009, I&M has deferred monthly, as a regulatory asset, any under-recovery of ECCR costs and, as a regulatory liability, any over-recovery of ECCR costs for future recovery or refund, respectively, through the yearly true-up for the ECCR factor to actual results. *Id.* He explained that the under or over-recovery is calculated by comparing revenues collected from the ECCR to actual environmental compliance costs. He stated if the ECCR revenues are less than the emission allowance costs, I&M records the under-recovery as a regulatory asset and if the ECCR revenues are greater than the emission allowance costs, I&M records the over-recovery as a regulatory liability. *Id.* at 5-6.

Per Mr. Krawec's testimony for the reconciliation period, I&M has over-recovered \$1,423,280 for the emission allowance costs. *Id.* at 5; Petitioner's Exhibit SMK-1. According to Mr. Krawec, when this is netted with the \$455,452 under-recovery as of the beginning of the current reconciliation period, I&M has a cumulative over-recovery of \$967,828 remaining at November 30, 2011. He said that I&M's filing reflected annual NO_x surrenders in March 2011 of 389 allowances

with a total company expense of \$67,096. He said there were no surrenders for Seasonal NO_x or SO₂. *Id.* at 6. Mr. Krawec explained how the ECCR factor is calculated. *Id.* at 6. Mr. Krawec testified that the forecast component of \$7,553,818 is reduced by the reconciliation component of (\$967,828). The net amount of \$6,585,990 is then divided by the projected billing energy to arrive at an ECCR rate per kWh of \$0.000493. Petitioner's Exhibit SMK-3. *Id.* Mr. Krawec stated that I&M is requesting to implement a decrease in the ECCR factor. *Id.* at 7. Per the testimony of Mr. Krawec, the factor decrease will result in annual ECCR revenues of approximately \$6.6 million, or a decrease of \$5.1 million from current levels. Petitioner's Exhibit SMK-4. *Id.* Mr. Krawec explained that upon implementation of the new ECCR factor a residential customer using 1,000 kWh of electricity per month would experience a monthly rate decrease of \$0.39. Petitioner's Exhibit SMK-6. *Id.* Last, Mr. Krawec testified that I&M has provided a standard audit packet that consists of the exhibits and work papers supporting the calculation of I&M's ECCR costs. *Id.* at 8. In addition, pursuant to the Commission's June 23, 2010 Order in Cause No. 43856, I&M has included in the audit package the information requested by the OUCC.

I&M witness Richard A. Riley, Financial Forecasting Manager for AEPSC testified that the forecast period for this ECCR proceeding is April 2012 through March 2013. I&M Exhibit D, at 2. Mr. Riley provided forecasted information to determine the amount of allowance consumption expense and gains and losses on the sale of emission allowances to be included in the ECCR. Petitioner's Exhibit RAR-1. *Id.* at 3. Mr. Riley supported the components of the forecast and the Indiana jurisdictional calculation for allowance consumption expense, and gains/losses on the sale of emission allowances. Mr. Riley explained that the jurisdictional factor used was the same as the one used in Cause No. 43306. Mr. Riley further explained that the forecast of allowance consumption expense was prepared in a reasonable manner. According to Mr. Riley, these expenses were projected based upon the same forecast that was used to develop the forecasted fuel rate in Cause No. 38702 FAC68, which will create consistency between I&M's ECCR and its fuel rate. He noted that the legal uncertainties surrounding both delayed and proposed environmental regulations could impact the forecast of allowance expenses for I&M. Specifically, he said the forecast presented in this filing was prepared prior to the December 30, 2011, court stay of CSAPR. As a result, forecasted allowance expenses may be somewhat understated. *Id.* at 3-4.

Mr. Riley testified that the Company continues to be subject to both a seasonal NO_x requirement and an annual NO_x requirement. Per Mr. Riley, the annual requirement began on January 1, 2009 as a result of CAIR. He testified that the forecast of SO₂ allowance expense factors in the requirement under CAIR require I&M to remit to the EPA two 2010 and later vintage allowances for each ton of SO₂ emissions. For older vintage allowances the requirement was for one SO₂ allowance to be remitted for each ton of emissions. *Id.* at 4. Mr. Riley explained that the Company expenses allowances based on the WAI price of allowances held in current inventory. Per Mr. Riley, the WAI price is the total dollar balance of current inventory divided by the number of allowances held. According to Mr. Riley, for SO₂, the inventory balance includes zero cost allowances received from the EPA, allowances purchased from affiliates through the IAA approved by the Federal Energy Regulatory Commission, and allowances purchased from non-affiliates. For NO_x, the inventory is composed of zero cost allowances received from the EPA and purchased allowances. *Id.* at 4. Mr. Riley testified that forecasted consumption expense for the year ending March 2013 is expected to be lower by \$4 million compared to the actual consumption expense for the year ended November 30, 2011. Per Mr. Riley, this decrease is driven by a \$5 million projected

decrease in NO_x consumption expense. *Id.* at 5. He said that the implementation of CSAPR is expected to greatly decrease the value and, therefore, I&M's WAI cost of NO_x allowances. He said I&M is also expected to consume fewer NO_x allowances. *Id.* at 5. Last, Mr. Riley testified that I&M's forecast of allowance consumption costs, net of gains or losses on the sales of allowances, for year ending March 2013, is fair and reasonable. *Id.* at 5.

b. OUCC Testimony. OUCC witness Wes Blakley reviewed I&M's calculation of its ECCR factors, specifically the billing and reconciliation calculations. He testified that I&M's estimate of the ECCR adjustment factors appeared to be accurate from a purely mathematical standpoint. However, he noted that the OUCC has identified several concerns with the inputs to I&M's calculations, as addressed by OUCC witness Armstrong. OUCC Exhibit 2, at 4.

OUCC Witness Cynthia M. Armstrong testified that the OUCC identified three issues in the calculation of I&M's proposed ECCR rate, including I&M purchasing allowances from affiliates at prices above market, inclusion of the full gains realized from selling emission allowances and the inclusion of allowance surrender costs associated with AEP's Consent Decree. OUCC Exhibit 1, at 4. She stated that she found twelve transactions during the reconciliation period in which I&M procured both Seasonal and Annual NO_x allowances at prices significantly above the market price for those allowances. She said all of these transactions were marked either as "Accrual for NO_x Purchase Obligation" or "NO_x Purchase Obligation." She stated that I&M explained that these allowances were procured according to the Cardinal Station NO_x Emission Allowance Agreement, which is an agreement between Ohio Power Company ("OPCo"), AEPSC and Buckeye Power and which governs the responsibility for NO_x emission allowances required for the operation of the Cardinal Generating Station's units in Ohio. *Id.* at 4-5. She said the agreement requires OPCo and AEPSC to purchase Buckeye's surplus NO_x allowances from Cardinal Units 2 and 3 at a price that is essentially equivalent to the cost of installing and operating the units' SCR systems. She explained that the Cardinal NO_x Agreement is unrelated to the IAA, which governs SO₂ allowance transactions among affiliates. *Id.* at 5.

Ms. Armstrong stated that the OUCC opposes recovery of the full costs resulting from the purchase of allowances from Buckeye Power, and instead proposes that these allowances be recovered at the market price at the time the accrual or transaction was recorded. *Id.* She stated that full recovery of these costs is not appropriate because the only reason I&M is incurring the expenses of allowances procured according to this agreement is because AEPSC has allocated these allowances to I&M from OPCo's allowance inventory. *Id.* at 6. She stated that if I&M was acting as a stand-alone company that was managing its own emission allowances, it would have procured the NO_x allowances it needed to cover its emissions at the market rate for Seasonal and Annual NO_x allowance prices. *Id.* Ms. Armstrong further stated that the OUCC is not aware of a case in which I&M presented this agreement and its potential impact on I&M's rates before the Commission and sought approval of the agreement. She said that the Commission should be given the opportunity to review this contract and approve or disapprove of its costs prior to passing these costs to Indiana ratepayers. *Id.* Ms. Armstrong presented testimony regarding how she calculated the impact of recording the NO_x Obligation at market price and estimated that the impact of recovering the NO_x Obligation Purchases at market price would result in an overall downward adjustment of \$2,557,245

in I&M's total company allowance consumption expense during the reconciliation period. *Id.* at 6-7; OUCC Attachments CMA-3 through CMA-7.

Ms. Armstrong next testified that I&M has not provided much supporting information related to the calculation of I&M's total allowance gains or losses reflected on Line 4 of Petitioner's Exhibit SMK-1. *Id.* at 8-9. She said the OUCC is aware that I&M issued 4,801 SO₂ allowances in December 2010 in accordance with the IAA settlements, and recorded Total Allowance Gains at \$4,444 for December 2010, but she did not know if these allowances were issued because they were associated with the primary and economy energy transactions, or if they were transferred for current period compliance and allocation of the system allowance bank. *Id.* at 9. She said that if this issuance was due to the allocation of the system allowance bank, then I&M should have received compensation for this transaction at the AEP System Cost of Compliance, which would have been \$520.34 per allowance. She said that in this case, I&M should have recorded gains in December of \$1,663,114, which would result in another downward adjustment to the ECCR rate. *Id.* at 9. Rather than propose an adjustment at this time, Ms. Armstrong wanted to give I&M the opportunity to explain how its allowance gains were calculated and why they are recorded at the level reflected on Line 4 of Petitioner's Exhibit SMK-1. She said that if I&M did receive compensation at the AEP System Cost of Compliance for the allowances it issued in December 2010, then the OUCC would expect I&M to correct its ECCR calculation to reflect additional gains or revenues realized from this issuance. *Id.* at 9-10.

Ms. Armstrong also objected to I&M recovering allowance surrender costs associated with the Consent Decree via the ECCR for the reasons set forth in the OUCC's testimony in Cause Nos. 43992 and 43992 S1. She said that the OUCC has removed any allowance surrender costs resulting from the Consent Decree in its calculation of consumption costs for the purposes of calculating the ECCR rate in this proceeding. *Id.* at 10. She testified that if the Commission determines these costs to be reasonable to recover from consumers, then I&M can include these costs in a subsequent ECCR filing. Finally, Ms. Armstrong recommended that I&M provide additional documentation in the audit packet for the next ECCR filing. This additional documentation should include: (1) revenue received from the sale or issuance of emission allowances; (2) detailed information regarding how the IAA Settlements were determined for the year, including the determination of each member's annual over-compliance or under-compliance, the AEP System Allowance Bank, and each member's allocation of the AEP System Allowance Bank; and (3) the actual monthly SO₂ and NO_x emissions generated by OSS for the reconciliation period. If there is any additional calculation that would impact the monthly allowance consumption expense for off system sales recorded during the reconciliation period, then this information should also be provided. *Id.* at 11.

c. Petitioner's Rebuttal. Mr. Donald M. Hubschman, Manager, Asset Investments, AEPSC, responded to Ms. Armstrong's contention that the purchase price I&M paid for NO_x allowances was not prudent. I&M Exhibit E, at 2. He explained that the agreement with Buckeye was entered into in 2004 and provides that AEPSC procure Buckeye's excess NO_x emission allowances. He explained that Buckeye creates excess NO_x emission allowances by operation of a SCR. He explained that the year before the AEPSC entered into the Buckeye NO_x agreement market allowance prices were very high and volatile. *Id.* at 3. He said that year, allowances prices peaked at \$8,000 per allowance, with a low price that year of \$1,980 per allowance. He stated that by entering into this agreement, where AEPSC was obtaining NO_x allowances at a fixed price from Buckeye

based on Buckeye's cost to generate the allowances, AEPSC could limit the companies' exposure to the volatile NOx allowance market. He noted that the volatility of the NOx allowance market has also been described by I&M witnesses in Cause Nos. 43636 ECR1, 43636 ECR2, 43636 ECR3, and 43636 ECR4. He explained that the Buckeye NOx agreement has allowed I&M to purchase NOx allowances at a fixed cost, providing a measure of price certainty and also protecting I&M from being fully exposed to what can be a very volatile NOx allowance market. *Id.* at 3-4. He added that given the volatility and uncertainty of the NOx emission allowance market (as referenced above), the contract provided the operating companies with a hedge against future market instability. *Id.* at 4. He explained that I&M is not aware of any requirement that some, any, or all emission allowance purchases be made only at market prices. He added that the NOx emission allowance process has been managed since 2004, when NOx emission market prices were very high, to comply with state and federal requirements. He said that at that point in the process emission costs were deemed prudent and reasonable on the basis of a cost-based approach as managed through the AEPSC. *Id.*

I&M witness Dooley responded to Ms. Armstrong's characterization of the NOx allowance purchase and her comments regarding I&M's reported SO₂ emission allowance gains reflected in I&M's filing. I&M Exhibit F, at 2. Mr. Dooley explained that I&M recorded purchase accruals in 2011 in order to ensure that the Company would have sufficient NOx allowances emission to meet obligation requirements. *Id.* at 3. He explained that these accruals included those recorded by I&M to purchase NOx emission allowances from Buckeye Power. He noted that Buckeye Power is not an affiliate of these companies. Buckeye Power is a third-party, nonprofit, cooperative similar in nature to Wabash Valley Power Authority, that generates and sells wholesale power in Indiana and neighboring states. He explained that I&M's acquisition of NOx emission allowances from Buckeye Power were made directly with Buckeye Power and involved the purchase of Buckeye Power's surplus NOx allowances from Cardinal Units 2 and 3 which Buckeye Power owns. *Id.* at 3-4. He stated that Buckeye Power submitted invoices for NOx emission allowance purchases directly to I&M, and I&M paid Buckeye Power directly for those purchases. NOx emission allowance transfers for these purchases were made between Buckeye Power's EPA account and I&M's EPA account. *Id.* at 4. He added that previous emission allowance purchase costs were included in prior ECCR filings. Mr. Dooley explained that Ms. Armstrong's attachments do not accurately reflect or fairly represent I&M's actual incurred and recorded emission allowance expenses. He said her argument incorrectly implies that only purchases at the lower of cost or market should be considered acceptable and the calculations shown in her Attachments reflect this incorrect argument. He opined that Ms. Armstrong's calculation should not be adopted by the Commission in this proceeding. *Id.*

Mr. Dooley explained that the actual sales transaction associated with the 4,801 SO₂ allowances related to the IAA's primary and economy energy transactions for 2010. *Id.* at 5. He testified that in accordance with the IAA, primary and economy related allowance transactions are priced at the selling company's WAI and as such there is no dollar gain associated with the sale. He stated that the \$4,444 gain identified by Ms. Armstrong is not related to the sale of the 4,801 SO₂ emission allowances. He explained that the \$4,444 gain recorded in December 2010 relates to I&M's realization of the expiration of an exchange-traded call option premium in that month. He stated the option was not exercised. *Id.* at 6. He said the amount of this option premium had previously been received and deferred by I&M up to and until the option expiration date, in accordance with AEP's practice associated with option premiums. He concluded that I&M properly reflected the gains or

revenues in its ECCR calculation. Finally, Mr. Dooley stated that I&M is willing to provide the additional documentation identified in Ms. Armstrong's testimony. *Id.*

6. Settlement Agreement and Testimony in Support of the Settlement Agreement.

A copy of the Settlement Agreement is attached hereto and incorporated by reference into this Order. With regard to the Commission's Order in these consolidated proceedings, the Settlement Agreement proposes the following terms:

1. The factor in the ECCR 1 proceeding will include 50% of the costs, as calculated by the OUCC (\$1,278,622 total company), related to the purchase of NOx allowances from Buckeye Power during the reconciliation period⁴.
2. The factor in the ECCR 1 proceeding will include 50% of the costs of emission allowances (SO₂ and NOx) surrendered in accordance with sections 4 and 5 of the NSR Consent Decree, as calculated by I&M (\$33,548 total company).
3. The factor in the ECCR 1 proceeding will include \$8,000 in allowance gains as reflected in I&M's filing. The factor in future ECCR proceedings will reflect the Indiana jurisdictional share of net booked gains and losses, if any.
4. For future ECCR proceedings, the cost of NOx allowances purchased by I&M from Buckeye Power will be limited to the lower of actual costs or market price. This includes the cost of NOx allowances purchased by I&M from Buckeye Power that are currently included in I&M's inventory of NOx allowances.
5. Based on the foregoing, the factor to be approved by the Commission in ECCR 1 will be \$0.000429 per kWh.
6. For future ECCR proceedings, 20% of the Indiana jurisdictional share of I&M's costs of emission allowances (SO₂ and NOx) surrendered in accordance with sections 4 and 5 of the NSR Consent Decree will be included in the factor. The surrendered allowance expense will be the number of allowances surrendered multiplied by the weighted average cost of the applicable inventory.
7. For future ECCR proceedings, I&M will provide the documentation identified on page 11 of OUCC's Exhibit No.1 in ECCR 1.
8. Approval of the agreement will resolve all issues in the Subdocket and the Subdocket will be closed. The factor approved in Cause No. 43992 will be finalized without refund, as the initial factor was not affected by the nominal amount of surrendered allowances.
9. Finally, the Settling Parties agree that nothing in the Settlement Agreement is to be construed to be a finding or admission of liability by I&M or AEP regarding any of the contested matters and, due to the unique circumstances of AEP's NSR Consent Decree, the surrender of emission allowances in accordance with the sections 4 and 5 of the NSR Consent Decree will not be construed to be a civil penalty.

⁴ The parties confirmed in their May 4, 2012 Responses to the Commission's Docket Entry that the factor in the ECCR 1 proceeding will include 50% of the OUCC-calculated \$2,557,245 cost reduction, as opposed to an agreement to include 50% of the costs associated with the Buckeye Power contract.

I&M witness Dooley offered testimony in support of the Settlement Agreement. He provided an overview of the terms of the Settlement Agreement. I&M Exhibit A, at 3-5. Mr. Dooley explained that the Settlement Agreement is a result of serious negotiations and bargaining in which the Settling Parties evaluated the issues and reached a compromise in the public interest. *Id.* at 6. He also stated his opinion that approval of the Settlement Agreement is in the public interest because it reflects compromise and resolves disputed issues in both proceedings without further expenditure of time and resources of the Commission and the Settling Parties. *Id.*

After reviewing the Settlement Agreement and supporting evidence, on May 1, 2012, the Presiding Officers issued a Docket Entry requesting that the Settling Parties provide additional evidence concerning the reason(s) why the Settlement Agreement is in the public interest and should be approved by the Commission. The OUCC and I&M both provided written responses on May 4, 2012.

The OUCC's response states its belief that the Settlement Agreement reflects a reasonable compromise of issues in dispute and provides a reasonable calculation of the appropriate ECCR rate going forward. Public's Exhibit 3, at 1-2. The OUCC states that it believes resolution of both issues of the appropriate regulatory relief of the Consent Decree emission allowance surrender costs and the NO_x allowances procured from Buckeye Power will save time and resources that would be required to continue litigating the issues. The ECCR factor proposed in the Settlement Agreement also will allow ratepayers to more quickly benefit from a lower ECCR rate. *Id.* at 2. Regarding the Buckeye Power NO_x allowances, the OUCC provides that it accepts the decision of OPCo and AEPSC to enter into the Cardinal NO_x agreement may have been prudent given the NO_x Allowance markets at the time, but does not feel that I&M should be entitled to recover all of the costs associated with purchasing allowances from Buckeye Power at above market prices. The OUCC states that it believes it is a reasonable compromise to allow I&M to recover 50% of the OUCC calculated cost reduction due to the Buckeye NO_x allowances during this reconciliation period, along with a provision to ensure that in future proceedings, ratepayers will not continue to pay for additional above-market costs. *Id.* at 2-3. Regarding the Consent Decree emission allowance surrenders, the OUCC addresses some testimony filed in Cause No. 44075, I&M's pending rate proceeding, and states that it is willing to concede that AEP's ability to negotiate resolution of the NSR claims has provided benefit to I&M's ratepayers. *Id.* at 3. However, the OUCC states that it does not believe I&M should be entitled to recover all costs associated with the Consent Decree allowance surrenders, which is the resolution achieved in the Settlement Agreement. *Id.* at 4.

I&M's response states that the intent of the Settlement Agreement is to split the amount in controversy and to also reflect in the agreed factor the amount of the allowance purchase not in controversy. I&M Exhibit L, at 2. I&M further notes that the terms of the Settlement Agreement are well within the scope of the evidence presented by the Parties in both proceedings. *Id.* at 3-4. I&M states that the evidence presented in the Subdocket shows that the emission allowance issues under review are complex, and that settlement allows the Parties to achieve fair resolution of the issues in a manner that balances their respective interests. *Id.* at 4.

7. Commission Discussion and Findings. The Commission begins with a general discussion of Settlement Agreements. Settlements presented to the Commission are not ordinary

contracts between private parties. *U.S. Gypsum, Inc. v. Indiana Gas Co.*, 735 N.E.2d 790, 803 (Ind. 2000). When the Commission approves a settlement, that settlement “loses its status as a strictly private contract and takes on a public interest gloss.” *Id.* (quoting *Citizens Action Coalition v. PSI Energy*, 664 N.E.2d 401, 406 (Ind. Ct. App. 1996)). Thus, the Commission “may not accept a settlement merely because the private parties are satisfied; rather [the Commission] must consider whether the public interest will be served by accepting the settlement.” *Citizens Action Coalition*, 664 N.E.2d at 406. Furthermore, any Commission decision, ruling, or order—including the approval of a settlement—must be supported by specific findings of fact and sufficient evidence. *United States Gypsum*, 735 N.E.2d at 795 (citing *Citizens Action Coalition v. Public Service Co.*, 582 N.E.2d 330, 331 (Ind. 1991)). The Commission’s own procedural rules require that settlements be supported by probative evidence. 170 I.A.C 1-1.1-17(d). Therefore, before the Commission can approve the Settlement Agreement, we must determine whether the evidence in this Cause sufficiently supports the conclusions that the Settlement Agreement is reasonable, just, and consistent with the purpose of Indiana Code ch. 8-1-2, and that such agreement serves the public interest.

The Commission is compelled to address circumstances regarding the Parties’ presentation of the Settlement Agreement to the Commission. Each of the underlying proceedings involved extensive testimony regarding strongly contested issues. In support of the Settlement Agreement, I&M submitted brief testimony that primarily summarized the terms of the Settlement Agreement, and contained very little evidence explaining why the terms of the Settlement Agreement are in the public interest. The OUCC submitted no testimony in support of the Settlement Agreement. The agreed proposed order submitted by the Parties contained a statement that the Settlement Agreement speaks for itself. In fact, no settlement agreement presented to this Commission can or does speak for itself; as noted above, settlement agreements must be supported by probative evidence to gain Commission approval. We addressed a similar issue in our Order on Less than All of the Issues in *Indiana Michigan Power Company*, Cause No. 44033 (IURC, February 22, 2012). In that Order, we reminded the parties “that their success in obtaining approval of any Settlement Agreement ... is dependent upon the provision of adequate evidence and support for the agreement.” *Id.* at 6. In similar fashion in this proceeding, the Presiding Officers had to issue a Docket Entry to prompt the Parties to submit sufficient evidence to support the Settlement Agreement. The Commission is concerned about the repeated need to remind the Parties of their responsibilities concerning evidentiary support for settlement agreements.

Nonetheless, sufficient evidence demonstrates and we find that the Settlement Agreement reflects a fair, just and reasonable resolution of the matters pending before the Commission and therefore is in the public interest. As explained by witness Dooley, the agreed terms set forth the resolution of the disputed issues in ECCR 1 and provide the method used to determine the agreed ECCR 1 factor. As shown by the Settlement Agreement, the Parties’ agreed factor reflects an adjustment of the factors proposed in I&M’s case-in-chief that decreases the cost of the NOx allowances I&M purchased from Buckeye Power. Settlement Agreement, at ¶¶1, 4-5. The Settlement Agreement also addresses how these costs will be treated in future ECCR filings. *Id.* at ¶¶4. More specifically, the cost of NOx allowances purchased by I&M from Buckeye Power will be limited to the lower of actual costs or market price. This includes the cost of NOx allowances purchased by I&M from Buckeye Power that are currently included in I&M’s inventory of NOx allowances. *Id.* at ¶4. In its direct testimony filed in ECCR 1, the OUCC raised a question about certain allowance gains reflected in I&M’s filing. As explained by witness Dooley, the Parties discussed this question

and came to the conclusion that this issue was not in dispute; this is reflected in the Settlement Agreement. *Id.* at ¶3

The Settlement Agreement reflects that the Parties also reached a compromise regarding the contested issues regarding the emission allowance surrender costs incurred under the Consent Decree. The Settlement Agreement addresses this issue with regard to the factor to be approved in Cause Nos. 43992 and 43992 ECCR 1, and future ECCR filings. *Id.* at ¶¶ 2, 6, 8-9. In ECCR 1 and future filings, the Settlement Agreement reflects that the level of costs that may be included in the ECCR factor is less than the actual cost. *Id.* at ¶¶ 2, 6. The factor in the ECCR 1 proceeding will include 50% of the costs of emission allowances surrendered in accordance with the Consent Decree. For future ECCR proceedings, 20% of the Indiana jurisdictional share of I&M's expense of surrendered allowances will be included in the factor. Surrendered allowance expense will be the number of allowances surrendered multiplied by the weighted average cost of the applicable inventory.

Further, the Commission observes that, in general, utility requests to recover costs from ratepayers resulting from consent decrees, such as the one at issue in this Cause, have the potential to be highly contested and complex proceedings due to the lack of involvement of the state consumer advocate representing ratepayer interests. In this Cause the OUCC stated, "Theoretically, the OUCC could intervene in lawsuits or criminal proceedings the DOJ or EPA pursues against an Indiana utility for these types of violations, but federal courts have denied ratepayers' request to intervene in environmental cases. Therefore, the OUCC's ability to take part in settlement negotiations that lead to a Consent Decree may be limited, if not precluded entirely." OUCC Exhibit 4, p. 11. However, we note that a utility could voluntarily choose to involve the OUCC in consent decree negotiations, which may have the potential to result in more efficient proceedings before the Commission.

The Settlement Agreement provides that the ECCR 1 factor will be \$0.000429 per kWh. The calculation of the revised factor is shown in I&M Settlement Exhibit TMD-1. The Commission calculates that upon implementation of the new ECCR factor a residential customer using 1,000 kWh of electricity per month would experience a monthly bill decrease of \$0.45. The Settlement Agreement recognizes that the factor approved in Cause No. 43992 will be finalized without refund, as the factor approved in that docket was not affected by the nominal amount of surrendered allowances. This is consistent with the 43992 Order (p. 11, n. 1). Finally, in its testimony in ECCR 1, the OUCC asked that I&M provide additional documentation in future ECCR filings. As noted by witness Dooley, the Settlement Agreement reflects that I&M has agreed to do so. *Id.* at ¶7.

Finally, the Commission notes that its approval of the Settlement Agreement's provisions regarding rate recovery for emission allowance costs, especially those associated with the NSR Consent Decree surrenders, is specific to the facts and circumstances of these proceedings and should not be construed as an indication of how the Commission may rule in other proceedings. In this regard, we also note that while the Parties agreed amongst themselves that nothing in the Settlement Agreement should be construed as a finding or an admission of liability by I&M or AEP, and that the Consent Decree emission allowance surrenders shall not be construed as a civil penalty, this agreement is not binding on the Commission and we make no such determination here. Finally, the parties agree that the Settlement Agreement should not be used as precedent in any other proceeding or for any other purpose, except to the extent necessary to implement or enforce its terms.

Consequently, with regard to future citation of the Settlement Agreement, we find that our approval herein should be construed in a manner consistent with our finding in *Richmond Power & Light*, Cause No. 40434 (IURC, March 19, 1997).

IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION that:

1. The Settlement Agreement is approved.
2. Petitioner's proposed Environmental Compliance Cost Rider factor as set forth in the Settlement Agreement shall be and hereby is approved.
3. Petitioner shall file with the Electricity Division of the Commission its tariff reflecting the approved Environmental Compliance Cost Rider factor approved herein.
4. The ECCR factors approved in the June 22, 2011 Order in Cause No. 43992 shall be and hereby are finalized.
5. This Order shall be effective on and after the date of its approval.

ATTERHOLT, BENNETT, LANDIS AND ZIEGNER CONCUR; MAYS ABSENT:

APPROVED: MAY 23 2012

I hereby certify that the above is a true and correct copy of the Order as approved.



**Brenda A. Howe
Secretary to the Commission**

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

IN THE MATTER OF THE VERIFIED PETITION OF)
INDIANA MICHIGAN POWER COMPANY FOR)
APPROVAL OF AN ADJUSTMENT TO ITS RATES)
THROUGH ITS ENVIRONMENTAL COMPLIANCE)
COST RIDER ADJUSTMENT COMMENCING WITH)
THE BILLING MONTH OF APRIL 2011 PURSUANT) CAUSE NO. 43992 S1
TO THE COMMISSION'S ORDER IN CAUSE NO.)
43306 AND 43856.)

IN THE MATTER OF THE VERIFIED PETITION OF)
INDIANA MICHIGAN POWER COMPANY FOR)
APPROVAL OF AN ADJUSTMENT TO ITS RATES)
THROUGH ITS ENVIRONMENTAL COMPLIANCE) CAUSE NO. 43992-ECCR 1
COST RIDER ADJUSTMENT COMMENCING WITH)
THE BILLING MONTH OF APRIL 2012 PURSUANT)
TO THE COMMISSION'S ORDER IN CAUSE NO.)
43306 AND 43856.)

STIPULATION AND SETTLEMENT AGREEMENT

THIS AGREEMENT is made and entered into by and among Indiana Michigan Power Company ("I&M"), and the Indiana Office of Utility Consumer Counselor ("OUCC") (collectively the "Parties" and individually "Party"). The Parties having been duly advised by their respective staff, experts and counsel, and solely for purposes of compromise and settlement, stipulate and agree that the terms and conditions set forth below represent a fair, just and reasonable resolution of the matters in these proceedings pending before the Indiana Utility Regulatory Commission ("Commission"), subject to their incorporation into a final, non-appealable order ("Final Order") of the Commission without modification or further condition that may be unacceptable to any Party. If the Commission does not approve this Stipulation and Settlement Agreement ("Settlement Agreement"), in its entirety, the entire Settlement Agreement

shall be null and void and deemed withdrawn, unless otherwise agreed to in writing by the Parties.

A. TERMS AND CONDITIONS OF FINAL ORDER

In full resolution of the issues in the subdocket and rate adjustment proceeding, the parties agree as follows:

1. The factor in the ECCR 1 proceeding will include 50% of the costs, as calculated by the OUCC (\$1,278,622 total company), related to the purchase of NO_x allowances from Buckeye Power during the reconciliation period. The projected costs will be adjusted in accordance with paragraph 4 below.
2. The factor in the ECCR 1 proceeding will include 50% of the costs of emission allowances (SO₂ and NO_x) surrendered in accordance with sections 4 and 5 of the NSR Consent Decree, as calculated by I&M (\$33,548 total company).
3. The factor in the ECCR 1 proceeding will include \$8,000 in allowance gains as reflected in I&M's filing. The factor in future ECCR proceedings will reflect the Indiana jurisdictional share of net booked gains and losses, if any.
4. For future ECCR proceedings, the cost of NO_x allowances purchased by I&M from Buckeye Power will be limited to the lower of actual costs or market price. This includes the cost of NO_x allowances purchased by I&M from Buckeye Power that are currently included in I&M's inventory of NO_x allowances.
5. Based on the foregoing the factor to be approved by the Commission in ECCR 1 will be \$0.000429 per kWh.
6. For future ECCR proceedings, 20% of the Indiana jurisdictional share of I&M's costs of emission allowances (SO₂ and NO_x) surrendered in accordance with sections 4 and 5 of the NSR Consent Decree will be included in the factor. The surrendered allowance expense will be the number of allowances surrendered multiplied by the weighted average cost of the applicable inventory.
7. For future ECCR proceedings, I&M will provide the documentation identified on page 11 of Public's Exhibit No. 1 in ECCR 1.
8. Approval of the agreement will resolve all issues in the subdocket and the subdocket will be closed. The factor approved in Cause No. 43992 will be finally approved without refund, as the initial factor was not affected by the nominal amount of surrendered allowances.

9. Nothing in this agreement is to be construed to be a finding or admission of liability by I&M or AEP regarding any of the contested matters and, due to the unique circumstances of AEP's NSR Consent Decree, the surrender of emission allowances in accordance with the sections 4 and 5 of the NSR Consent Decree will not be construed to be a civil penalty.

B. PRESENTATION OF THE SETTLEMENT TO THE COMMISSION

1. The Parties shall support this Settlement Agreement before the Commission and request that the Commission expeditiously accept and approve the Settlement Agreement. The concurrence of the Parties with the terms of this Settlement Agreement is expressly predicated upon the Commission's approval of the Settlement Agreement in its entirety without any modification or any condition that may be unacceptable by any Party. If the Commission does not approve the Settlement Agreement in its entirety and without change, the Settlement Agreement shall be null and void and deemed withdrawn, upon notice in writing by any Settling Party within fifteen (15) business days after the date of the Final Order that any modifications made by the made by the Commission are unacceptable to it.

2. The Parties shall jointly move for leave to file this Settlement Agreement and supporting evidence. Such evidence will be offered into evidence without objection and the Parties hereby waive cross-examination. The Parties propose to submit this Settlement Agreement and evidence conditionally, and that, if the Commission fails to approve this Settlement Agreement in its entirety without any change or with condition(s) unacceptable to any Party, the Settlement Agreement and supporting evidence shall be withdrawn and the Commission will continue to hear Cause Nos. 43992-S1 and 43992-ECCR 1 with the proceedings resuming at the point they were suspended by the filing of this Settlement Agreement.

3. A Final Order approving this Settlement Agreement shall be effective immediately, and the agreements contained herein shall be unconditional, effective and binding on all Parties as an Order of the Commission.

4. The Parties shall jointly agree on the form, wording and timing of public/media announcement (if any) of this Settlement Agreement and the terms thereof. No Party will release any information to the public or media prior to the aforementioned announcement. The Parties may respond individually without prior approval of the other Parties to questions from the public or media, provided that such responses are consistent with such announcement and do not disparage any of the Parties. Nothing in this Settlement Agreement shall limit or restrict the Commission's ability to publicly comment regarding this Settlement Agreement or any Order affecting this Settlement Agreement.

C. EFFECT AND USE OF SETTLEMENT

1. It is understood that this Settlement Agreement is reflective of a negotiated settlement and neither the making of this Settlement Agreement nor any of its provisions shall constitute an admission by any Party to this Settlement Agreement in this or any other litigation or proceeding. It is also understood that each and every term of this Settlement Agreement is in consideration and support of each and every other term.

2. This Settlement Agreement shall not constitute and shall not be used as precedent by any person in any other proceeding or for any other purpose, except to the extent necessary to implement or enforce the terms of this Settlement Agreement.

3. This Settlement Agreement is solely the result of compromise in the settlement process and except as provided herein, is without prejudice to and shall not constitute a waiver of

any position that any of the Parties may take with respect to any or all of the items resolved here and in any future regulatory or other proceedings.

4. The Parties agree that the evidence in support of this Settlement Agreement constitutes substantial evidence sufficient to support this Settlement Agreement and provides an adequate evidentiary basis upon which the Commission can make any findings of fact and conclusions of law necessary for the approval of this Settlement Agreement, as filed. The Parties shall prepare and file an agreed proposed order with the Commission as soon as reasonably possible.

5. The communications and discussions during the negotiations and conferences and any materials produced and exchanged concerning this Settlement Agreement all relate to offers of settlement and shall be privileged and confidential, without prejudice to the position of any Party, and are not to be used in any manner in connection with any other proceeding or otherwise.

6. The undersigned Parties have represented and agreed that they are fully authorized to execute the Settlement Agreement on behalf of their designated clients, and their successors and assigns, who will be bound thereby.

7. The Parties shall not appeal or seek rehearing, reconsideration or a stay of the Final Order approving this Settlement Agreement in its entirety and without change or condition(s) unacceptable to any Party (or related orders to the extent such orders are specifically implementing the provisions of this Settlement Agreement). The Parties shall support or not oppose this Settlement Agreement in the event of any appeal or a request for a stay by a person

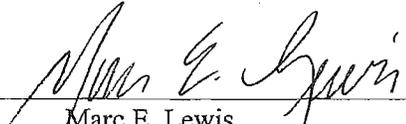
not a party to this Settlement Agreement or if this Settlement Agreement is the subject matter of any other state or federal proceeding.

8. The provisions of this Settlement Agreement shall be enforceable by any Party before the Commission and thereafter in any state court of competent jurisdiction as necessary.

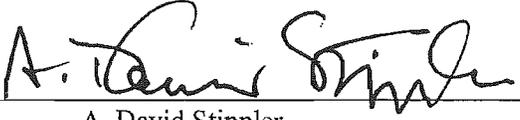
9. This Settlement Agreement may be executed in two (2) or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

ACCEPTED and AGREED as of the 19th day of April, 2012.

INDIANA MICHIGAN POWER COMPANY


Name: Marc E. Lewis
Its: Vice President, External Relations

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR


Name: A. David Stippler
Its: Utility Consumer Counselor