

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)
COST RIDER ADJUSTMENT COMMENCING WITH)
THE BILLING MONTH OF APRIL 2011 PURSUANT TO)
THE COMMISSION'S ORDER IN CAUSE NO. 43306)
AND 43856.)

CAUSE NO. 43992
APPROVED: JUN 22 2011

BY THE COMMISSION:
Kari A.E. Bennett, Commissioner
Loraine L. Seyfried, Chief Administrative Law Judge

On February 4, 2011, Indiana Michigan Power Company ("Petitioner," "Company" or "I&M") filed a Verified Petition for an Environmental Compliance Cost Rider ("ECCR") Adjustment with the Indiana Utility Regulatory Commission ("Commission") to be effective with the first billing cycle for the billing month of April 2011 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 4, 2011. On March 31, 2011 the Indiana Office of Utility Consumer Counselor ("OUCC") filed its direct testimony and exhibits, and on April 6, 2011, I&M filed its rebuttal testimony and exhibits. The Commission issued questions to I&M by docket entry dated April 12, 2011, to which I&M responded on April 14, 2011.

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 April 15, 2011, at 9:30 a.m. 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. At the hearing, the Presiding Officers also established a post-hearing briefing schedule.

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. The 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.** In Cause No. 43306, I&M proposed, among other things, an Environmental Compliance Cost Rider to track net emission allowance costs. In its March 4, 2009 Order in Cause No. 43306, the Commission approved the ECCR as set forth in the Settlement Agreement in that Cause. Under the ECCR, I&M tracks net emission allowances for purposes of seeking cost recovery via retail rates on an annual basis. The initial ECCR factor was established pursuant to the Commission's March 4, 2009 Order in Cause No. 43306. I&M's current ECCR factor was established pursuant to the Commission's June 23, 2010 Order in Cause No. 43856.

4. **Petitioner's Request.** In its Verified Petition, I&M seeks Commission approval for an ECCR Adjustment commencing with the billing month of April 2011 or the first full billing month following a Commission Order. This is I&M's second annual ECCR Adjustment petition and includes the reconciliation of actual costs for December 1, 2009 through November 30, 2010 and a projection of emission allowance costs for a forecast period of April 1, 2011 through March 31, 2012. Future ECCR Adjustment petitions will also reconcile actual environmental compliance costs experienced during a preceding twelve month period and will reflect projected environmental compliance costs.

5. **Petitioner's Direct Testimony.** I&M witness Scott Krawec, Director of Regulatory Services for I&M, testified that the current ECCR was designed to recover approximately \$12.0 million of Indiana jurisdictional annual emission allowance costs. Pet. Ex. 2 at 4. He explained the ECCR consists of two components: (1) a projection of environmental compliance costs for the forecast period; and (2) the cumulative under-recovery of ECCR costs as of November 30, 2010, which includes the over-recovery of actual jurisdictional emission allowance costs to actual billing under the ECCR for the period December 1, 2009 through November 30, 2010 (the "reconciliation period"). *Id.* at 4-5. 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.* at 5.

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.*

Mr. Krawec stated that for the reconciliation period, I&M has over-recovered \$1,548,408 for the emission allowance costs. *Id.* As reflected on Petitioner's Exhibit SMK-1, when this is netted with the \$2,003,861 under-recovery as of the beginning of the current reconciliation period, I&M has a cumulative under-recovery of \$455,452 remaining at November 30, 2010.

Mr. Krawec explained how the ECCR factor is calculated. Pet. Ex. 2 at 6. He testified that, as reflected on Petitioner's Exhibit SMK-3, the forecast component of \$11,282,159 is added to the reconciliation component of \$455,452. The total of \$11,737,611 is then divided by the projected billing energy to arrive at an ECCR factor per kWh of \$0.000879. *Id.*

Mr. Krawec stated that I&M is requesting to implement a decrease in the ECCR factor. *Id.* Mr. Krawec stated, as reflected on Petitioner's Exhibit SMK-4, the factor decrease will result in annual ECCR revenues of approximately \$11.7 million, or a decrease of \$213,542 from current levels. *Id.* He testified that upon implementation of the new ECCR factor and as reflected on Petitioner's Exhibit SMK-6, a residential customer using 1,000 kWh of electricity per month would experience a monthly rate decrease of \$0.02. *Id.*

Last, Mr. Krawec testified that I&M has developed a standard audit packet to be provided to the Commission and OUCC, which consists of the exhibits and work papers supporting the calculation of I&M's ECCR costs. *Id.* at 7. In addition, pursuant to the Commission's June 23, 2010 Order in Cause No. 43856, I&M included in the audit package the information requested by the OUCC. In particular, I&M provided the following information:

1. A list of all emission allowance transactions for the reconciliation period that includes all purchases, transfers, and sales made during the reconciliation period. In addition, the prices at which emission allowances were procured or sold.
2. Monthly Weighed Average Inventory Cost calculation for the current year during the reconciliation period and the projected period to support how I&M derives its monthly emission allowance consumption expense.
3. Monthly unit emission for reconciliation and projected periods.
4. Monthly emission allowances consumed for the reconciliation period. For the projected period, the monthly emission allowances I&M anticipates to consume as well as an explanation of the methodology for estimating projected period emission allowance consumption.
5. The calculation of allowances consumed in providing off-system sales in the same manner as previously provided.
6. Documentation of the sharing of SO₂ allowances through the settlement of the Interim Emission Allowance Agreement.

I&M witness Richard A. Riley, Financial Forecasting Manager for American Electric Power Service Corporation, supported the forecast of the expenses to be included in the ECCR. Pet. Ex. 3 at 2. He testified that the forecast period for this ECCR proceeding is April 2011 through March 2012. *Id.* Mr. Riley stated Petitioner's Exhibit RAR-1 provides the 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. *Id.*

Mr. Riley testified concerning 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. *Id.* at 3. He further opined 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 FAC66. *Id.*

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 the Clean Air Interstate Rule (“CAIR”). Further, according to Mr. Riley, since 2010, CAIR has also required I&M to remit to the U.S. Environmental Protection Agency (“EPA”) two SO₂ allowances for each ton of SO₂ emissions. *Id.* Before 2010, the requirement was for one SO₂ allowance to be remitted for each ton of emissions. Mr. Riley explained that the Clean Air Transport Rule (“CATR”) was not assumed to be implemented in the forecast period. He explained that the timing and form of implementation of the CATR is uncertain and should not be used as a basis for setting rates. *Id.* at 4.

Mr. Riley explained the Company’s calculation of allowance consumption expense. He stated the Company expenses allowances based on the weighted average inventory (“WAI”) price of allowances held in current inventory. *Id.* Per Mr. Riley, the WAI price is the total dollar balance of current inventory divided by the number of allowances held. He stated for SO₂, the inventory balance includes zero cost allowances received from the EPA, allowances purchased from affiliates through the Interim Allowance Agreement (“IAA”), 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.*

Mr. Riley testified that forecasted consumption expense for the year ending March 2012 is expected to be higher by \$5 million compared to the actual consumption expense for the year ended November 30, 2010. Per Mr. Riley, this increase is driven by a \$7 million projected increase in SO₂ consumption expense. *Id.* He said that while I&M is expected to consume more allowances during the forecast period than during the year ended November 30, 2010, the more significant explanation is the increase in I&M’s WAI for SO₂ allowances. He explained that the WAI is expected to increase because the requirement under the CAIR to surrender two allowances for every ton of emissions has depleted I&M’s inventory of low cost allowances. *Id.* According to Mr. Riley, I&M is required, under the Federal Energy Regulatory Commission (“FERC”) approved IAA, to purchase or sell allowances from AEP affiliates at AEP’s cost of compliance, which can increase I&M’s WAI. *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 the year ending March 2012, is fair and reasonable. *Id.*

6. OUCG Testimony. OUCG witness Cynthia M. Armstrong, Utility Analyst, testified the OUCG agrees with I&M’s ECCR calculation. Pub. Ex. 1 at 3. Ms. Armstrong noted that I&M included costs associated with the surrender of NO_x allowances pursuant to the AEP Consent Decree entered into with the EPA to settle New Source Review (“NSR”) claims. *Id.* She stated that although the OUCG objects to including these costs for recovery via the ECCR, removing them has

no effect on the proposed ECCR factor. However, Ms. Armstrong stated the OUCC feels it is necessary to address these costs because they could become substantial in the future. *Id.*

Ms. Armstrong stated the OUCC views the allowance surrender costs to be a form of a penalty for the Company's alleged environmental violations. She explained while allowance surrenders are not specifically referred to as a penalty in the Consent Decree, and the Company has a separate Civil Penalty that it was required to pay to the EPA, allowance surrenders generally serve to rectify the harm caused by AEP's (and I&M's) excess emissions from not obtaining pre-construction permits required under the NSR and Prevention of Significant Deterioration provisions of the Clean Air Act ("CAA"). *Id.*

Ms. Armstrong stated that surrender of the emission allowances also ensures the Company complies with hard emission caps placed on its generation units by not allowing the sale of those excess allowances above the cap to other generation units. *Id.* at 4. She noted, as in previous cases, the OUCC asserts that "remedial measures such as these constitute a penalty for past wrongdoings that should not be included in rates." *Id.* She stated that in the past, consuming additional emission allowances would have been associated with the production of more power for customers or the generation of additional revenues through off-system sales. Now, because the allowances must be surrendered, if I&M is permitted to recover these costs in rates, customers will be charged more in consumption costs without receiving an additional benefit for the allowance surrender. *Id.*

Ms. Armstrong believes the only reason these additional costs are being incurred is because I&M (and AEP) allegedly violated environmental laws when it made major modifications to its generating facilities without first acquiring the permits to do so. *Id.* She stated that while ratepayers reasonably rely upon I&M to manage its assets efficiently and within the confines of the law, they have no control over how I&M chooses to run its operations. She concluded it is unfair for ratepayers to have to pay for the additional emission allowance costs resulting from I&M's alleged legal violations. Ms. Armstrong further testified that it is not clear from the record in Cause No. 43306 whether these costs were approved by the Commission. She noted that the test year did not include the allowance surrender costs and therefore concluded that these costs have not yet been approved for inclusion in I&M's ECCR. *Id.* at 4-5.

Ms. Armstrong also testified that the OUCC has concerns over whether the IAA as currently written offers an equitable solution for I&M customers in sharing SO₂ allowance costs and revenues. *Id.* at 5. According to Ms. Armstrong, the OUCC's main concerns with the IAA are the requirement that each company must own its Member Load Ratio ("MLR") share of the system allowance bank, the method in which the system cost of compliance is calculated, and whether the IAA as currently written is appropriate to use in light of new environmental regulations that the EPA plans to implement in the coming years. *Id.* at 6.

Ms. Armstrong expressed the OUCC's concern with requiring I&M to own enough allowances to cover its MLR share of the AEP System Allowance Bank, as this provision fails to account for the fact that I&M has nuclear generating assets that do not produce emissions and are not allocated any SO₂ allowances via the Acid Rain Program. She testified that the OUCC is concerned that I&M, since it does not receive allowances from the EPA for its nuclear assets, will be placed in a position where it must always purchase allowances from other members to meet its MLR share of the system allowance bank once it exhausts its own allowances. *Id.* at 6. Per Ms. Armstrong, the OUCC

does not view this as equitable since these zero-emission nuclear assets do not create the need for the system to own SO₂ allowances. Further, the OUCC is concerned that this provision of the agreement forces I&M to subsidize the allowances of other member companies. Ms. Armstrong further testified as to her understanding that prior to 1996, the allowance agreement based member requirements for the AEP System Allowance Bank on consideration of a company's future compliance needs instead of on its MLR. Ms. Armstrong stated the OUCC views a method in which a member company is allocated the System Allowance Bank according to its true compliance needs as more equitable than what the current IAA provides. *Id.* at 7.

Ms. Armstrong testified the OUCC is also concerned that the manner of calculating the system cost of compliance overstates the true cost of the allowances contained within the bank. *Id.* She explained that the IAA states that the system cost of compliance for the calendar year 1995 was \$115.43 per ton, and for each subsequent year, the system cost of compliance is then escalated annually at a rate of 10.56%. Therefore, the system cost of compliance is not calculated by the actual value of the allowances contained within the bank, but is based on the value of allowances at one particular point in time and the subsequent escalation of this amount at a high rate. *Id.* According to Ms. Armstrong, the OUCC is concerned that this manner of calculating the system cost of compliance overstates the true cost of the allowances contained within the bank. Particularly, the OUCC is concerned that this unnecessarily inflates the consumption costs of allowances for I&M customers. Ms. Armstrong testified that when I&M is required to purchase or add allowances to its inventory at an inflated rate, it causes the WAI of its SO₂ allowances to increase substantially. *Id.* Ms. Armstrong indicated that in the current filing, I&M was required to purchase over 16,000 allowances from the AEP system at a system cost of \$470.64 per ton, resulting in the monthly cost to consume allowances to more than double for I&M's ratepayers. *Id.* at 7-8. Ms. Armstrong stated that an alternative and more equitable method for determining the system cost of compliance would be to do an annual calculation. *Id.* at 8.

Finally, Ms. Armstrong testified that future EPA regulations could be incompatible with the IAA. *Id.* She stated that since the beginning of 2010, CAIR requires any SO₂ allowances of 2010 vintage or later to be surrendered at a 2 to 1 ratio, or two allowances be surrendered for every one ton of SO₂ emitted. Whereas, she further stated, any banked SO₂ allowances of 2009 vintage or earlier may be surrendered at a 1 to 1 ratio to meet compliance requirements for 2010 and beyond. She explained that as a result of CAIR, many companies are finding that it is easier and more beneficial to separate these two types of allowances into two separate inventories. *Id.* Ms. Armstrong stated that this creates incompatibility with the IAA in two ways. First, the IAA appears to be written in a manner that, consistent with the acid rain regulations when drafted, assumes a 1 to 1 surrender ratio for allowances from member companies. *Id.* at 8-9. Secondly, since AEP and member companies are keeping two separate allowance inventories, the method of determining the system cost of compliance for the 2010 and later vintage inventories is not consistent with what the agreement specifies. *Id.* at 9.

Ms. Armstrong testified that CAIR will likely be replaced by the CATR within the next two years. *Id.* She explained that as currently proposed, the CATR allows for intrastate emission allowance trading and limited interstate trading. She added that it is also important to note that sources will not be able to use allowances banked prior to 2012 in order to cover its emissions. Ms. Armstrong noted EPA is also proposing alternatives to the rule that would implement stricter standards than the proposed rule. The first alternative would only permit intrastate emission

allowance trading; but in the second alternative, EPA would set a pollution limit for each state and specify the allowable emission limit for each power plant. *Id.* at 9-10. Ms. Armstrong further testified there is a possibility that no interstate trading will be allowed in the final version of CATR, or even if the CATR allows interstate trading it will be very limited. Ms. Armstrong stated that for the provisions of the IAA to work, members must be able to freely trade allowances with other members. She explained this is not likely to occur under future scenarios if CATR is implemented. She also explained that CATR may eliminate the availability of previously banked allowances for compliance purposes, which may render the provisions regarding the AEP system allowance bank unnecessary. *Id.* at 10. Ms. Armstrong testified it is for these reasons that the OUCC believes that it is necessary for the IAA to either undergo major modifications or be suspended completely. *Id.*

Ms. Armstrong stated that the IAA is a FERC-approved agreement that has been reviewed by the Commission and has existed for more than 15 years, and the OUCC does not oppose the recovery of IAA settlements in this ECCR. *Id.* However, according to Ms. Armstrong, the OUCC believes there is value in AEP re-visiting the IAA to rectify the issues raised by the OUCC and modernizing the agreement to reflect considerable changes in air regulations. *Id.* Ms. Armstrong testified that developing and obtaining approval of a new allowance agreement will take several years and considerable coordination with many state commissions and parties to complete; but nevertheless, the company must begin preparing for changes in the law, and considering either a new allowance agreement, or its dissolution, as part of the company's planning process. *Id.* at 10-11. Ms. Armstrong suggested the OUCC and I&M meet to discuss the issues she raised regarding the IAA.

Ms. Armstrong stated that with the exception of the concerns noted in her testimony, nothing indicates I&M's calculation of the ECCR factor for the relevant period is unreasonable. *Id.* at 12. She also stated that none of the issues she raised change the proposed ECCR factor calculated by I&M. *Id.* But, she stated the OUCC feels it is necessary for the Commission to determine whether the Consent Decree emission allowance surrender costs are permitted to be recovered through rates to avoid any confusion in calculating future ECCR factors. Lastly, Ms. Armstrong stated all of the documentation the OUCC requested was provided by I&M with its workpapers in this filing. She requested that I&M continue to provide supporting workpapers in subsequent ECCR filings. *Id.* at 13.

7. Petitioner's Rebuttal Testimony. I&M witness Kelly D. Pearce provided rebuttal testimony on the various issues raised by the OUCC, including the OUCC's concern that each company must own its MLR share of system allowance bank; how the system cost of compliance is calculated within the IAA; and future EPA air regulations being incompatible with the IAA.

Mr. Pearce first responded to Ms. Armstrong's concern that each company must own its MLR share of the system allowance bank. Pet. Ex. 4 at 4. He explained that this concern is driven by I&M's ownership of nuclear generation. He noted that the final settlement of the IAA in the FERC filing dated June 21, 1996, at page 4, stated that:

[T]he proposed amendments simplify the administration of the agreement by eliminating the need to estimate each Member's future compliance needs. In addition, MLR sharing of the System bank is consistent with the proposed MLR sharing of costs and revenues associated with sales of allowances to non-affiliates.

He pointed out that this agreement was reached among the participating stakeholders in 1996 with full knowledge at the time that I&M had nuclear generation. *Id.* Mr. Pearce also stated that Ms. Armstrong did not raise this concern in Cause No. 43306 when she was similarly describing the system allowance bank. *Id.* Mr. Pearce acknowledged that I&M has nuclear generation and therefore emits less SO₂, and receives fewer EPA allowances relative to its total generation compared to the other member companies. However, Mr. Pearce testified that the impact of a given member company buying or selling allowances from the system bank in a given year is impacted predominantly by the environmental control activities performed by each of the companies. *Id.* at 4-5. Mr. Pearce indicated over the last five years of the system allowance bank settlement, I&M has been a net seller of allowances in the years 2006 through 2008. Only in the last two years, as other companies took initial or additional efforts to reduce their SO₂ emissions, has I&M been a net purchaser of allowances in the system bank. *Id.* at 5.

Mr. Pearce also responded to Ms. Armstrong's concern regarding the requirement to purchase allowances at the system cost of compliance. *Id.* He testified that the system cost of compliance was intended to reflect a cost-based price for allowances between the companies based on the incremental cost of remediation. The average embedded cost of allowances includes allowances allocated at zero cost by the EPA, and consequently does not reflect the cost impacts that occur when emissions are reduced at the margin. *Id.* He stated that it was recognized at the time of the previously described IAA settlement that such cost would not necessarily reflect the market prices since these would be a function of how the rest of the CAA impacted utilities responded in their compliance plans, *i.e.*, by building scrubbers, fuel switching, and/or purchasing. *Id.*

Mr. Pearce responded to Ms. Armstrong's third concern that future EPA air regulations could be incompatible with the IAA. He testified that since the system cost of compliance, as defined in Section 1.32 of the IAA, is based on tons of SO₂, the system cost of compliance was divided accordingly for allowances that would be subject to surrender under 2-for-1 compliance. *Id.* at 5-6. He stated that consequently, pre-2010 vintage allowances which preserve their 1 to 1 ratio of allowances surrendered per ton of SO₂ emitted were purchased at the cost of \$520.34/allowance. He further explained the 2010 allowances were purchased at half of this rate, namely \$260.17/allowance, since each allowance is associated with only one-half of a ton of SO₂. He testified that Exhibit KDP-1 shows how the purchases of these vintages resulted in the overall blended cost of \$365.39/allowance. *Id.* at 6.

Mr. Pearce responded to Ms. Armstrong's concerns about the CATR and future potential environmental regulations. He explained that I&M is in full agreement that the IAA is in need of revisiting. He noted that it is in part for this reason that I&M and all of the other member companies noticed each other on December 17, 2010 to terminate the AEP Interconnection Agreement under the three-year notice provision. He added that since the IAA is a companion agreement to the AEP Interconnection Agreement, it is anticipated that it too will be terminated or replaced with a new superseding agreement concurrently with a similar action addressing the AEP Interconnection Agreement. *Id.*

I&M witness John C. McManus responded to the OUCC's testimony of Ms. Armstrong regarding allowances surrendered pursuant to the Consent Decree. Pet. Ex. 5 at 3. Mr. McManus explained that on October 9, 2007, AEP and certain affiliated operating companies (the "AEP Companies") entered into a Consent Decree with the Department of Justice, the EPA and others to

resolve all complaints filed against the AEP Companies, including I&M, related to the NSR provisions of the CAA. *Id.* Per Mr. McManus, the negotiated settlement agreement 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. The AEP Companies admitted no violations of law and all claims against them were released. *Id.* Mr. McManus sponsored a copy of the Consent Decree, which was admitted as Petitioner's Exhibit JMM-R1.

Mr. McManus testified the NSR litigation was not unique to AEP. Pet. Ex. 5 at 3. According to Mr. McManus, on the same day that the complaint was filed against the AEP Companies, similar complaints and notices of violation were filed for alleged violations of the NSR provisions of the CAA against several other utilities. He testified several of those cases were settled on terms similar to those included in the AEP Consent Decree. *Id.* at 3-4.

Mr. McManus further summarized the portions of the Consent Decree that affect I&M's generation. *Id.* at 4. He stated the Consent Decree provides a schedule for the installation of NO_x and SO₂ controls and places a declining cap on AEP Eastern System-wide emissions of SO₂ and NO_x. Mr. McManus stated, as previously explained in his direct testimony in I&M's recent rate case, the Consent Decree includes retrofit of selective catalytic reduction ("SCR") and flue gas desulfurization ("FGD") on Rockport Unit 1 by no later than December 31, 2017 and retrofit of SCR and FGD on Rockport Unit 2 by no later than December 31, 2019. *Id.* In addition, from the effective date of the Consent Decree, Tanners Creek Units 1-3 will continue burning coal with sulfur content no greater than 1.2 lb/mmBtu on an average annual basis, and Tanners Creek Unit 4 will continue burning coal with sulfur content no greater than 1.2% on an annual average basis. Mr. McManus testified that all four units at Tanners Creek will continue to operate their existing NO_x combustion controls. Further, the Consent Decree also includes annual caps on NO_x and SO₂ emissions from the AEP Eastern System units, and provisions for surrendering a portion of the allowances allocated to the AEP Eastern System units that exceed the caps. *Id.*

Mr. McManus testified that I&M's ECCR filing includes \$11,615 of costs associated with the surrender of NO_x allowances incurred during the reconciliation period in its calculation of the ECCR factor for this filing. He stated this is a total Company amount and the Indiana retail jurisdictional amount actually reflected in the proposed factors in this proceeding is \$7,574. *Id.* at 4-5.

Next, Mr. McManus testified regarding the provisions of the Consent Decree relating to the surrender of allowances. According to Mr. McManus, the Consent Decree provisions identified by Ms. Armstrong are set forth in Section IV of the Consent Decree – titled NO_x Emission Reductions and Controls. He noted there are similar provisions in Section V of the Consent Decree – titled SO₂ Emission Reductions and Controls. *Id.* at 5.

Mr. McManus stated that Section IV, Paragraphs 70 through 80 of the Consent Decree provide for the use and surrender of annual NO_x allowances. Beginning in 2009, under a formula set forth in the consent decree, AEP is required to identify the number of Restricted NO_x allowances potentially subject to surrender in 2016 by the AEP East Operating Companies, including I&M. *Id.* He noted a description of the formula is set forth in I&M Exhibit JMM-R2. *Id.* Per Mr. McManus, 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. The same procedure is followed for SO₂ allowances subject to

surrender under Section V of the Consent Decree at the end of calendar years beginning in 2010. Mr. McManus stated it is his understanding that the reconciliation period in this case extended only through November 2010. *Id.*

Mr. McManus disagreed with Ms. Armstrong's and the OUCC's contention that the allowance surrender costs associated with the Consent Decree are a "form of penalty for the Company's alleged environmental violations" because it contradicts the plain language of the Consent Decree, its purpose and the public policy favoring settlement. *Id.* at 6. He explained surrendering allowances that exceed the caps on AEP Eastern System emissions helps to assure that real emission reductions are maintained, and that emissions, in the form of allowances, are not just transferred to units outside the AEP Eastern System. *Id.*

Finally, Mr. McManus responded to Ms. Armstrong's concern that if the surrendered allowances are permitted to be recovered through rates, I&M customers will be charged more in consumption costs without receiving an additional benefit for the allowance surrender. *Id.* at 7. Mr. McManus stated that the obligation to surrender NO_x allowances under the Consent Decree has not resulted in any decrease in the amount of power generated for customer needs or off-system sales. *Id.* He testified that Ms. Armstrong fails to recognize the allowance surrenders were a negotiated part of the compliance requirements included in the Consent Decree, assure that the system-wide emission reductions are achieved, and help to provide an end to the uncertainty associated with this multi-year litigation, all of which benefits I&M's customers. He stated although I&M may incur a small incremental cost for additional NO_x allowances, the alternative would be to install additional NO_x controls at a much higher incremental cost. *Id.*

8. Commission Discussion and Findings. As an initial matter, we note that the ultimate factor to be approved in this ECCR proceeding is not in controversy. The parties agree and the Commission finds, as set forth further below, I&M's requested ECCR factor should be approved. However, the OUCC raised two specific concerns with I&M's filing, *i.e.*, the IAA and the surrendered emission allowance costs, which we address below.

A. Interim Allowance Agreement. The OUCC's concerns regarding the IAA do not change the proposed ECCR factor in this proceeding. The record reflects that Ms. Armstrong's concerns about the IAA were adequately addressed in I&M's rebuttal testimony. In particular, Mr. Pearce explained that I&M and the other member companies intend to terminate the AEP Interconnection Agreement, and it is anticipated that the IAA will be terminated or replaced with a new superseding agreement concurrently with a similar action addressing the AEP Interconnection Agreement. I&M has indicated that it looks forward to working with all of the stakeholders, including the OUCC, to determine the future of the IAA that will include consideration of the OUCC's concerns raised herein. Therefore, we find that such costs, which are incurred pursuant to a FERC-approved agreement that has existed for more than 15 years, are recognizable for ratemaking purposes and are properly included in I&M's calculation of its ECCR factor.

B. Recovery of Surrendered Emission Allowance Costs. Although the OUCC did not object to the proposed ECCR factor, it did object to the inclusion of costs associated with NO_x

allowances surrendered pursuant to the Consent Decree.¹ The OUCC argued, among other things, these costs are a form of penalty for alleged environmental violations and result in additional costs that I&M's ratepayers should not have to bear. I&M disagreed, asserting the emission allowance surrender provision was not contained in the penalty portion of the Consent Decree and the associated costs are legally mandated because the allowance surrenders are required by the Consent Decree. The parties also disagreed as to whether the Settlement Agreement, as approved by the Commission's Order in *Indiana Michigan Power Co.*, Cause No. 43306 (IURC March 4, 2009) ("43306 Order"), authorized recovery of the allowance surrender costs incurred pursuant to the Consent Decree.

First, we note that neither the Settlement Agreement nor the Commission's 43306 Order specifically address whether the costs of the NO_x emission allowances surrendered under the Consent Decree were contemplated as being included or excluded from the ECCR tracker. Rather, the Settlement Agreement simply provides for the approval of an environmental tracker "for the purpose of tracking net emission allowances." 43306 Order, Stipulation and Settlement Agreement at 6. However, the Commission noted in its June 23, 2010 Order in Cause No. 43856 at 7, the evidence presented in Cause No. 43306 "supports a finding that the ECCR agreed upon by the parties was to track SO₂ and NO_x emission allowance costs...." Accordingly, the Commission has previously found NO_x emission allowance costs are a type of cost that may be included in the ECCR.

However, the mere fact that the Commission has authorized the implementation of a tracker to recover NO_x emission allowance costs does not mean that I&M is automatically authorized to recover any and all NO_x emission allowance costs it may incur. The Commission's approval of any costs requested for recovery in a tracker proceeding has always been subject to a prudence review wherein the utility must demonstrate its requested rate relief is just and reasonable. *See*, Ind. Code § 8-1-2-4 (requiring every charge made by a public utility to be "reasonable and just"); *see also, e.g., Southern Ind. Gas & Elec. Co.*, 43406 RCRA 6 (IURC Sept. 1, 2010); *Indpls Power & Light Co.*, 42170 ECR 15 (IURC Aug. 25, 2010).

I&M relies heavily on the Consent Decree and its terms as supportive of its request to recover the NO_x emission allowance surrender costs. However, based on the evidence presented, I&M has failed to adequately demonstrate that its agreement to surrender NO_x emission allowances and the costs associated with the surrender are just and reasonable. While a Consent Decree is a court-approved settlement agreement with the federal government resulting in legal obligations with which I&M must comply, the decision to enter into the Consent Decree was voluntary. Consequently, if I&M wishes to seek recovery of specific costs incurred as a result of its decision to enter into the Consent Decree, it is incumbent upon I&M to demonstrate that its decision to incur those costs was prudent and that the inclusion of such costs in customer rates is just and reasonable.

While Mr. McManus opined the emission allowance surrender cost is reasonable because such cost is less than the alternative (*i.e.*, installation of NO_x controls), I&M failed to offer sufficient evidence demonstrating recovery of the emission allowance surrender costs incurred pursuant to the Consent Decree was reasonable. Nor does the fact that other utilities have entered into Consent Decrees and received Commission approval to recover certain associated costs provide sufficient

¹ The total jurisdictional costs proposed to be included in the ECCR for the emission allowance surrender is approximately \$7,400. Its inclusion or exclusion in the calculation results in no material difference in the resulting factor.

evidentiary support that I&M should be authorized to recover the allowance surrender cost it is requesting herein. Furthermore, I&M's assertion that the surrender of emission allowances is not a "penalty" because the Consent Decree, an agreement drafted by I&M and the federal government, does not identify the surrender as such is not conclusive evidence that it is not in fact a "penalty."

Consequently, as this case presents an issue that warrants further review, we find that a subdocket should be convened to explore through the submission of additional evidence whether I&M's request to recover the emission allowance surrender costs is just and reasonable.

C. Approval of ECCR factor. Based upon the evidence of record, and consistent with our discussion above, the Commission approves I&M's proposed Environmental Compliance Cost Rider factor as shown on Petitioner's Exhibit SMK-5 subject to refund of the cost associated with the surrender of emission allowances based upon the outcome of the subdocket proceeding.

D. Approval of Docketing Convention. In its Petition, I&M sought approval to use a standard docketing convention for future ECCR filings. We find that, consistent with the Commission's current docketing convention for other tracker filings, I&M shall use a docketing convention for the next and subsequent annual ECCR filings. Therefore, the next annual filing following issuance of this Order shall be Cause No. 43992 ECCR 1.

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

1. Petitioner's proposed Environmental Compliance Cost Rider factor shall be and hereby is approved, subject to the Commission's findings in the subdocket proceeding as discussed above.

2. Petitioner shall file with the Electricity Division of the Commission its tariff reflecting the approved Environmental Compliance Cost Rider factor in the form of Exhibit SMK-5.

3. A subdocket proceeding, Cause No. 43992 S1, is hereby established in accordance with Paragraph 7.B. A Prehearing Conference and Preliminary Hearing shall be held on July 26, 2011 at 9:30 a.m. in Room 224, 101 West Washington Street, Indianapolis, Indiana.

4. Petitioner shall file its next and subsequent ECCR filings in accordance with Paragraph 7.D.

5. This Order shall be effective on and after the date of its approval.

ATTERHOLT, BENNETT, MAYS AND ZIEGNER CONCUR; LANDIS ABSENT:
APPROVED: JUN 22 2011

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



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