STATE OF MISSOURI
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held at its office in Jefferson City on the 26th day of August, 1992.

In the matter of the application of Kansas City Power & Light Company for review of its Phase I Compliance Plan and other activities under the Clean Air Act.	))))	Case No. EO-92-250

ORDER ESTABLISHING JURISDICTION AND CLEAN AIR ACT WORKSHOPS

On March 27, 1992, Kansas City Power & Light Company (KCPL) filed an application with the Commission requesting:

(1) a determination that a sale or other disposition by KCPL to a third party of sulfur dioxide emission allowances created by the Clean Air Act does not require Commission approval under Section 393.190, R.S.Mo.; and

(2) an order instituting a proceeding to review and approve (a) KCPL's Phase I Compliance Plan and associated elections under the federal Clean Air Act (42 U.S.C.S. 7401 et seq.) and (b) KCPL's Clean Air Act compliance planning methodologies and procedures.

On April 15, 1992 the Commission issued and Order And Notice establishing a date for a prehearing conference and an intervention date. Union Electric Company (UE), St. Joseph Light & Power Company (SJLP), The Empire District Electric Company (Empire) and Missouri Public Service (MPS) were granted intervention, and the prehearing was held as scheduled on May 28, 1992.

As a result of the prehearing conference the parties filed a Prehearing Conference Memorandum. In the memorandum the parties identified three general issues which they recommended be addressed by the Commission in this docket. The three areas are (1) whether sales or other disposition of SO_2 allowances, created by the Clean Air Act Amendments of 1990 (CAAA), require Commission authorization under Section 393.190.1, R.S.Mo. (1986); (2) whether KCPL's EPA Phase I permit application, and the various elections KCPL made and declined to make, should be

reviewed and approved by the Commission; and (3) whether proceedings should be instituted to identify and analyze the various operational, rate and accounting issues raised by the CAAA.

The parties proposed that the Commission adopt a briefing schedule for areas (1) and (2), which the Commission subsequently did. Briefs were filed and this order will address the points raised by the parties concerning issues (1) and (2).

I. Does Section 393.190.1 require Commission authorization before SO_2 emission allowances can be sold or transferred?

Section 393.190.1 requires an electrical corporation operating as a public utility, such as KCPL, which is subject to the Commission's jurisdiction to obtain authority from the Commission before it can "sell, assign, lease, transfer, mortgage or otherwise dispose of or encumber the whole or any part of its franchise, works or system, necessary or useful in the performance of its duties to the public...." This provision is designed to ensure the continuation of adequate service to the public served by the utility. ***State ex rel. City of St. Louis v. P.S.C.***, 73 S.W.2d 393, 400 (Mo. banc 1934).

In 1990 the United States Congress enacted the CAAA (Clean Air Act Amendments of 1990), which included provisions to reduce the amount of sulfur dioxide emissions annually by establishing a base line of emissions for each steam-electric generating unit and requiring each unit to meet emission limitations by specified deadlines. The emission limitations can be met through alternative methods, including an emission allocation and transfer system. The Act also encourages energy conservation, use of renewable and clean alternative technologies, and pollution prevention. 42 U.S.C.S. §§7651 et seq.

The emission allocation and transfer system established by the Act consisted of annual allowances allocated for each unit which can be held or distributed by a utility equal to the annual tonnage emission limitation calculated under various provisions of the CAAA. 42 U.S.C.S. §7651b. These allowances may either be used in the designated year or banked for future use.

KCPL has filed a request in this case for the Commission to determine whether the selling or other disposition of the emission allowances is subject to Commission approval under Section 393.190.1. The CAAA anticipates and encourages a national market of allowance trading to allow utilities flexibility in meeting the emission limitations established in the Act. KCPL, UE, SJLP and MPS contend that allowances are not subject to Commission jurisdiction pursuant to Section 393.190 since they are not part of KCPL's "franchise, works or system", while Commission Staff (Staff) and the Office of Public Counsel (OPC) contend that the allowances are a part of KCPL's "franchise, works or system" and thus any transfer or sale made without Commission authority is void.

KCPL generally contends that the phrase "franchise, works or system" encompasses (a) the buildings, machinery and other property used to generate electricity; (b) the property used to transmit and distribute electricity and otherwise run the business; and (c) the rights granted by municipalities and counties to locate public utility property on public rights of way. In addition, KCPL and other parties argue that the allowances do not constitute a property right and therefore inferentially are not part of its franchise, works or system.

The Commission finds that the question of whether the allowances constitute a property right under federal law is not particularly germane to the issue of whether they are part of a utility's franchise, works or system under Missouri law. Even though the CAAA explicitly states that the allowances do not constitute a property right, the CAAA also states explicitly that nothing in the Act shall be construed as requiring a change in State law regulating electric

utility rates and charges or affecting State law regarding State regulation or as limiting State regulation (including any prudence review) under such a State law. 42 U.S.C.S. §7651b(f). Commission jurisdiction over the sale of allowances does not hinge on whether they are property rights of KCPL.

To decide whether allowances are part of KCPL's franchise, works or system, the Commission must look to the statutory language and intent of Section 393.190.1. The section states that:

> No gas corporation, electrical corporation, water corporation or sewer corporation shall hereafter sell, assign, lease, transfer, mortgage or otherwise dispose of or encumber the whole or any part of its franchise, works or system, necessary or useful in the performance of its duties to the public, nor by any means, direct or indirect, merge or consolidate such works or system, or franchises, or any part thereof, with any other corporation, person or public utility, without having first secured from the commission an order authorizing it so do to. Every such sale, assignment, lease, transfer, mortgage, disposition, encumbrance, merger or consolidation made other than in accordance with the order of the commission authorizing same shall be void.

There has been argument presented concerning the term "franchise" and whether it would include allowances created by federal statute. The Commission finds that it need not address this question since its decision concerning the terms "works" and "system" resolves the issue of its authority over the sale or transfer or allowances.

The term "works" as supported by KCPL and the other utilities could be limited to a literal meaning of things physical in nature, part of the tangible property used to generate electricity. The same limitation could be placed on the term "system", thus indicating that "system" is almost a redundancy of "works". The Commission does not believe the term "system" is intended to be so literally construed. It is, of course, true that court cases and Commission decisions interpreting Section 393.190 have dealt with tangible property such as generating plants, transmission lines and substations. Those are the issues that have been before the courts and the Commission and concerning which decisions

were made. The Commission, though, believes that a utility's system is greater than the physical parts which would be its "works". A utility's system is the whole of its operations which are used to meet its obligation to provide service to its customers. ***City of St. Louis*** at 400. The U.S. Congress has mandated that KCPL meet emission standards. Those standards are based upon KCPL's steam-electric generating units. To enable KCPL to meet the emission limits, Congress created emission allowances which attach to each generating unit. These emission allowances have been made an integral part of KCPL's generating facilities and, thus, an integral part of its generating system. KCPL must utilize these allowances in meeting its obligations under the CAAA and in meeting its obligations to its Missouri ratepayers. The Commission finds that emission allowances are necessary and useful in the performance of KCPL's duties to the public and are part of KCPL's "system", and any sale or transfer of these allowances is void without prior Commission approval.

Even though the Commission has found that allowance sales or transfers are subject to its jurisdiction, the Commission does not intend to impede the trading of those allowances under any reasonable plan proposed by KCPL. All parties agree that flexibility is mandatory if a utility is to obtain maximum benefits from the national allowance market which is anticipated. The Commission anticipates that KCPL will file an application for authority to sell or transfer allowances which allows for this necessary flexibility. This could take the form of a request for blanket authority for sale or transfer of a maximum number of allowances within a certain time period and within a certain price range. Although a limited time period would entail periodic requests for authorization, approval of a plan should still allow KCPL flexibility while ensuring the Commission's statutory obligations are fulfilled. In addition, these periodic filings and authorizations would not preclude an in-depth review of KCPL's actions by the Commission in some later proceeding or indicate the approval of

any ratemaking treatment for the allowances or proceeds generated by these sales or transfers.

II. Should the Commission engage in a review and approval process regarding KCPL's Phase I permit application and related elections and decisions?

The reduction of SO_2 emissions by steam-electric generating units is to be achieved in two phases. Phase I requires specifically identified units to reduce emissions beginning in 1995. Phase II requires compliance with emission standards by essentially all existing fossil fueled boilers, including Phase I units, that serve electric generators with a capacity greater than 25 megawatts, and all new generating units. Phase I and Phase II compliance plans must be filed by utilities which show how the utility plans to use emission allowances or other alternatives to cover the annual SO_2 emissions of affected units. The Phase I compliance plan must be filed by February 15, 1993 and Phase II compliance plan must be filed by January 1, 1996.

KCPL has three Phase I units, Montrose Units 1, 2 and 3. KCPL owns all or portions of four Phase II units, Iatan, Hawthorn 5, and LaCygne 1 and 2. Based upon the agreement of the parties, KCPL is seeking review by the Commission of specific elections with regard to Phase I and Phase II compliance and proposes that operational rate and accounting issues be the subject of workshops. The specific elections which KCPL is requesting the Commission review and approve are: (a) its EPA Phase I permit application, (b) its election concerning the calculation of LaCygne 2 and Iatan allowances, (c) its election concerning Phase I Montrose allowances, (d) its decision to apply to have Hawthorn 5 designated as a "substitution unit" under §404(b), and (e) its decision to decline to obtain "extension unit" status for Montrose 1-3 under §404(d).

KCPL contends that none of the five matters presented for review is complex and the Phase I and Phase II allowance elections are based on straightforward calculations of the various alternatives for which KCPL chose the alternatives which yielded the most allowances. KCPL's states that its decision not to install scrubbers on Montrose Units 1-3 during Phase I is based as well on a direct comparison of the cost of the scrubbers with the reasonably expected value of the associated allowances. It is KCPL's contention that the prudence of its attempt to have Hawthorn 5 designated as a substitution unit is also easily determined at this time. Finally, KCPL states that its Phase I permit application simply reflects KCPL's decisions on the Phase I-related matters.

KCPL has indicated it is not asking the Commission to review and determine now the prudence of its long term plan to meet the energy requirements of its customers in compliance with the CAAA. As indicated by KCPL, the long term plan will be the focus of the informal workshops and the IRP filings, once they begin. KCPL's position, basically, is that since these actions will be subject to review, the timing of the prudence review should be now rather than later. Staff agrees that a prudence review of the five items could be performed as requested.

KCPL's optimistic statement that the matters for which it seeks a prudence review are easily reviewed may be true of the five items but it does not fit with the Commission's understanding or the commenters' remarks concerning the proper focus of a review of CAAA compliance plans. The ***Interim Report From The Keystone Dialogue On State Regulation Of Allowance Trading*** indicates that early policy guidance by a state commission "should provide guidance on compliance options and constraints and should begin to establish criteria and regulatory processes that will be used to review and approve plans and their implementation at later stages." ***Mimeo*** at p. 8. The interim report presents thirteen issues and recommendations concerning this early review. The issues and recommendations

are: integrated resource planning, compliance options, allowance reserves, allowance banking, economic dispatch incorporating environmental compliance costs, allowance transactions, allowance price forecasting, allowance pooling, Phase I extension allowance pooling, interjurisdictional allowance distribution, cost recovery mechanisms, reporting requirements, and planning objectives and horizon. ***Mimeo*** at pp. 9-14.

The National Regulatory Research Institute (NRRI) presents a similar list and discussion of the complex issues involved in CAAA compliance in its May 1992 report, ***Public Utility Commission Implementation Of The Clean Air Act's Allowance Trading Program***. The NRRI report gives a brief discussion of issues similar to the Keystone report and states rather significantly that "if a state commission preapproves a compliance plan, it relieves the utility of any significant risk of underrecovering its costs and impedes future adjustments or innovations that would improve the efficiency of the system within the preapproved period.... The effect can be dramatic if allowance prices turn out to be low relative to scrubbing costs, and the preapproval compliance plan included *significant investments in scrubbers*." ***Mimeo*** at p. 77.

The Commission recognizes that compliance with the CAAA and participation in the allowance trading market create unique and complex pressures on a utility. The Commission also recognizes that the traditional ratemaking prudence review procedures may inhibit the development of the most cost-effective and efficient compliance plan. Particularly, the tradeoffs between allowance purchases and emission control technology could be significant, depending upon the market price of allowances.

The Commission, though, also recognizes the problems inherent in preapproval. As noted by the NRRI report, there are four problems with preapproval or a periodic review process of a utility's decisions. The first problem is the potential for the shifting of technology and demand risks from the

shareholders to the ratepayers. The second problem is the significant resources preapproval or periodic approval would require of the Commission. The third problem, as stated earlier, is, preapproval is likely to lock the utility into the plan approved by the Commission. The fourth problem is that, once approved, a utility may have less incentive to closely scrutinize its costs.

The NRRI report recommends that rather than engage in preapproval or periodic approval of utility decisions, state commissions issue clear guidelines detailing the Commission's regulatory approach toward CAAA compliance. This approach, the report states, would tend to reduce regulatory risk without the potential of shifting technological and demand risks to ratepayers.

The Commission is generally in agreement with the approach proposed by these two reports. In addition, the Commission is of the opinion that review of individual decisions of a utility as they are making those decisions could involve the Commission in the management of the utility. Decisions concerning how best to meet the requirements of the CAAA are management decisions and it is management which should do the appropriate analyses and weigh the risks. Part of the risk that management must consider is the regulatory risk, i.e., the risk associated with Commission review.

The Commission agrees with the commenters that the reduction of regulatory risk in the area of CAAA compliance would allow the primary focus of management decisions to be on the most cost-effective method of compliance rather than cost recovery. The Commission, though, agrees with the commenters that Commission preapproval could reduce a utility's options or ability to change its decisions, and thus it could be an impediment to cost-effectiveness rather than a benefit.

The Commission also is of the opinion that decisions made concerning CAAA compliance will play an important part in a utility's integrated resource plan (IRP). Even though KCPL's five decisions are made now, they will affect its

IRP proposals, especially those elections which affect Phase II requirements. The Commission is concerned that actions taken now do not limit alternatives for compliance with the CAAA or the IRP rule. In addition, UE, SJLP, Empire and MPS imply from their briefs that they see no need for preapproval, and the Commission is not convinced it should preapprove compliance plans for one utility and not for others.

At the early stages of the CAAA compliance process, the Commission would be willing to provide guidance and general policy considerations. The Commission, though, finds it is not reasonable to begin the preapproval process prior to establishing those general guidelines and policy considerations. By taking a position on these five matters, the Commission could be making policy judgments without a full review of all policy considerations. The Commission finds that its participation in the CAAA compliance process at this stage should be similar to that suggested by the Keystone report and the NRRI report, that is, establishing general policy guidelines.

The parties should meet and discuss which policy considerations should be presented to the Commission and whether a process similar to that proposed in the IRP rulemaking, Case No. EX-92-299, should be utilized, or should the consideration be a part of the discussion in the workshops for identifying and addressing operational, rate and accounting issues raised by the CAAA.

III. Should informal workshops be established for identifying and addressing operational, rate and accounting issues?

The Prehearing Conference Memorandum filed by the parties states that there are a myriad of issues which are raised by the requirements of the CAAA. These issues include, among others: (1) should SO_2 allowances be factored into economic retail dispatch decisions, and if so, how; (2) how should prudent allow-

ance inventory levels be calculated; (3) how should allowances held for long term compliance purposes be treated for accounting and ratemaking purposes; (4) how should the proceeds of allowance sales be treated for accounting and ratemaking purposes; (5) to the extent that bulk power sales use up allowances that could otherwise be used to provide retail service, what are the indicia of "prudent" bulk power sales; (6) what information concerning utility operations under the CAAA will be required by the Staff; and (7) whether regulatory incentives should play a role in allowance trading.

The parties indicate that the above issues are not ripe for Commission determination. EPA has not issued its final regulations and the allowance trading market has not been formed. To help identify additional issues and address those described above, the parties are proposing the establishment of informal workshops. KCPL states that these workshops will result in the proposal of policies and other actions for Commission consideration.

The Commission finds that the informal workshop format is reasonable and should be adopted. The complexity of compliance with the CAAA and the resultant effects on electric utilities and the Commission's ratemaking process are subjects that need detailed and thorough analysis. As stated earlier, the Commission is not committing itself to the complete strategy of regulation of CAAA compliance proposed by the reports, but it does believe that the procedures proposed in the Keystone report and the NRRI report should be addressed and, where found appropriate, presented for Commission consideration.

As indicated in the previous section on preapproval, the Commission would consider adopting some type of guidelines for CAAA compliance. The workshop approach or a procedure such as that proposed for the IRP is preferable to preapproval of specific utility management decisions. The Commission's main goal is to allow sufficient flexibility so that the most cost-effective options can be considered and adopted by the utilities.

IT IS THEREFORE ORDERED:

1. That the sale or other disposition of emission allowances created by the Clean Air Act Amendment of 1990 is subject to Commission jurisdiction pursuant to Section 393.190, R.S.Mo. (1986).

2. That the Commission will not engage in preapproval of Kansas City Power & Light Company's decisions and elections concerning compliance with the Clean Air Act Amendment of 1990 as requested.

3. That the parties shall participate in informal workshops to be scheduled by Commission Staff to consider rate, accounting and other issues raised by the Clean Air Act Amendment of 1990.

4. That this order shall become effective on the 8th day of September, 1992.

BY THE COMMISSION

Brent Stewart

Brent Stewart
Executive Secretary

(S E A L)

McClure, Chm., Mueller, Rauch
and Kincheloe, CC., concur.
Perkins, C., absent.