State of Alabama

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SECRETARY

Alabama Power Company,
Petitioner

Petition: Request for Certain Authorizations Related to the Effects of Pending Environmental Mandates.

Informal Docket No. U - 5033

ORDER

BY THE COMMISSION:

On August 24, 2011, Alabama Power Company ("Alabama Power" or the "Company") petitioned the Alabama Public Service Commission ("Commission") for certain authorizations related to cost impacts that could result from the implementation of new regulations by the Environmental Protection Agency ("EPA")[1]. Specifically, the Company seeks authorization to establish a regulatory asset on its balance sheet in which it would record the unrecovered investment cost associated with full or partial unit retirements caused by such regulations, including the unrecovered plant asset balance and the unrecovered cost associated with site

[1] While most of these new regulations remain under consideration, the Cross-State Air Pollution Rule ("CSAPR") was finalized by EPA in July. CSAPR establishes new standards relating to sulfur dioxide (SO_2) and nitrogen oxide (NOx) emissions in 27 states (including Alabama). A compliance strategy related to this new rule is still being developed. Other proposed air quality regulations being considered by EPA include new national emission standards for hazardous air pollutants from coal-fired and oil-fired electric generating units (the "EGU/HAPS MACT rule"), new national ambient air quality standards relating to ozone, particulate matter, sulfur dioxide and nitrogen dioxide, and new standards relating to the emission of greenhouse gases by natural gas, coal-fired and oil-fired electric generating units. EPA also is considering new standards under the Resource Conservation and Recovery Act for the management of coal combustion by-products generated by commercial electric power producers and proposed standards under the Clean Water Act to reduce the impacts to aquatic life associated with cooling water intake structures, to minimize the effects of thermal discharges, and to otherwise protect water quality. For ease of reference, all of these regulations (including the recently enacted CSAPR) are characterized herein as proposed or pending regulations.

Each of the regulations referenced above has the potential to require Alabama Power to incur costs in order to meet new requirements. The EGU/HAPS MACT rule is of particular concern due to the stringency of the proposed standards and the extremely short compliance deadlines. Specifically, the proposed rule contemplates the installation of the maximum achievable control technology ("MACT") to control certain defined hazardous air pollutants (including mercury). Furthermore, if the rule is enacted as proposed, affected utilities would have only three years from finalization to comply with the rule's requirements. At this time, EPA is scheduled to finalize the EGU/HAPS MACT rule in November 2011.

removal and closure. Other costs to be recorded in this regulatory asset would include expenses associated with fuel, materials and supplies that are no longer needed in connection with the operation of such a unit. In the petition, Alabama Power also seeks authorization to establish a separate regulatory asset in which it would record certain employee severance costs that might arise in the event of full or partial unit retirements due to EPA's regulations. Finally, Commission approval is requested regarding the Company undertaking limited preparatory activities designed to preserve its compliance options until the environmental mandates are known and final.

Our Staff has reviewed the Company's petition and recommends Commission approval, in that granting these requests will assist Alabama Power in its efforts to mitigate the cost impacts to customers that may result from these EPA mandates. For the reasons set forth below, the Commission finds that the Company's requests are reasonable and well-supported, as is its approach for dealing with the current uncertainty surrounding the final outcome of EPA's pending regulations. Accordingly, the Company's petition is due to be, and hereby is, granted.

BACKGROUND

Over the past decade, environmental regulations applicable to the electric utility operations of Alabama Power have necessitated the installation of a number of emission control technologies on approximately two-thirds of the Company's coal-fired generating capacity. In complying with these federal and state requirements, the Company sought to ensure that reliable sources of cost-effective generation would continue to be available to serve its customers. To this end, controls have been installed at costs lower than industry averages and service reliability has remained high. Emissions of sulfur dioxide and nitrogen oxides have declined significantly, even as customer demand for energy has increased.

As explained in Alabama Power's petition, the EPA is developing several new environmental regulations that would severely impact the ongoing operation of the Company's coal-fired generating units, especially those not equipped with Selective Catalytic Reduction and Flue Gas Desulfurization facilities. Depending upon the scope, stringency, and timing of such regulations, the projected cost of compliance to Alabama Power and to its customers could be significant. To date, the EPA's actions signal continued commitment to its current approach, but many involved in the utility industry – including this Commission – are urging EPA to moderate its proposed regulations or, at the very least, to expand the associated compliance deadlines.

Faced with these uncertainties, and in an effort to avoid major expenditures that might later prove to be unnecessary or ill-timed, Alabama Power has determined not to commence any large construction projects until the applicable EPA regulations are final and compliance obligations are mandated.[2] Even so, it cannot ignore the possibility that EPA may adopt the strict requirements and constricted compliance deadlines currently being proposed. In order to address such potential outcomes, the Company is undertaking certain preparatory activities of a limited nature directed to engineering, research, permitting, easements, fuel transportation, and other such areas in advance of actual rule finalizations. These preparatory activities will better position Alabama Power to preserve viable compliance options and, if necessary, be able to implement solutions that would minimize the total cost impacts to customers resulting from the EPA's final regulations, while at the same time maintaining reliable service.

As explained in the petition, the Company could soon be required to decide whether it should make substantial capital investments in emission control technologies on certain coal-fired generating units, in accordance with the MACT requirements, or pursue other strategies. Such strategies could include fuel transition at some units, which would entail the partial retirement and/or obsolescence of certain equipment at those plants. Alternatively, it may be appropriate for the Company to fully retire an affected coal-fired unit. In any case, the decision would result in the obsolescence of equipment, fuel, materials and supplies associated with that unit, as well as the displacement of personnel at the unit who could not otherwise be relocated. While the Company states that it would take appropriate steps to find uses for the existing equipment, fuel, materials

[2] This same approach is reflected in the mechanism established by the Commission for the recovery of these types of costs (Rate CNP, Part C), which is generally predicated on the existence of an environmental mandate.

and supplies and to place impacted employees elsewhere, it is reasonable to expect that some costs of this nature would be incurred.

DISCUSSION AND FINDINGS

In view of the potential impacts of these pending environmental mandates, consideration must be given to the cost and consequential rate effects that would normally occur under the application of Generally Accepted Accounting Principles ("GAAP"). If a unit or portions of a unit were designated for retirement, GAAP would require the Company to recognize certain expenses associated with that decision. First, GAAP would require accelerated recognition of the expense related to unrecovered investment costs associated with any such retirement, including the unrecovered plant asset balance and costs associated with dismantlement and asset retirement obligations. Second, GAAP would require the unused fuel, materials and supplies that become obsolete due to a full or partial unit retirement to be immediately expensed. Third, GAAP would require the Company to immediately recognize severance costs incurred as part of the displacement of employees due to the full or partial unit retirement. Absent the accounting authorizations requested herein, GAAP would require these costs to customers to be realized in timeframes that would have a destabilizing effect on the Company's rates.

The GAAP requirement having the greatest potential rate impact relates to the acceleration of the expense related to unrecovered investment costs. Generally speaking, depreciation accounting aims to distribute the cost of a capital asset (*e.g.*, a generating plant) over its expected useful life. In normal circumstances, the unrecovered investment costs associated with that asset are recovered through depreciation rates (which, as applied, yield depreciation expense) predicated on the asset's remaining useful life. In the event EPA's mandates effectively truncate a coal-fired unit's useful or remaining life, the effect of GAAP guidance would be to immediately accelerate the depreciation to recover the remaining book value of the plant and the associated dismantlement and asset retirement obligations over that shorter period of time. The result would be a sharp increase in the amount of depreciation expense, thus putting upward pressure on rates to customers.

A decision to retire or partially retire a unit could cause certain unused fuel, materials and supplies directly attributable to the unit to become obsolete, in that they no longer would be needed in connection with the operation of the unit and may not be usable at other generating plants or feasibly sold. In such circumstances, GAAP requires the unused fuel, materials and supplies that become obsolete due to the retirement to be written down to their net realizable value,[3] with the expense recognized in the same period the Company determines that these items are obsolete.[4] While the period of expense recognition would not necessarily coincide with the period in which a unit retirement determination has been made (as would be the case with the depreciation expense), the expense would have to be recognized no later than the date of the actual retirement.

Similarly, the decision to retire a unit or transition to a different fuel source could create additional cost burdens in the form of employee severance costs. Severance costs are related to employee displacement that is caused by the premature retirement of a unit or the transition of a unit to a fuel source that is less labor intensive. Accounting guidance would require the Company to recognize its severance obligations when the costs are incurred.[5] As with the unrecovered investment costs associated with a unit retirement or fuel source transition, the uneven manner in which these costs could arise creates the prospect for sudden, upward cost pressure on rates.

To avoid these consequences on customers, Alabama Power is requesting authorization from the Commission to change the timing in which costs caused by the implementation of EPA's proposed regulations would be recovered.[6] Specifically, the Company seeks permission to

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[3] *See* ASC 330-10-20.

[4] *See* ASC 330-10-35-1.

[5] *See* ASC 712-10-25.

[6] The Commission's authority to establish such accounting methodologies is set forth in ASC 980-10-05 (formerly referred to as Statement of Financial Accounting Standards No. 71-Accounting for the Effects of Certain Types of Regulation).

establish a regulatory asset on its balance sheet in which it would record the unrecovered investment costs associated with any unit to be retired (in whole or part) as a result of an environmental mandate, including the unrecovered plant asset balance and costs associated with dismantlement and asset retirement obligations. The Company also would record in this regulatory asset the expenses associated with the fuel, materials and supplies that were no longer needed in connection with a fully or partially retired unit. Once this account is established, the Company would amortize that portion of the regulatory asset associated with each such unit over that unit's remaining useful life, as determined prior to the retirement decision. The accelerated recognition of expenses would thus be mitigated, in that the remaining investment costs related to the affected units will continue to be recovered over a longer period of time. In this way, Alabama Power's customers would avoid the sharp increase in recoverable expenses that would otherwise occur.

Alabama Power also seeks authorization from the Commission to establish a separate regulatory asset on its balance sheet for the purpose of recognizing, in a more tempered fashion, the expenses associated with employee severances arising from the premature retirement or fuel source transition (partial retirement) of any units due to environmental mandates. As described in the petition, the Company would record all such employee severance costs in the regulatory asset, but only in the event those costs total at least $750,000 in any given calendar year. Appropriate increments of the balance in this account would be amortized over periods of not less than 24 months or more than 60 months.

Finally, and consistent with its efforts to avoid large construction projects until the final EPA regulations and associated compliance obligations are known, the Company seeks approval that its undertaking of limited preparatory activities in order to evaluate and preserve viable compliance options is reasonable and appropriate in view of EPA's pending proposals. In pursuing this approach, the Company's stated goal is to avoid major expenditures that might later prove unnecessary or ill-timed, while at the same time preserving viable options for a cost-effective compliance program when the environmental mandates under EPA's regulations are known and final.

As explained above, granting the requested authorizations will allow Alabama Power to implement an accounting methodology that is intended to benefit customers by addressing certain potential cost pressures they would otherwise face. Should environmental mandates from EPA result in the Company prematurely retiring a generating unit or partially retiring certain unit equipment in order to effectuate the transition of that unit's operational capability to a different fuel type, the Company will be able, through these authorizations, to recover the remaining investment costs, as well as expenses associated with unused fuel, materials and supplies, over the time period that would have been utilized for that unit, but for the mandates. In this respect, the Company emphasizes that the requested authorizations will not impact the costs currently associated with these units or that would arise as the result of a retirement. The authorizations instead relate to the timing of such cost recovery, and the establishment of a means to relieve customers of the rate pressure they may otherwise bear. In like manner, the regulatory asset associated with employee severance would enable those costs, subject to a specified threshold, to be amortized over a somewhat longer period, thereby mitigating pressure on rates to customers.

Based on the Company's petition, the evaluation and recommendation of our Staff, and other available information, the Commission **FINDS** that the requested accounting authorizations related to the described cost impacts that may result from pending EPA regulations are reasonable, appropriate, and beneficial to retail customers. The Commission **FURTHER FINDS** that the Company's compliance strategy, as described in the body of this order, to address the uncertainty surrounding EPA's pending proposals is reasonable and appropriate. To that end, the Commission approves the undertaking of limited preparatory activities that will enable the Company to preserve viable compliance options so that, when the compliance obligations become known and final, the Company can select the option that is expected to produce the lowest total cost for customers and an appropriate level of service reliability.

IT IS, THEREFORE, ORDERED BY THE COMMISSION that the Company's petition is hereby granted, specifically including authorization to establish the regulatory assets and apply the associated amortizations described therein.

IT IS FURTHER ORDERED that, consistent with normal monitoring activities, the Company shall coordinate with our Staff, through periodic meetings, status reports, and other such communications, so that the Commission can remain informed of the Company's compliance plan and strategy as the EPA regulatory process moves forward.

IT IS FURTHER ORDERED that the accounting treatment authorized herein may extend to include additional entries in these regulatory assets in response to EPA regulations, not addressed in this Order, which may arise in the future. To that end, the Company shall keep our Staff, and hence the Commission, informed as to other regulations later proposed by EPA that, if implemented, could prompt decisions that would lead to such additional entries. The Company shall notify our Staff in writing before any such entries are made in connection with EPA regulations that are not addressed in this Order. Absent written notice of disapproval within ten (10) business days of that notification, the Commission shall have concurred in the appropriateness of the additional entries to these regulatory assets, as described in the Company's written notification.

IT IS FURTHER ORDERED BY THE COMMISSION, that jurisdiction in this cause is, hereby, retained for any further order or orders that this Commission may find just and reasonable under the circumstances.

IT IS FURTHER ORDERED BY THE COMMISSION, That this Order shall be effective as of the date hereof.

DONE at Montgomery, Alabama, this 7th day of, September, 2011.

ALABAMA PUBLIC SERVICE COMMISSION

Lucy Baxley, President

Twinkle Andress Cavanaugh, Commissioner

Terry L. Dunn, Commissioner

ATTEST: A True Copy

Walter L. Thomas, Jr., Secretary