STITES & HARBISON PLLC
ATTORNEYS

421 West Main Street
Post Office Box 634
Frankfort, KY 40602-0634
[502] 223-3477
[502] 223-4124 Fax
www.stites.com

March 8, 2011

RECEIVED
MAR 08 2011
PUBLIC SERVICE COMMISSION

Mark R. Overstreet
(502) 209-1219
(502) 223-4387 FAX
moverstreet@stites.com

HAND DELIVERED

Jeff R. Derouen
Executive Director
Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, KY 40602-0615

RE: P.S.C. Case No. 2011-00042

Dear Mr. Derouen:

Enclosed please find and accept for filing the original and ten copies of the two sets of Power Point slides discussed at the March 2, 2011 informal conference in this matter. A copy is being served on counsel for KIUC and the Attorney General.

Please do not hesitate to contact me if you have any questions.

Very truly yours,

Mark R. Overstreet

MRO
cc: Michael L. Kurtz
Dennis G. Howard, II

Kentucky Power Company

Meeting Our Commitments to:

Customers

Communities

Reliability

RECEIVED
MAR 08 2011
PUBLIC SERVICE
COMMISSION

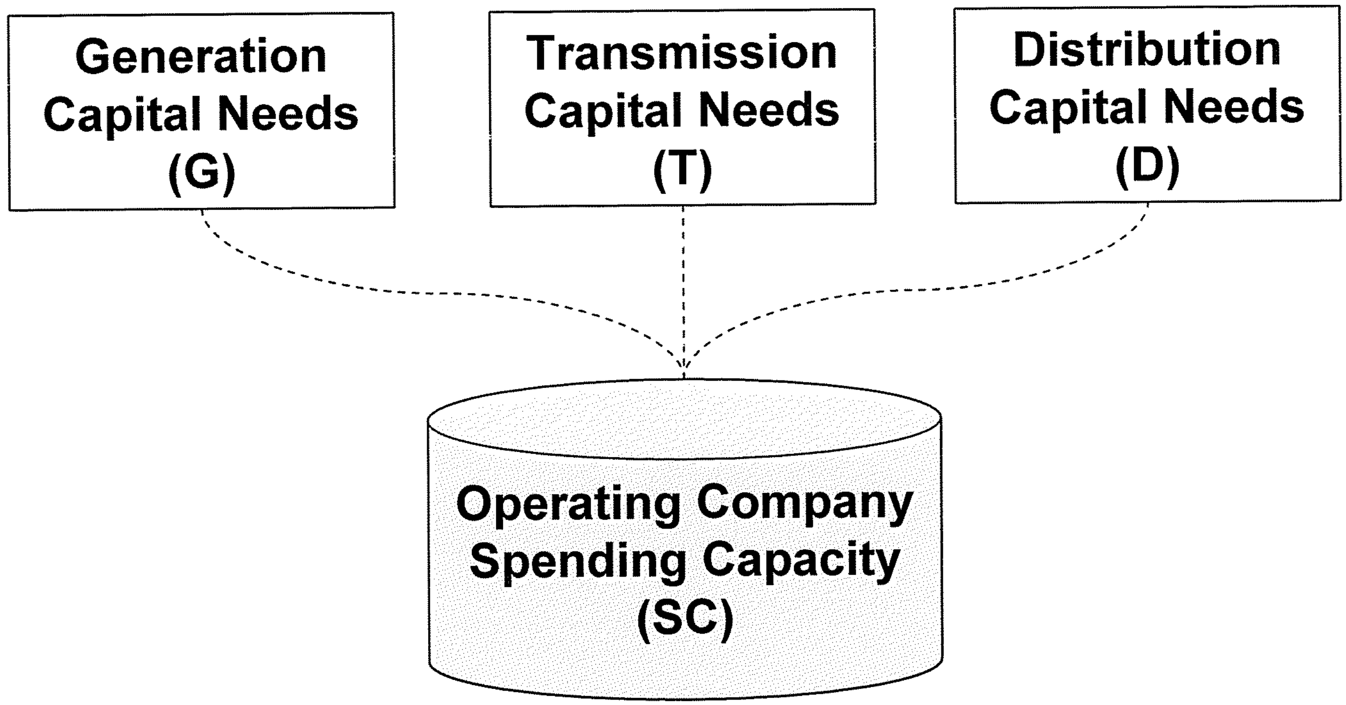
AEP AMERICAN ELECTRIC POWER

Today's electric industry challenges

Challenges facing AEP operating companies:

- Operating companies are facing significant pressure to maintain their credit ratings
- Capital spending needs are significant in all areas of the business and extend over the next decade
- AEP's transmission system requires a sustained level of investment to meet our customers' needs
- Significant additional transmission investment is mandated by RTOs or for NERC compliance
- Constrained spending on infrastructure could limit our ability to enhance reliability

Simplified description of the challenge facing the AEP operating companies



- Issues:

1. More and more of the G, T and D capital needs are mandatory
2. Operating companies' spending capacities (SC) are limited without additional borrowing, which jeopardizes credit ratings
3. Simply put: G + T + D > SC

AMERICAN ELECTRIC POWER

The current options to address the challenge are not satisfactory

- What are the options to address the issue that G + T + D > SC?

1. Spend G, T and D and exceed SC, incurring additional debt

   Potential of a credit downgrade that would significantly increase costs to customers

   – The average difference in the cost of debt between BBB and BB utilities is 2.63% since 2008*

   – Any cost increase would apply to all refinancing activities

   – A downgrade below investment grade would also increase the cost of short-term debt and could even jeopardize an operating company's ability to access short-term debt markets

2. Reduce G, T and/or D so that G + T + D = SC

   – This could present reliability issues in the future and require significant O&M investment to maintain

   – The first projects to get cut or deferred are "non-mandated" or "discretionary" investments that are intended to <u>enhance</u> service quality to customers

AMERICAN ELECTRIC POWER

* Based on differences in 10-year average utility bond yields; data sourced from Bloomberg

AEP Transco is a targeting solution to address these issues

- AEP expects to file for certification of Transco as a public utility

- AEP Transco, as an alternative vehicle to raise capital for new transmission investments, helps the operating companies by reducing their transmission capital needs (T)
  - Provides greater financial transparency for shareholders, lenders and credit rating agencies based on the transmission-only business model, attracting a greater supply of capital
  - Helps to maintain the financial condition of the Operating Companies by avoiding additional pressure on credit metrics
  - Maintains our ability to enhance transmission service to customers

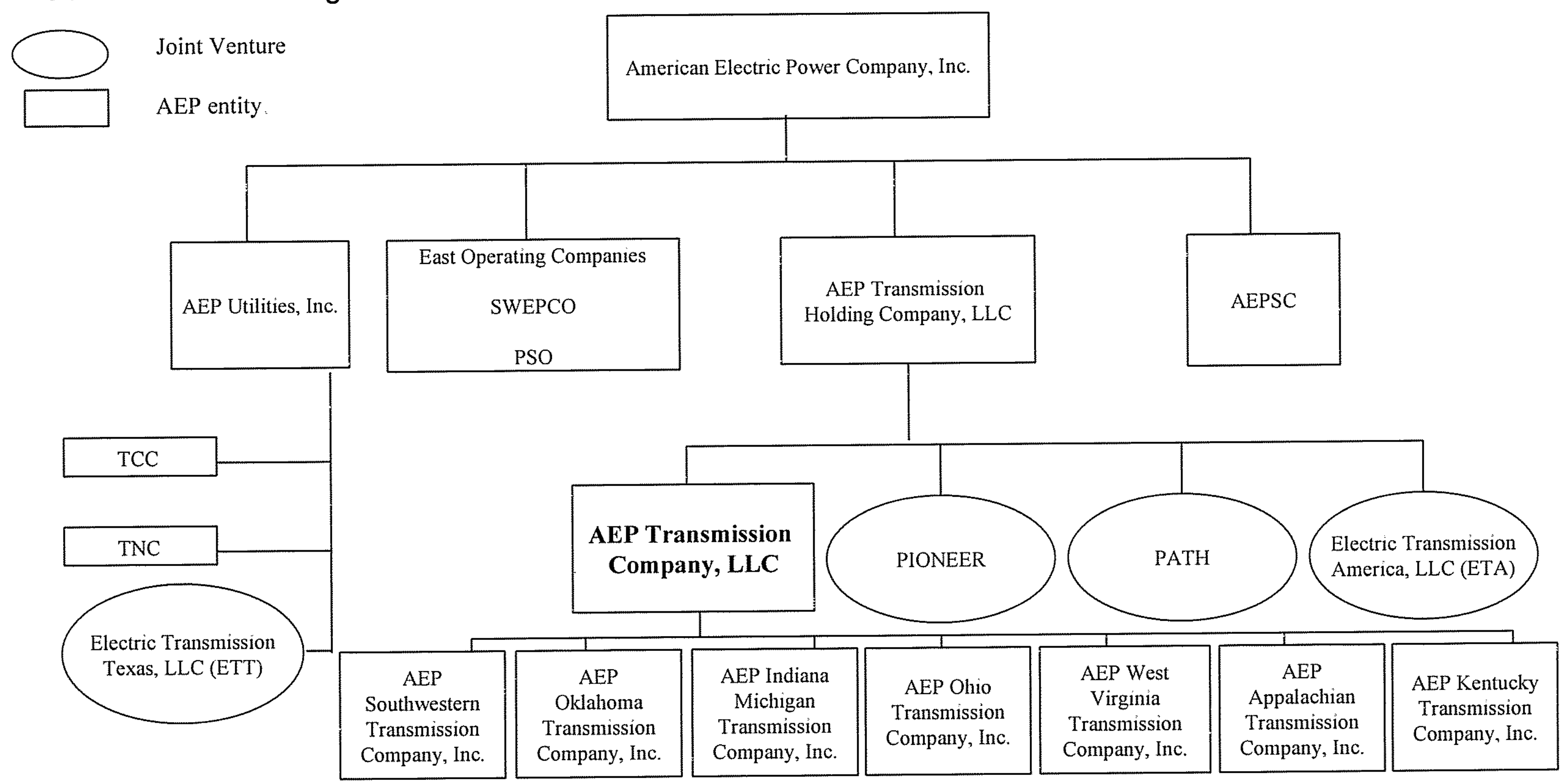
- AEP Transco may also achieve a lower cost of debt than the operating companies
  - Increased Wall Street interest in investment in Transcos
  - Strong equity layer in Transco's capital structure (50% equity)
  - The average difference in the cost of debt between A and BBB utilities is 0.63% since 2008*
    - This would translate into ~$1 million of annual interest savings on $300 million of total investment

AMERICAN ELECTRIC POWER

* Based on differences in 10-year average utility bond yields; data sourced from Bloomberg

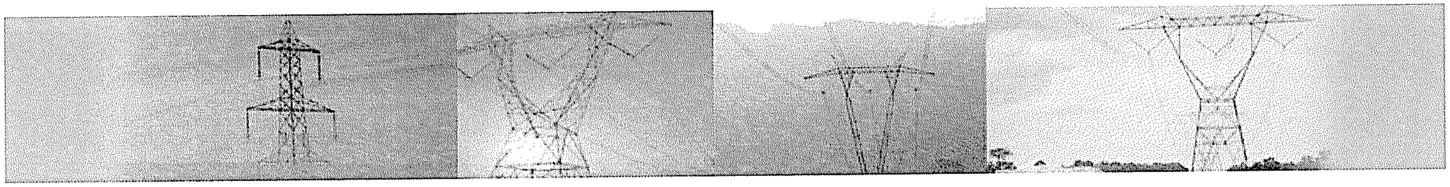
AEP Organization Structure

- AEP Transmission Company, L.L.C. is a holding company for seven new transmission-only public utility companies
  - 100% owned subsidiaries of AEP – not partnerships
  - Held along with AEP's other transmission-only joint ventures under AEP Transmission Holding Company, LLC
  - Covers AEP's existing states



AEP AMERICAN ELECTRIC POWER

Wall Street View

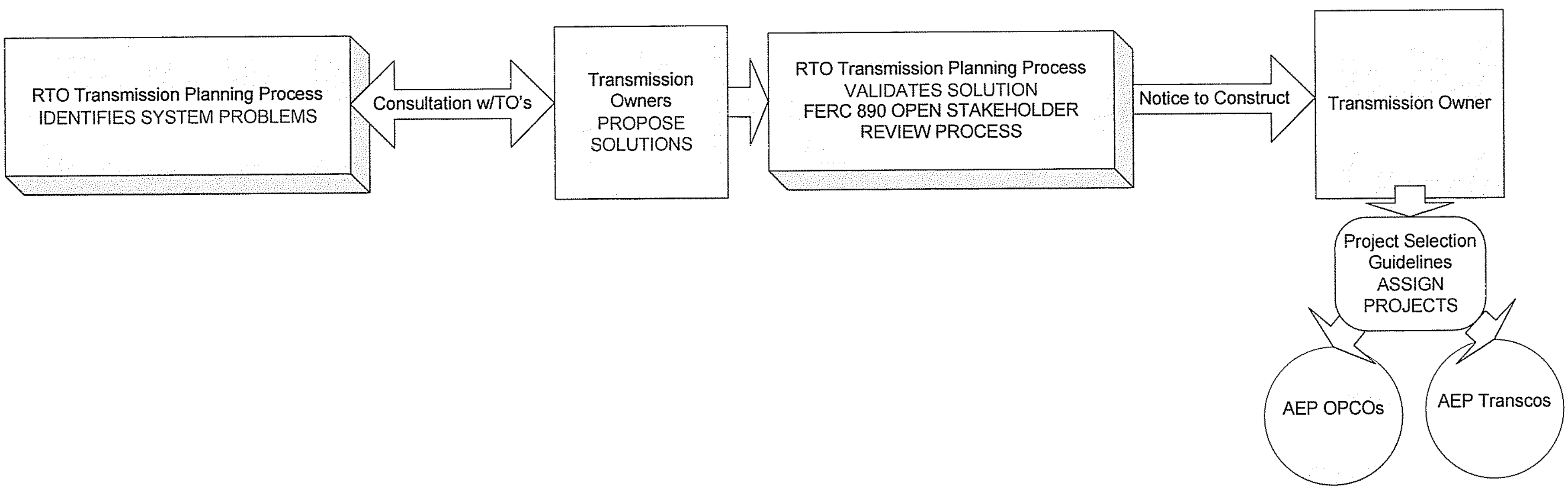


❑ Excerpts from J.M. Cannell Report

- Gained through a series of interviews concluded with investors and credit rating agencies
- The investment community is well aware of the need not only to expand the transmission grid but also to upgrade existing infrastructure
- The entity provides a vehicle for showcasing the transmission business and will provide a clear direct way to invest in it
- A separate and easier evaluation of earnings, asset and EBITDA of this business line will be able to be assessed
- Transmission ratemaking will be unified under a single regulatory entity thus leading to simplicity and transparency in analysis
- The separate Transco unit would have a neutral to slight positive impact on the OPCos' balance sheets, credit quality, and credit ratings

RTO Transmission Planning Process is Unaffected

Process with AEP Transmission Company.....



AEP AMERICAN ELECTRIC POWER

Project Selection Overview

- New Transmission companies will develop transmission projects *(FERC Form 1 general ledger)* which fall into the following categories:
  - Greenfield Projects: New transmission facilities that do not require replacement or modification of existing facilities or components
  - Facility additions: New transmission components installed at existing AEP Operating Company-owned facilities
  - Facility Upgrades: Replacement of an entire existing AEP Operating Company-owned facility
  - Component Replacement: Replacement of certain existing AEP Operating Company-owned Transmission facility or replacement of large system component(s) within a Transmission facility; (e.g. 765kv Breakers and EHV transformer replacements)
- AEP capital prioritization will continue to be managed by AEP Transmission in the same integrated manner that it is today for its operating companies. AEP transmission system will continue to be operated as an integrated system and managed by AEP Transmission
- Capital allocated to the operating companies will focus on system maintenance and rehabilitation as required to maintain the quality of the existing system

Other Operational Aspects of the Transmission Companies

- AEP Service Corporation and the Operating Companies will provide services to the Transmission Companies through services agreements
- The provisions of the service agreements are modeled after those in the service agreement in effect between AEP Service Corporation and KPCo
- AEP Transco will not have any employees of their own; the same AEP Service Corporation and Operating Company employees will perform the same functions as they do today
- Appropriate work orders will be established for capturing all of the AEP Transcos' costs; additionally, AEP Transcos will be allocated it's share of corporate overhead costs

Kentucky Transmission Project :
Hazard Area Improvements

- Total project cost is estimated at $40M (Represents preliminary cost estimates)

- Site selection is underway and there is about $3 M (direct cost) spending planned in 2011 for engineering, right-of-way, and land purchase

- The facilities are being proposed to be in service by December 2014

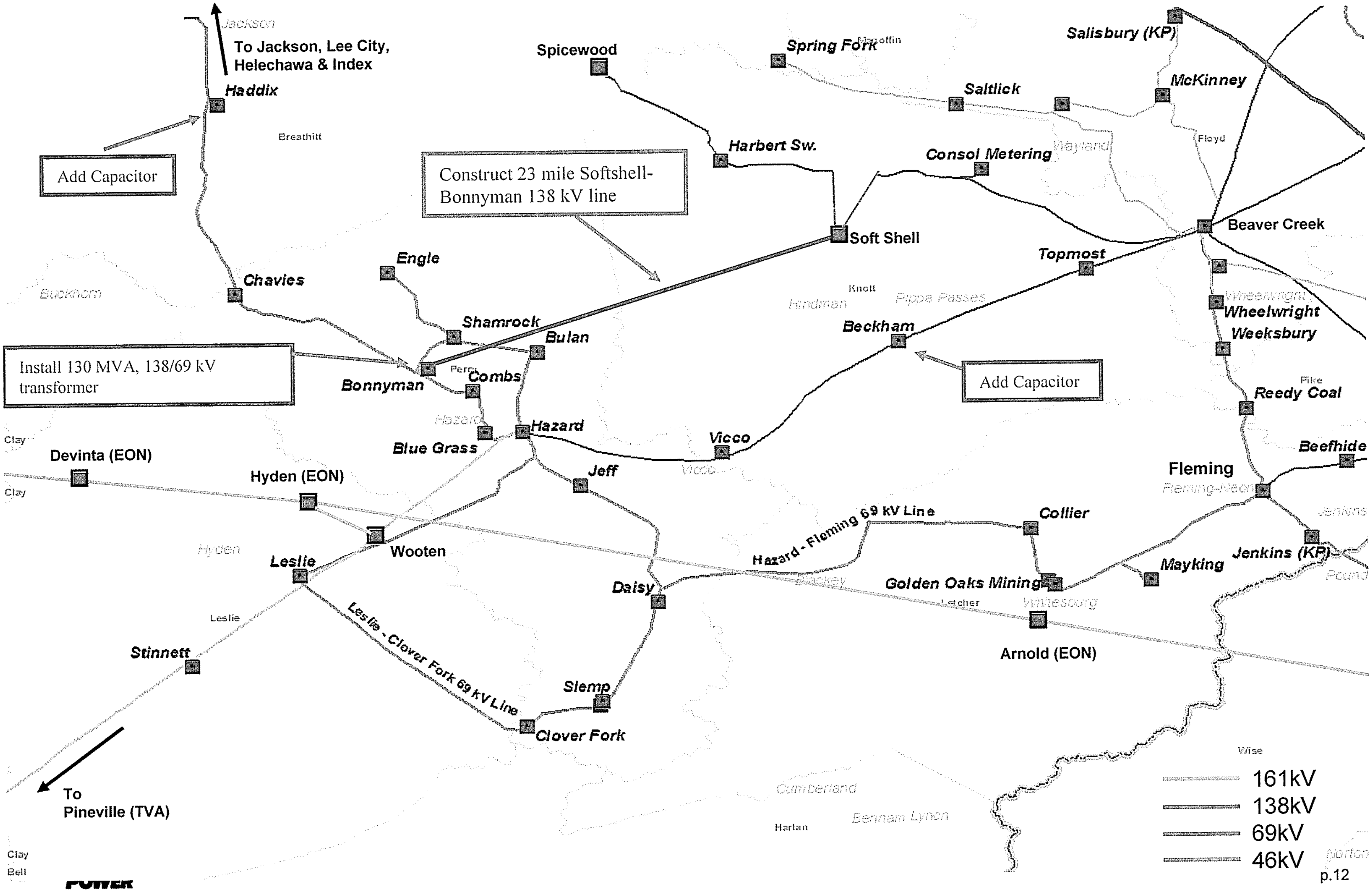
- Line Overview

  - A *new* 138 kV line will be constructed from Soft Shell Station to Bonnyman Station, and 138/69 kV facilities will be installed at Bonnyman

  - The local Hazard Area consists of a 69 kV sub-transmission loop plus a larger system area that is over 300 MW and principal sources into the area include AEP's Beaver Creek – Hazard 138 kV line, two 161 kV interconnections with EON at AEP's Wooten Station, and one 161 kV interconnection with TVA at Stinnett Station

  - Under existing system conditions, the transmission system could experience thermal overloads (up to 110% of rating) and low voltages (as low as 86% of nominal) affecting an area load of approximately 160 MW

Kentucky Transmission Project : Hazard Area Improvements



Kentucky Transmission Project :
Hazard Area Improvements

❑ Why is the Line Needed?

- This project is mandatory and is included in the PJM RTEP as a baseline upgrade.
- Improve reliability of service for approximately 160 MW load by establishing a 2nd 138/69 kV source to the Hazard area
- Alleviate thermal overload and low voltage problems during normal and single-contingency outage conditions.
- Mitigate thermal overload during BES double contingency outage conditions as identified by PJM.
- Provide the necessary flexibility to allow for routine maintenance of transmission equipment without requiring power interruption of up to 300 MW of load in the area.

Kentucky Transmission Project :
Hazard Area Improvements

- Permitting & Certification for the project will be some time in 2011
  - Permitting - CPNC is required - 278.020 Certificate of convenience and necessity required for construction provision of utility service or of utility -- Exceptions -- Approval required for acquisition or transfer of ownership -- Public hearing on proposed transmission line -- Severability of provisions
- Notice to Construct
  - Will need to be done 30-90 days before we file the CPNC

FERC Formula Rate Filing Request December 2009 (FERC Docket No.ER10-355-000)

The proposed formula rate will track AEP's actual cost of service:

- Transco's formula rate parallels the formula rate accepted for the AEP East Operating Companies in Docket No. ER08-1329
- The formula is designed to track changes in actual costs and projected capital additions
- A true-up mechanism implemented following the end of a rate period ensures that any deviation from actual costs during the rate period is reflected in an adjustment (with interest) to the annual transmission revenue requirement in the subsequent rate period
- Settlement filed September 24, 2010

OATT formula rate comparison: overall mechanics and protocols

- The mechanics of the Transco OATT formula rate is substantially the same as the operating company's OATT formula rate

- Each July 1, in the annual update the rate is set for the next Rate Year (7/1 of that year to 6/30 of the following year).

- The rate consists of three primary components (using 7/1/2011 update as an example):

  1. Projected rate base (net plant in service) as of 12/31/2011 times the approved WACC (Weighted Average Cost of Capital)

  2. Cost of Service for the previous calendar year (1/1/2010-12/31/2010)

  3. Addition or subtraction True-Up cost of service for the previous rate year

Summary of OATT Formula Rates (Transco vs. OpCo)

What's the Same

- ❑ Oversight of what gets built
- ❑ Project Capital Costs
- ❑ Formula Rate Mechanics
- ❑ ROE
- ❑ O & M Expense

What's Similar

- ❑ Depreciation Expense
- ❑ Tax Rates

What's Different

- ❑ Capital Structure
  - AEP Transco need slightly more equity to start
- ❑ Cost of Debt
  - AEP Transco's are initially a FERC settled rate and soon will be AEP Transco's actual rate

OATT formula rate comparison: overall pre-tax weighted average cost of capital

	Operating Company OATT FERC Docket No. ER08-1329	Transco OATT FERC Docket No. ER10-355
Pre-tax WACC	CSP 8.50% OPCo 8.25% I&M 8.87% APCo 8.40% KPCo 8.67%	8.42%

- ❑ AEP Transco WACC is in line with the cost of capital of the operating companies

AMERICAN ELECTRIC POWER

OATT formula rate comparison: ROE, Caps on Equity, and Cost of Debt

	Operating Company OATT FERC Docket No. ER08-1329		Transco OATT FERC Docket No. ER10-355
ROE	11.49% (includes 50 basis point adder for ongoing RTO participation)		11.49% (includes 50 basis point adder for ongoing RTO participation)
Actual Equity %	CSP	47.7%	Targeting 50% equity
	OPCo	50.9%	
	I&M	49.8%	
	APCo	44.8%	
	KPCo	44.0%	
Caps on Equity %	CSP	51%	50% for at least three years (can only be changed through a FERC 205/206 filing)
	OPCo	55%	
	I&M	50%	
	APCo	50%	
	KPCo	50%	
Cost of Debt	CSP	5.77%	5.35% represents weighted average of the PJM Operating Companies; will be replaced with Transco's actual cost of debt upon initial issuance
	OPCo	4.89%	
	I&M	6.28%	
	APCo	5.90%	
	KPCo	6.46%	

AMERICAN ELECTRIC POWER

AEP AMERICAN® ELECTRIC POWER

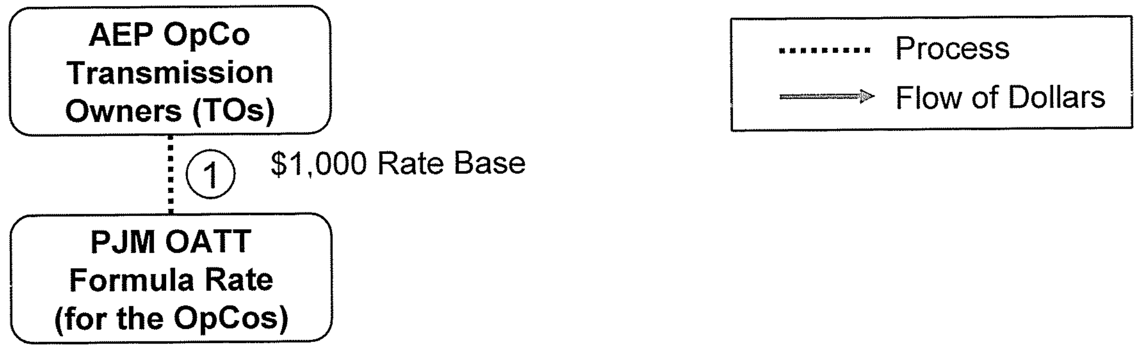
Transmission Rate Making
AEP Transmission Company

Each operating company has two sides that pertain to transmission:

1. A transmission owner (TO) side that makes rate base investments and incurs expenses and, then, seeks to recover its revenue requirement at wholesale

2. A load serving entity (LSE) side that incurs network transmission service charge and seeks to recover this expense in its retail rates

Operating Companies Flow of Transmission Dollars – Step 1

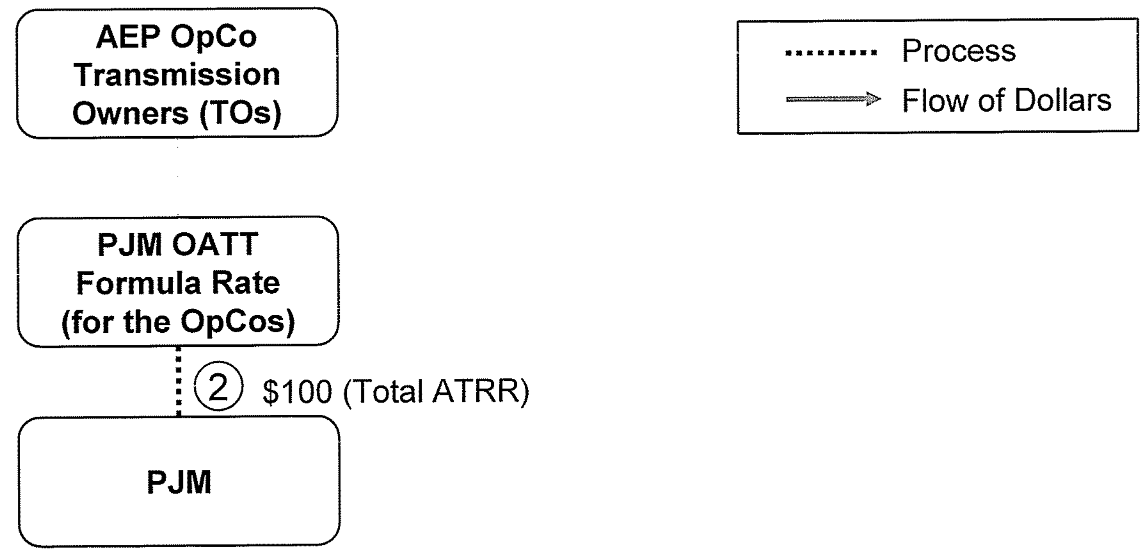


1 The AEP East operating companies' transmission return of and on rate base and expenses[1] are fed into the PJM OATT formula rate (PJM formula rate currently in settlement).

For purposes of an illustrative example, let's assume this Rate Base is $1,000

1. Currently, for the AEP East operating companies, the expenses include charges and credits under the Transmission Equalization Agreement (TEA), which net to zero across the AEP East operating companies.

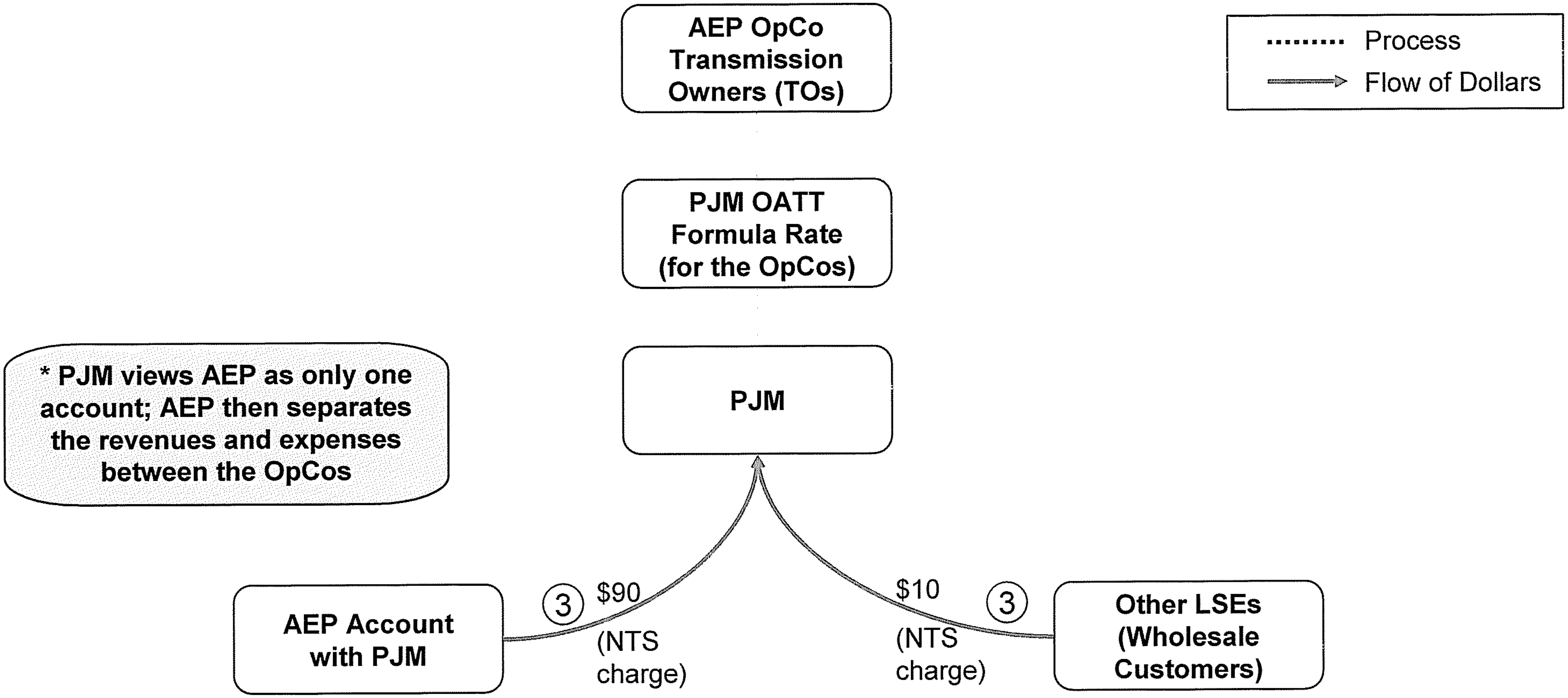
Operating Companies Flow of Transmission Dollars – Step 2



2 The formula rate determines the Annual Transmission Revenue Requirement (ATRR), including return and expense, of the AEP East operating companies, collectively the “Total ATRR”.

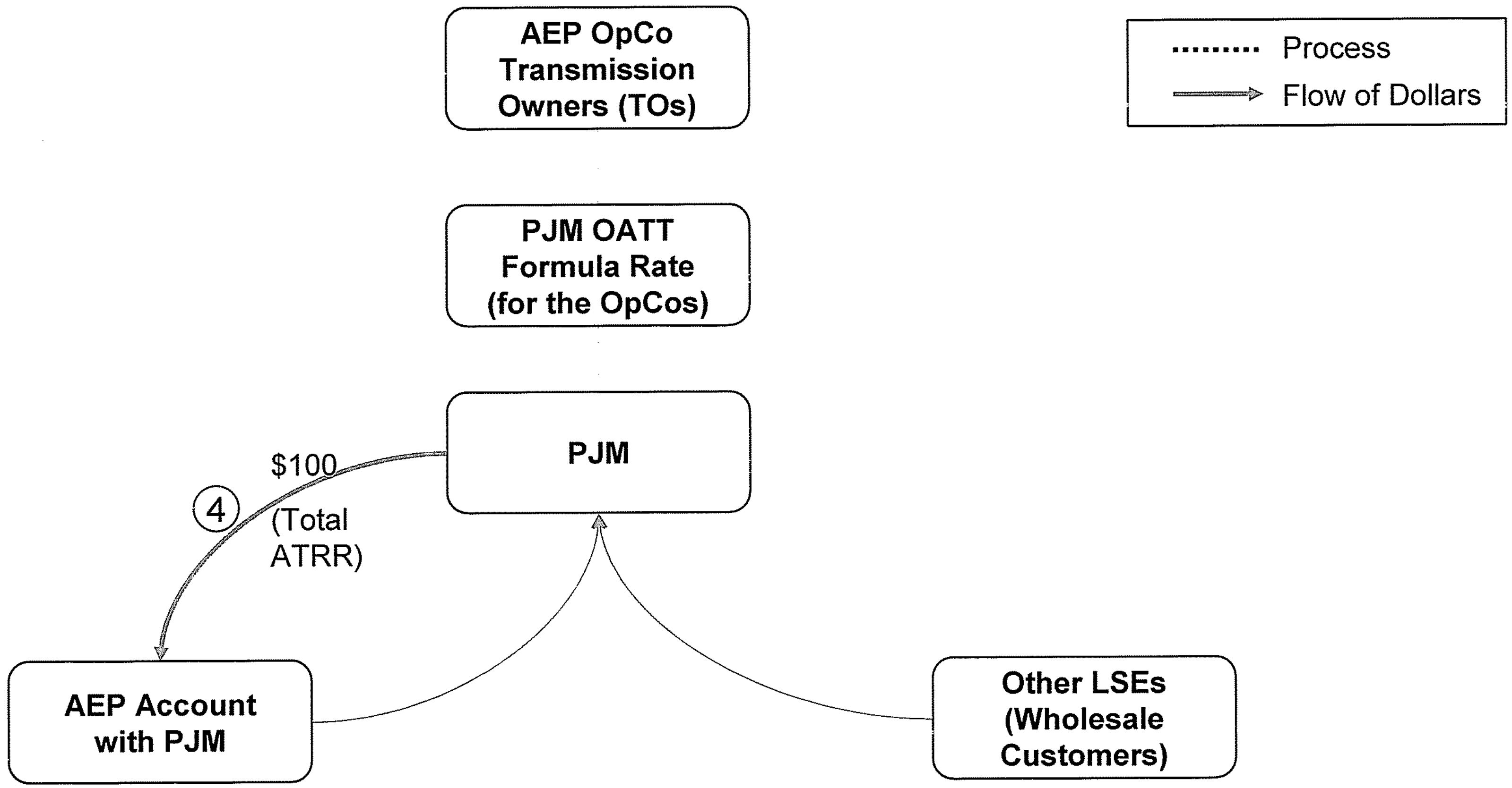
For purposes of an illustrative example, let’s assume this Total ATRR is $100

Operating Companies Flow of Transmission Dollars – Step 3



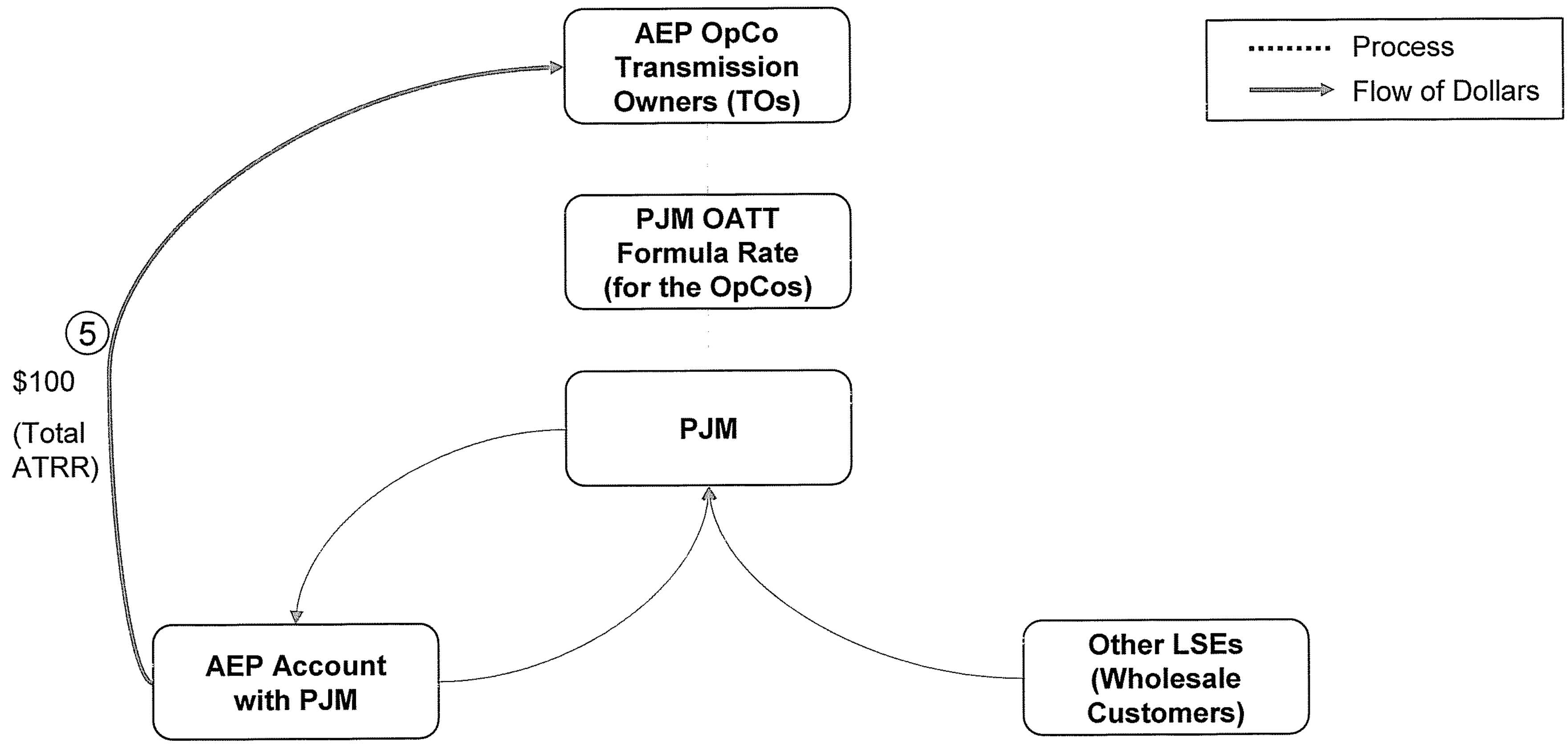
3 PJM collects each Load Serving Entities' (AEP* and Wholesale Customers) load share (one coincident peak or "1 CP" method) of the Total ATRR. This is the Network Transmission Service (NTS) charge to the LSE.

Operating Companies Flow of Transmission Dollars – Step 4



4 PJM pays to AEP the Total ATRR.

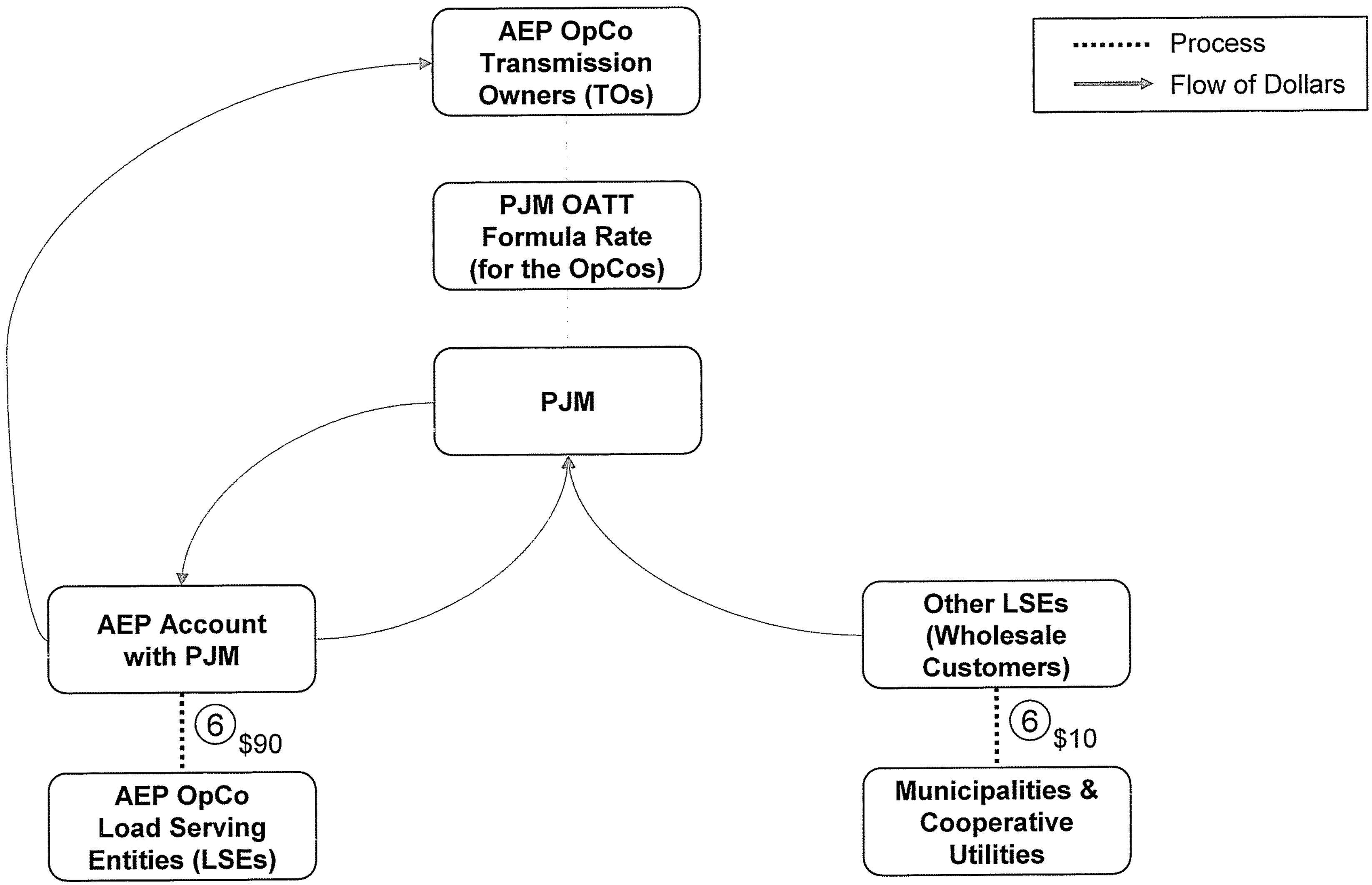
Operating Companies Flow of Transmission Dollars – Step 5



(5) AEP allocates the Total ATRR to the AEP East operating companies (TOs) based on each OpCo's share of the ATRR, per the amended Transmission Agreement (TA).

At this point, the transmission owner side of each OpCo is "whole" having made its rate base investment of $1,000, incurred expenses and recovered its ATRR of $100. However, the AEP LSEs have not recovered the NTS charge from retail customers.

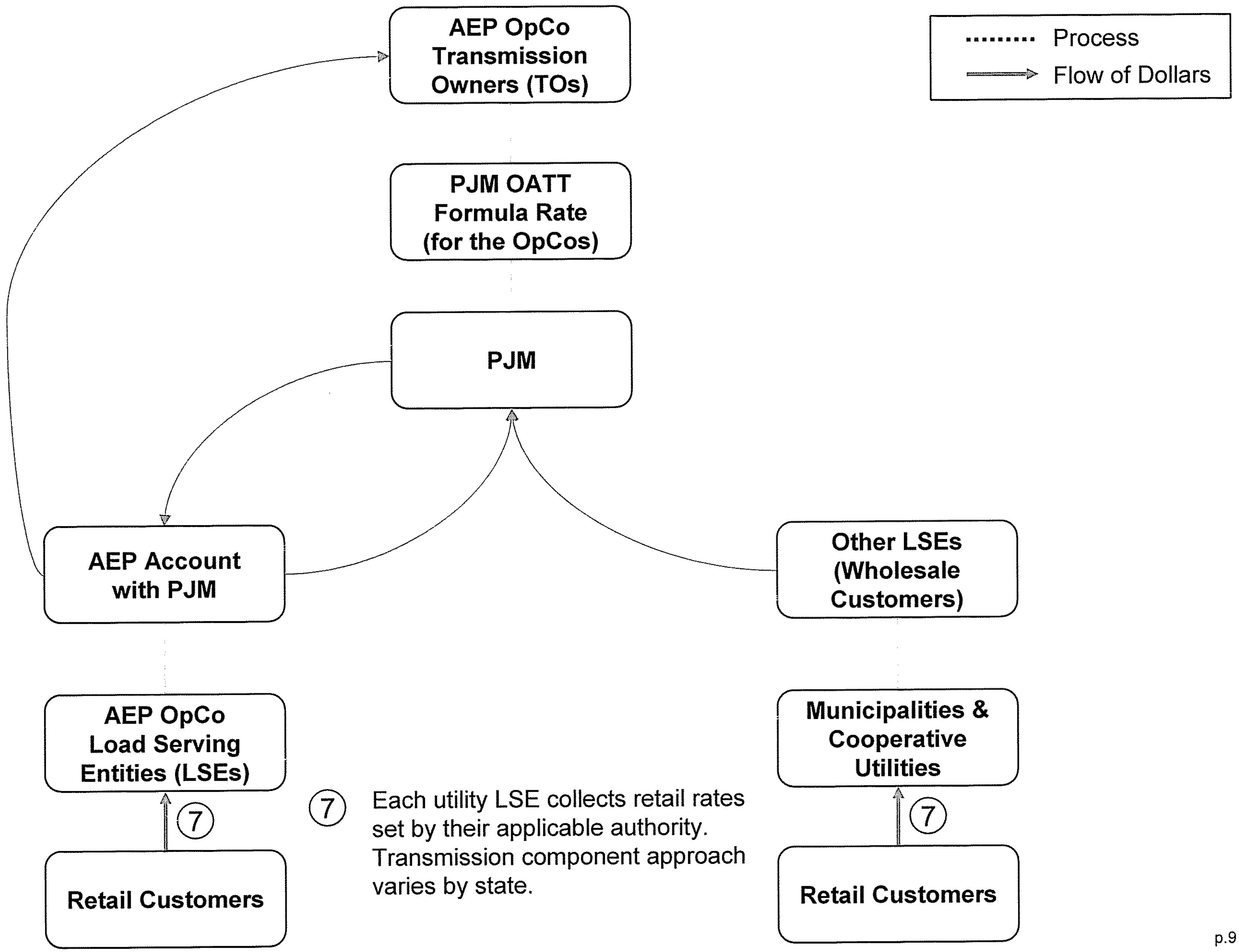
Operating Companies Flow of Transmission Dollars – Step 6



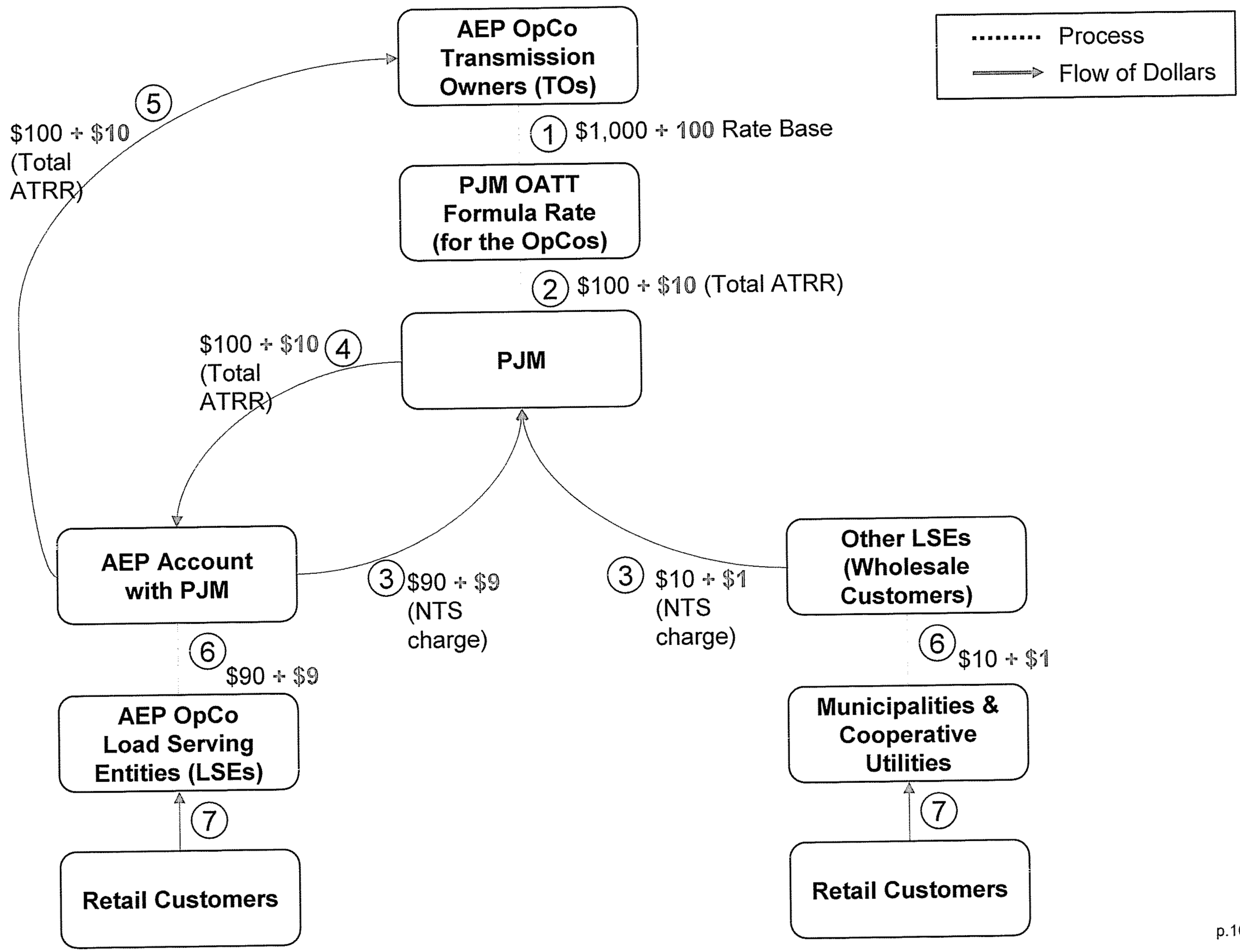
6 AEP and other LSEs allocate the Network Transmission Service charge to their member utilities; AEP's allocation is based on load share (12CP method) per the amended TA.

Note: this amount is also reduced by relatively minor amounts of point-to-point revenues collected by PJM that are allocated to LSEs as a credit to their Network Transmission Service bill.

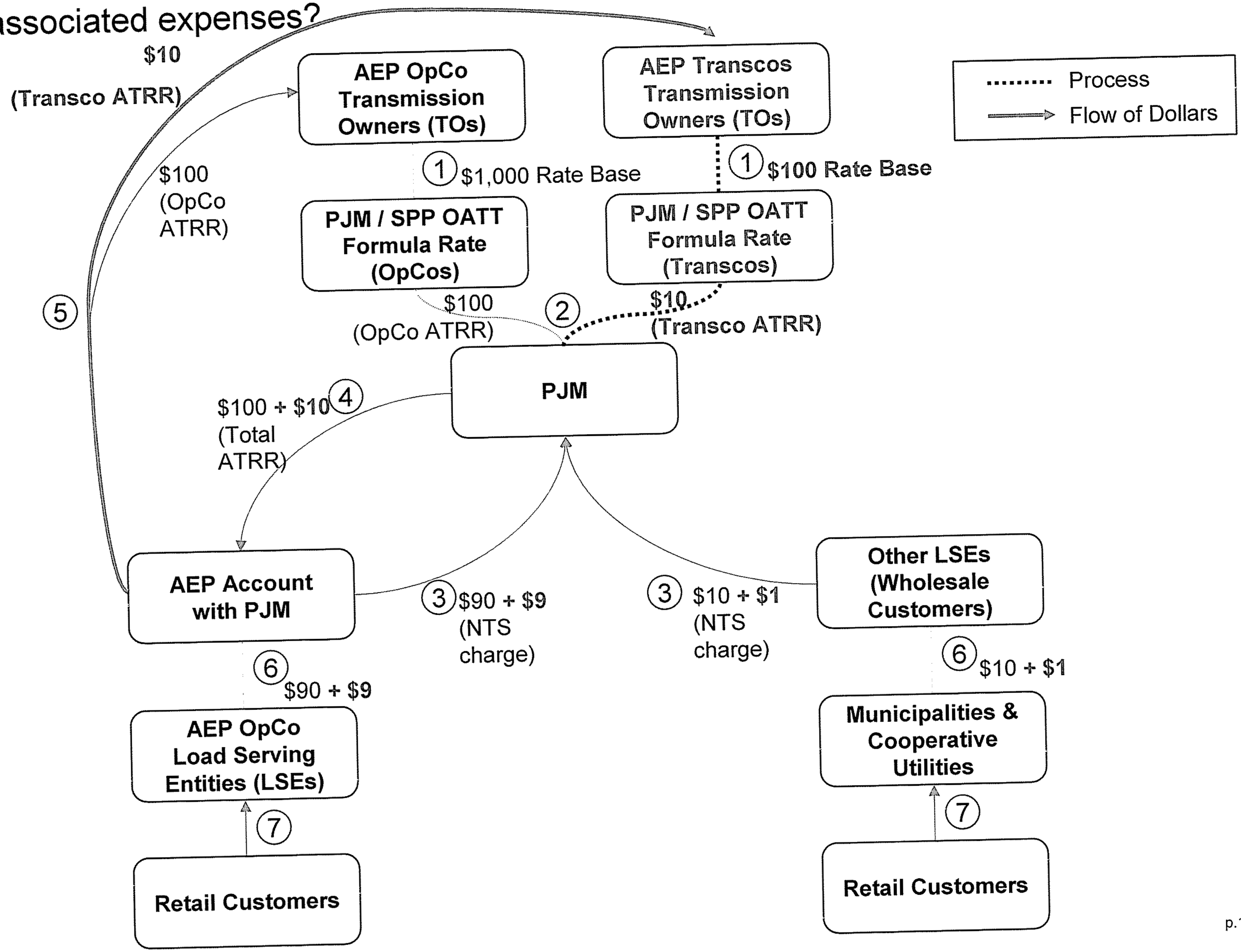
Operating Companies Flow of Transmission Dollars – Step 7



What happens if the Operating Companies make $100 of new rate base investment with associated expense?



What happens if the Transco Companies make $100 of new rate base investment with associated expenses?



Retail Ratemaking in Kentucky

- Today, the cost that retail customers in Kentucky pay for their Transmission service is a blend of the PJM OATT process and traditional ratemaking (base rate case)
  - When KPCo goes in for a rate case, it seeks to include the net of KPCo's OATT revenue (step 5) and NTS expense (step 6), as allocated to KPCo under the Amended TA
  - KPCo also seeks to include its transmission rate base and expenses in its bundled rates
  - Therefore, the incremental cost for retail Kentucky customers is calculated by taking the retail transmission revenue requirement plus or minus the net of OATT revenue and expense

- In the case of AEP Transco, KPCo would seek to include in base rates the NTS expense allocated to KPCo

Update on State Filings

- ***Ohio (filed)*** – PUCO approved the Ohio Transco December 29, 2010
- ***West Virginia (filed)*** – Procedural schedule is set, with company testimony filed January 6, 2011; hearing in June
- ***Kentucky*** – Filed application with company testimony February 7, 2011
- ***Indiana*** – Filed petition with company testimony March 1, 2011
- ***Arkansas and Louisiana*** - Filing date in Arkansas likely early 2011, with a filing in Louisiana expected to be at the end of 2011
- ***Virginia (withdrawn)*** – Filing withdrawn to give additional time to resolve issues with Staff
- ***Michigan and Oklahoma*** do not require any state filing