

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

JOINT APPLICATION OF KENTUCKY POWER)	
COMPANY D/B/A AMERICAN ELECTRIC)	
POWER, AMERICAN ELECTRIC POWER)	
COMPANY, INC. AND CENTRAL AND SOUTH)	
WEST CORPORATION FOR (1) APPROVAL OF THE)	
CHANGES TO THE SYSTEM SALES)	
CLAUSE TARIFF; (2) ENTRY OF CERTAIN)	CASE NO.
FINDINGS PURSUANT TO 15 U.S.C. 97Z;)	2002-00039
(3) ENTRY OF CERTAIN FINDINGS PURSUANT)	
TO 17 C.F.R. 200.53;)	
(4) THE ENTRY OF AN ORDER)	
DECLARING THAT THE TRANSFER OF THE)	
STOCK OF KENTUCKY POWER COMPANY)	
FROM AMERICAN ELECTRIC POWER COMPANY,)	
INC. TO ITS WHOLLY OWNED SUBSIDIARY,)	
CENTRAL AND SOUTH WEST CORPORATION)	
MAY BE CONSUMMATED WITHOUT APPROVAL)	
BY THE COMMISSION; OR, ALTERNATIVELY,)	
APPROVING THE TRANSFER PURSUANT TO)	
KRS 278.020(4) AND KRS 278.020(5); AND (5))	
FOR RELATED RELIEF)	

O R D E R

On February 11, 2002, Kentucky Power Company d/b/a American Electric Power (Kentucky Power), American Electric Power Company, Inc. (AEP), and Central and South West Corporation (CSW) (collectively Applicants) filed a joint application requesting the following relief:

1. Approval of changes to Kentucky Power s system sales clause tariff;
2. Entry of certain findings by the Commission pursuant to 15 U.S.C. 97z;
3. Entry of certain findings by the Commission pursuant to 17 C.F.R. 200.53;
4. Entry of a Commission Order declaring that the transfer of stock of Kentucky Power from AEP to its wholly owned subsidiary, CSW, may be consummated without Commission approval or, alternatively, approving the transfer pursuant to KRS 278.020(4) and (5).

Intervention was granted to the Attorney General's Office and Kentucky Industrial Utility Customers, Inc. Two informal conferences were held, Kentucky Power responded to requests for information, and a public hearing was held on April 30, 2002.

BACKGROUND

The joint application seeks approval of a corporate restructuring necessitated by the merger of AEP and CSW and the deregulation of generating facilities in two states in which AEP and CSW operate: Ohio and Texas. The corporate restructuring includes the separation of all regulated utility operations from the unregulated operations and the creation of a new first-tier subsidiary of AEP, which will be CSW, to own the regulated utilities, including Kentucky Power. The deregulation of AEP's generating facilities in Ohio has also necessitated a number of significant revisions to the AEP Interconnection Agreement, which is a power pooling arrangement among Kentucky Power and four other AEP affiliates. More specifically, the Ohio deregulation has resulted in AEP proposing to eliminate its two Ohio-based affiliates from the AEP Interconnection Agreement, resulting in a three-member power pool.

All the generating assets of four AEP affiliates, two in Ohio and two in Texas, along with limited generating assets of one affiliate in Oklahoma, are to be transferred to entities known as Exempt Wholesale Generators (EWG). Under the Public Utility Holding Company Act (PUHCA), a multi-state utility, such as AEP, that engages in competitive wholesale sales of electricity may qualify for certain regulatory exemptions under PUHCA if the sales of electricity are made by an EWG. One of the requirements for obtaining EWG status for AEP's out-of-state generating facilities, as listed in Exhibit 3 to the joint application, is the entry of certain findings by each regulatory

commission having jurisdiction over an AEP affiliate. The specific findings that need to be made by this Commission arise from two different provisions under PUHCA: 15 U.S.C. 79z-5a(c), which relates to authorizing the transfer of generating assets to an EWG; and 17 C.F.R. 200.53, which relates to the amount of retained earnings that a utility holding company can invest in an EWG.

The AEP Interconnection Agreement is a tariff that governs the wholesale sale of electric energy and is subject to the regulatory jurisdiction of the Federal Energy Regulatory Commission (FERC). Last year, AEP filed applications with FERC for authority to separate its regulated and unregulated utility operations, to transfer its unregulated generating assets to EWGs, and to revise the AEP Interconnection Agreement, from five members to three, to reflect the deregulation of generating assets owned by two AEP affiliates in Ohio. As part of the resolution of the issues in those FERC cases, AEP has set forth a proposal which has been designed to provide net long-term benefits to Kentucky Power and its retail customers, while allowing AEP to consummate its corporate restructuring. The AEP proposal includes the following provisions:

1. The extension of two existing wholesale power contracts whereby Kentucky Power purchases 15 percent of the output of two coal-fired 1300 MW generating units owned by an affiliate in Rockport, Indiana (Rockport). The cost for this purchased power will increase by \$2.9 million in the first 12 months and \$3.1 million annually thereafter;

2. The revision of Kentucky Power's System Sales Clause to: (a) recognize as an expense the environmental cost associated with sales to non-associated utilities;

and (b) allow it to recover \$2.9 million in the next 12 months, and \$3.1 million annually thereafter, to reflect a pass-through to retail customers of the increased cost for Rockport purchase power;

3. The entry of findings of fact by the Commission sufficient under the PUHCA, 15 U.S.C. 97z-5a(c), to authorize AEP's transfer of certain out-of-state generation to EWGs;

4. The entry of findings of fact by the Commission relating to investment authority sufficient under 17 C.F.R 200.53 to authorize AEP's transfer of certain out-of-state generating units to EWGs in the event the investment in those units exceeds the cap authorized by the Securities and Exchange Commission (SEC);

5. A declaration by the Commission that the transfer of Kentucky Power's stock from AEP to CSW is exempt from Commission approval or, alternatively, the granting of authority under KRS 278.020(4) and (5) for the stock transfer; and

6. The filing of an Integrated Resource Plan (IRP) by Kentucky Power with this Commission no later than June 30, 2006.

ROCKPORT PURCHASE POWER CONTRACTS

Kentucky Power's existing contracts to purchase 15 percent of Rockport expire on December 31, 2004. Under AEP's proposal, the contract for 15 percent of Rockport Unit No. 1, which amounts to 195 MW, will be extended for 5 years, while the contract for 15 percent of Rockport Unit No. 2, also amounting to 195 MW, will be extended for approximately 18 years. Kentucky Power will continue to pay on a cost-of-service basis for Rockport Unit No. 1, while paying cost-of-service plus a premium of \$3.1 million annually for Rockport Unit No. 2.

Kentucky Power also owns two coal-fired generating units with a total capacity of 1060 MW at its Big Sandy Generating Station in Louisa, Kentucky. This capacity, when combined with the 390 MW from Rockport Unit Nos. 1 and 2, is sufficient for Kentucky Power to satisfy its internal load during almost all hours of the year. The Commission has been concerned for some time about the 2004 expiration of the existing Rockport power contracts due to the relatively low cost of that power compared to today's costs to either construct new generation or purchase similar power in the wholesale market at competitive prices. Kentucky Power's existing contracts provide for the purchase of 15 percent of Rockport at its cost of service. However, FERC's current policy, as set forth in Order 888,¹ is to require those contracts to be repriced at their expiration at market-based rates.

The issue of Kentucky's utilities purchasing power at market-based rates to meet native load requirements was addressed by the Commission in Administrative Case No. 387.² In the December 20, 2001 Order, the Commission found that:

[R]eliance on power purchases that reflect market price volatility is not in the best interests of Kentucky consumers. AEP-KY must plan to meet its load by securing sufficient capacity that is not subject to market price volatility. Only by doing so will AEP-KY be able to maintain reasonable electric rates while mitigating to the extent possible market price and fuel price fluctuations.³

¹ FERC Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Stats. and Regs. ¶ 31,036 (1996).

² Administrative Case No. 387, A Review of the Adequacy of Kentucky's Generation Capacity and Transmission System (Order dated December 20, 2001).

³ Id. at 34-35.

Consistent with these Commission findings, the Applicants are now proposing long-term extensions for the purchase of Rockport power at fixed prices that will insulate ratepayers from the risk of market-price volatility, while ensuring AEP an assured revenue stream.⁴ While the contract for Rockport Unit No. 1 remains at cost of service, the contract for Unit No. 2 will increase to include a levelized return, which has not previously been recovered due to a prior sale/leaseback financing transaction.

The Commission finds that the proposed terms, including the pricing, for extending the Rockport contracts are quite reasonable. The contract extensions will provide Kentucky Power sufficient capacity, at reasonable and fixed prices, to meet its customers needs for most of the time during the next few years, with any shortfall being available from its affiliates under the terms of the AEP Interconnection Agreement.

SYSTEM SALES CLAUSE

Historically, Kentucky Power has had a relatively high level of revenue from off-system sales, although that revenue level has been variable. To ensure that ratepayers receive benefits from those sales, while also providing incentive for Kentucky Power to maximize those sales, a System Sales Clause has been in effect for over a decade. Under the System Sales Clause, for each month that the off-system sales net revenue exceeds a base amount, 50 percent of the excess is credited to ratepayers. Similarly, if the monthly off-system sales net revenue falls below the base amount, 50 percent of the shortfall is charged to ratepayers.

⁴ The Commission notes that AEP's restructuring applications as originally filed at FERC did not propose to extend the Rockport contracts. The contract extensions resulted from the hard work and diligent efforts of the intervenors in the FERC proceedings.

Kentucky Power has proposed two revisions to its System Sales Clause. The first is to recognize as an expense the environmental costs associated with sales of power to non-associated utilities. Currently, these environmental costs are not recovered from retail ratepayers and they are not recognized as a deduction when determining the amount of system sales revenue to be shared. The exclusion of these environmental costs from the system sales clause has resulted in an overstatement of sales revenue credited to ratepayers.

Kentucky Power previously sought to correct this situation in Case No. 2000-00107⁵ by modifying its environmental surcharge to recover these costs. However, the Commission determined in that case that these costs were not properly recovered under the terms of the environmental surcharge and that any recovery should be through a modification of its System Sales Clause. Kentucky Power's instant filing properly remedies this situation by offsetting these environmental expenses against the revenues in its System Sales Clause. This modification results in a proper matching of expenses to revenues and is consistent with the principle of matching costs to the cost-causer.

The second modification to the System Sales Clause is to recover the additional annual cost for Rockport Unit No. 2 as proposed under the contract extension. The additional cost will be \$2.9 million for the first year following approval of the contract

⁵ Case No. 2000-00107, An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of Kentucky Power Company d/b/a American Electric Power for the Six-Month Billing Periods Ending December 31, 1998 and December 31, 1999, and for the Two-Year Billing Period Ending June 30, 1999.

extension and \$3.1 million annually thereafter. This cost will be recovered through the System Sales Clause until it is included in base rates at some future date.

The Commission finds the proposed modifications to the System Sales Clause to be reasonable, particularly when viewed in context of the Applicants proposal to extend the Rockport purchase power contracts. Therefore, the Commission will approve the proposed modifications to the System Sales Clause.

EWG AUTHORITY

The Applicants request the entry of findings sufficient to satisfy the requirements under the PUHCA, 15 U.S.C.79z-5a(c), to permit the transfer of specified generating facilities owned by affiliates of Kentucky Power to an EWG entity. The requisite findings are that: (1) the transaction does not violate any state law; (2) the transaction will benefit consumers; and (3) the transaction is in the public interest.

Based on a review of the record, the Commission finds that the transfer of out-of-state generating facilities by affiliates of Kentucky Power will not violate any Kentucky law and there is no law in Kentucky that prohibits the proposed transaction. Kentucky Power's ratepayers will receive significant benefits from the transaction due to the Applicants proposal to extend the Rockport purchase power contracts at cost-of-service rates, plus a return on Rockport Unit No. 2. The contract extension and favorable pricing are substantial benefits tied to, and contingent upon, approval of the Applicants proposal to transfer out-of-state generation to EWGs. Finally, the transfer is in the public interest because it provides Kentucky Power's ratepayers with additional, low-cost generation needed to satisfy their load requirements.

EWG INVESTMENT AUTHORITY

In addition to the requisite Commission findings set forth above, Rule 53(a)(4) of the PUHCA, 17 C.F.R. 200.53, requires each state commission with jurisdiction over an affiliate to provide the SEC certain assurances in the event that the investment in generating facilities transferred to EWGs exceeds the Applicants investment authority, which is currently 100 percent of retained earnings. Specifically, the required assurances are that the state commission has the authority and jurisdiction to protect ratepayers in Kentucky and that it intends to exercise such authority.

Based on the extent of the Commission s jurisdiction under Kentucky Revised Statutes Chapter 278, and the commitments made by the Applicants in conjunction with the AEP/CSW merger,⁶ the Commission finds that the assurances are reasonable and they will be set forth in a letter to the SEC.

STOCK TRANSFER

The corporate reorganization proposed by the Applicants includes the transfer by AEP of 100 percent of the stock of Kentucky Power to CSW. Both Kentucky Power and CSW are now wholly owned, first-tier subsidiaries of AEP. After the proposed reorganization, Kentucky Power will be a wholly owned, second-tier subsidiary of AEP. By Order dated February 27, 2002, the Commission determined that no approval was needed under KRS 278.020(5) because the transaction qualified as an exempt reorganization under KRS 278.020(6)(b).

⁶ Case No. 1999-00149, The Joint Application of Kentucky Power Company, American Electric Power Company, Inc. and Central and South West Corporation Regarding a Proposed Merger (Order dated June 14, 1999).

The Commission also determined that there was no exemption available under KRS 278.020(4), which requires prior Commission approval for the transfer of ownership or control of a utility, by transfer of stock. Here, AEP will be transferring ownership and control of Kentucky Power to CSW through a stock transfer. The criteria for approval are that the acquirer have the financial, technical, and managerial abilities to provide reasonable service. The transaction will result in no changes to Kentucky Power's capital structure and its existing debt obligations will remain outstanding. Kentucky Power will neither assume any indebtedness nor issue any stock or debt as a result of the transfer.

CSW will acquire the stock of Kentucky Power and AEP's other regulated vertically integrated utilities and regulated distribution and transmission operations. AEP will continue to make equity capital available to fund Kentucky Power's total capital requirements as necessary. Following the reorganization, there will be no material change in the operating management, personnel, or operations of Kentucky Power. Those individuals now managing the utility and providing technical and operational services will continue to do so. There should be no adverse impact on the quality of service provided by Kentucky Power and the utility will maintain its principal corporate office in Frankfort, Kentucky.

Based on the evidence of record, the Commission finds that CSW has the financial, technical, and managerial abilities to acquire Kentucky Power.

IRP FILING

Kentucky Power periodically files an IRP as required by Commission regulation, 807 KAR 5:058. The analysis of future supply resources set forth in the IRP is based on

Kentucky Power's membership in the AEP power pool and the underlying assumption that future capacity decisions will reflect the needs of the power pool in aggregate rather than any one particular member. The Applicants now propose that Kentucky Power's next IRP, to be filed no later than June 30, 2006, will reflect both Kentucky Power's capacity needs as a member of the AEP power pool and its needs on a stand-alone basis without reference to the AEP power pool.

Based on the pending modification to the AEP power pool to reflect the withdrawal of two members due to the electric restructuring in Ohio, the Commission finds that the filing of an IRP for Kentucky Power on a stand-alone basis is reasonable and prudent. The Applicants' proposal also recognizes that while an IRP is normally reviewed only by Commission Staff and addressed in a Staff Report, Kentucky Power's next IRP will be subject to formal review and decision by the Commission. This procedure will ensure that Kentucky Power will have sufficient capacity available at reasonable costs to meet its load after the Rockport Unit No. 1 contract expires.

IT IS THEREFORE ORDERED that:

1. The modifications proposed by Kentucky Power to its System Sales Clause are approved. Within 10 days of the date of this Order, Kentucky Power shall file with the Commission revised tariffs showing the date of issue and that they were issued by authority of this Order.

2. The transfer of 100 percent of Kentucky Power's stock from AEP to CSW is approved.

3. Kentucky Power shall file with the Commission, no later than June 30, 2006, an IRP which analyzes future supply resources based on both continued membership in the AEP power pool and on a stand-alone basis.

Done at Frankfort, Kentucky, this 17th day of December, 2002.

By the Commission

ATTEST:


Executive Director