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Credit Opinion: Kentucky Power Company

Global Credit Research - 10 Feb 2014

Ashland, Kentucky, United States

Ratings

Category	**Moody's Rating**
Outlook	Stable
Issuer Rating	Baa2
Senior Unsecured	Baa2
Parent: American Electric Power Company, Inc.	
Outlook	Stable
Senior Unsecured	Baa1
Jr Subordinate Shelf	(P)Baa2
Commercial Paper	P-2

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Key Indicators

[1]**Kentucky Power Company**

	12/31/2009	**12/31/2010**	**12/31/2011**	**12/31/2012**	**9/30/2013**
CFO pre-WC + Interest / Interest	**3.9x**	**3.4x**	**3.8x**	**3.8x**	**4.1x**
CFO pre-WC / Debt	**17.6%**	**14.6%**	**17.7%**	**17.2%**	**18.7%**
CFO pre-WC - Dividends / Debt	**14.5%**	**11.3%**	**13.3%**	**12.0%**	**14.4%**
Debt / Capitalization	**46.1%**	**45.7%**	**44.0%**	**42.8%**	**42.9%**

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

Acquisition of 50% interest in Mitchell plant will help address expected capacity shortfall

Constructive regulatory environment

Maintenance of current ratings will depend on capital injections from the parent

Historically strong industrial sales remain flat in 2013

Recently stabilized key financial metrics will be materially pressured by plant acquisitions

CORPORATE PROFILE

Kentucky Power Company (KPCo, Baa2 senior unsecured, stable outlook) is a vertically integrated electric utility company headquartered in Frankfort, Kentucky and is a wholly owned subsidiary of American Electric Power Company (AEP, Baa1 senior unsecured, stable outlook). KPCo is one of AEP's smaller subsidiaries, with about $1.8 billion in rate base (6% of AEP's state jurisdictional total) and $1.6 billion assets (3% of AEP consolidated). KPCo's primary regulator is the Kentucky Public Service Commission (KPSC). KPCo's total owned generation capacity is 1,858 MW, consisting of two units at the Big Sandy plant, and a 50% ownership in the Mitchell plant. It also purchases approximately 195MW from its affiliate AEP Generating Company's share of the Rockport plant under a long-term unit power agreement. KPCo's total capacity of approximately 1,858 MW is 100% coal. KPCo's 2012 peak demand was reported as 1,378 MW, resulting in a negative reserve margin, which KPCo has primarily met with purchases from its market affiliates.

SUMMARY RATING RATIONAL

KPCo's Baa2 senior unsecured rating primarily reflect its reasonably constructive relationship with the KPSC, historical financial metrics that have improved to a consistent level with the rating, and the company's position as one of the smaller members the AEP family, balanced against a reserve deficit that will need to be addressed in serial rate filings, rates that are already high relative to in-state peers, and financial metrics that will likely be materially stressed as a result of asset acquisitions and other capacity purchases/construction that will be required to replace Big Sandy.

DETAILED RATING CONSIDERATIONS

MAKING PROGRESS IN REPLACING BIG SANDY CAPACITY AND ADDRESSING NEGATIVE RESERVE MARGINS

We view the settlement to move forward with the Mitchell Plant acquisition in lieu of the more expensive and operationally riskier Big Sandy retrofit as a credit positive.

Big Sandy, Unit 2 (800 MW) is expected to cease operation as a coal-fired plant in mid-2015. In May 2012, KPCo withdrew its application for a proposed $940 million environmental retrofit project at Big Sandy Unit 2, opting instead to retire the unit in 2015 and acquire a 50% ownership share in the Mitchell Plant from its affiliate Ohio Power Company (OPCo, Baa1, stable outlook), representing 780 MW for an estimated cost of $536 million, half of the asset's projected net book value. The Mitchell Plant consists of two environmentally controlled coal-fired units with a total capacity of 1,560 MW. The other 50% interest is currently owned by AEP Generation Resources. The West Virginia PSC deferred making a decision to transfer the remaining 50% interest in Mitchell Plant to APCo.

In October 2013, the KPSC approved the transfer of the 50% interest in Mitchell Plant. The approved settlement requires a freeze in KPCo's utility base rates until May 31, 2015, withdrawing KPCo's previous rate case application, and a $44 million annual limit on the recovery of costs associate with the transfer. On December 2013, KPCo filed an application with the PSCK to convert the 278 MW Big Sandy coal Unit 1 to a 268 MW natural gas fired unit which is expected to cost $50 million and to be in service around 2015. Currently, KPCo could possibly meet its additional capacity needs by continuing to purchase power from various affiliates and there is a pending application for a 59 MW PPA for a biomass plant.

However, on a forward-looking basis, according to the PJM UCAP, after the Mitchell transfer and conversion of Unit 1 at Big Sandy, KPCo will not have a negative reserve margin. In addition, KPCo will also be responsible for a portion of the Rockport upgrades, but the company will pay these costs over time through higher capacity costs. In addition to regulatory approvals to increase rates commensurate with its higher rate base and capacity expenses, KPCo will require additional equity injections from AEP (the last received was in 2009) to maintain an appropriate capital structure.

After Big Sandy Unit 2 retires in 2015, KPCo will have approximately 1,058 MW of owned capacity.

APPROVAL OF THE POWER COORDIANTION AGREEMENT ADDS A MODICUM OF UNCERTAINTY

Effective January 2014, under the Power Coordination Agreement (PCA) KPCo, Indiana Michigan (I&M, Baa1, stable outlook), and Appalachian Power Company (APCo, Baa1, stable outlook) will coordinate capacity, with American Electric Power Service Corporation (AEPSC, not rated) acting as agent (including review of procedures for cost and benefit allocations). Each operating company will be required to own or contract for sufficient

generation to meet its respective load and reserve obligations. There is no obligation for the utilities to first sell their energy or capacity to each other before selling to third parties, from which Moody's infers that sales to affiliates will mostly occur at a market price. The PAC is designed to provide the AEP East Utilities with the opportunity to (a) participate collectively under a common FRR capacity plan in PJM, and (b) to participate in specified collective off-system sales and purchase activities.

For its part, KPCo will need to address its current capacity shortfall through asset acquisitions and/or capacity purchases at market prices. KPCo's purchases from third parties at less advantageous market prices rather than affiliate transactions at cost-based costs could add pressure to the fuel/purchased power component of rates.

CONSTRUCTIVE REGULATORY ENVIRONMENT A CREDIT POSITIVE

Moody's views the regulatory environment in Kentucky as reasonably supportive to long-term credit stability, contributing to predictability of cash flows, a material credit positive. Utilities can start to collect interim rates approximately six months after filing a rate case if the KPSC has not acted on it. Electric utilities have generally been allowed to earn a return on essentially all construction work in progress (CWIP). There are also various riders and cost recovery mechanisms that help to reduce regulatory lag, including a fuel adjustment clause, an energy efficiency rider and, most significantly, an environmental cost recovery rider. Proceedings from the latter are conducted every two years. The KPSC has authorized significant amounts of environmental spending for some of the state's other investor-owned utilities, and Moody's expects that KPCo would be granted similar treatment for reasonable costs incurred to replace capacity that could not economically meet federally mandated environmental standards.

In June 2010, the KPSC approved a not overly-generous rate settlement agreement for KPCo authorizing a $64 million rate increase, based on a 10.5% authorized ROE with 43% equity, and recovery of $23 million of storm costs over five years. KPCo will have frozen base rates until May 31, 2015. However, later in the year, KPCo will file a base rate case for the transfer of Mitchell Plant to KPco under the asset transfer rider (ATR), which went into effect on January 1, 2014 and will allow KPCo some recovery of Mitchell's costs for 18 months while Big Sandy Unit 2 is still operational. After Big Sandy Unit 2 is retired, the full recovery of Mitchell will begin July 1, 2015 when new base rates go into effect. KPCo expects to file by the end of 2014. Environmental costs not recovered in base rates will be recovered in a ES Rider (Environmental Surcharge) that will goes into effect July 1, 2015.

HISTORICALLY STRONG INDUSTRIAL SALES CONTINUE TO BE FLAT IN 2013

Although KPCo's service territory is in the easternmost part of the state, with few urban areas other than Ashland, industrial sales represent a high percentage of total production - about 4% of retail KWh sales and 3% of retail revenues. Of the ten largest industrial customers, which represent 67% of industrial sales, there are six coal mining companies, two steel manufacturers, one refinery, and one chemical company per Moody's Analytics. Industrial sales were remarkably stable from 2006-2011, even during the recession, in part because coal prices have been generally been sufficient to keep the mines active. KPCo's territory is on the western edge of the Utica shale formation, which may spur further energy development in the longer term.

RECENTLY STABILIZED CREDIT METRICS WILL BE WEAKEN DUE TO HIGH CAPITAL EXPENDITURES AND NEW CAPACITY NEEDS

On balance, KPCo's financial credit metrics have mostly been appropriate for its Baa2 rating category over the past four years, after rebounding from a low point in 2008. On a three-year average basis through third-quarter 2013, KPCO's ratios were barely in line with mid-Baa scoring. The cash from operations before working capital adjustments to debt (Leverage ratio) is at 18%, its ratio of CFO pre-WC minus dividends to debt (RCF ratio) is at 13.5%, and its ratio of CFO pre-WC plus interest to interest (Coverage ratio) is at 3.9x. Whereas the debt to capitalization ratio is at 43.2% was more in line with a low-A scoring.

On a one-year basis LTM third-quarter 2013 ratios were all stronger than the three-year average ratios, Leverage ratio at 18.7%, RCF ratio at 14%, Coverage ratio at 4.1x, and debt to capitalization at 43%. Going forward, Moody's expects material deterioration in KPCo's metrics following the acquisition of the Mitchell plant, since about $265 million of debt will be assumed. In addition, since KPCo decided to re-power Big Sandy Unit 1, it will have additional construction expenditures during this period. Thus, our expectation that AEP will provide sufficient equity capital to maintain an appropriate capital structure is crucial to the continuance of the current ratings.

Liquidity

KPCo's liquidity is adequate. KPCo participates in the AEP Utility Money Pool with a borrowing limit of $250 million,

which provides access to the parent company's liquidity. As of Third-quarter 2013, KPCo had a no borrowings from the Money Pool. KPCo also utilizes AEP's receivable securitization facility.

For the twelve months ending September 2013, KPCo generated approximately $78 million of cash from operations, invested approximately $86million in capital expenditures and made $27 million in upstream dividend payments to AEP, resulting in approximately $35 million of negative free cash flow. In 2014, we expect KPCo to generate between $100-140 million of cash from operations, invest approximately $100-120 million in capital expenditures and pay dividends between $20-30 to its parent. As of Sept 30th, KPCo has no long-term debt maturities until 2017. KPCo assumed a portion of the term loan maturity May 2015 with the Mitchell assets.

AEP's liquidity is adequate. AEP has two syndicated credit facilities totaling $3.5 billion that were renewed and extended in mid-2011. One is a $1.75 billion facility expiring June 2016, and the other is also a $1.75 billion facility (upsized from $1.5 billion) expiring in July 2017. The facilities permit same-day borrowing and have a combined letter of credit sub-limit of $1.2 billion. The facilities contain a covenant requiring that AEP's consolidated debt to capitalization (as defined) will not exceed 67.5%. AEP states the actual ratio was 50.9% at Third-quarter 2013, indicating substantial headroom. AEP is not required to make a representation with respect to either material adverse change or material litigation in order to borrow under the facility. Default provisions exclude payment defaults and insolvency/bankruptcy of subsidiaries that are not significant subsidiaries per the SEC definition (in general, this would exclude subsidiaries representing less than 10% of assets or income, but AEP Texas Central and Southwestern Electric Power Company are also effectively excluded as significant subsidiaries due to definitional adjustments in the credit facilities. In July 2013, AEP Generating Resources (AEPGenCo, not rated), APCo, KPCo, and OPCo entered into a $1 billion term credit facility due in May 2015 to fund certain OPCo maturities on an interim basis and to facility its corporate separation of generation assets from transmission and distribution. As of third-quarter 2013, the outstanding position is $600 million

As of LTM third-quarter 2013, AEP had $147 million of cash on hand and approximately $2.8 billion of availability under its two syndicated revolving credit facilities after giving effect to $518 million of commercial paper outstanding and $185 million of issued letters of credit. In June 2012, AEP renewed its $700 million accounts receivable securitization, of which only the $315 million multi-year portion is included as an available source in our liquidity testing. On a consolidated basis for LTM third-quarter 2013, AEP generated approximately $4.2 billion in CFO pre-WC, made approximately $3.7 billion in capital investments and net asset purchases, and paid about $938 million in dividends, resulting in roughly $438 million of negative free cash flow. Including securitization bonds, put bonds and other amortizations, AEP has debt maturities of $1140 in 2014. Over the next two years, Moody's estimates (based on adjusted company projections) that AEP will generate roughly average $4 billion annually in CFO pre-WC, spend about average of 4 billion annually in capital expenditures, and assuming $1 billion in dividends annually, yielding negative free cash flow of average $950 million per year.

Rating Outlook

The stable rating outlook for KPCo is primarily based on our expectation that the company will continue to maintain a constructive relationship with the KPSC following the transfer of the 50% interest in the Mitchell Plant and that AEP will provide the capital injections needed for KPCo to maintain the stabilized key financial credit metrics that support the current rating.

What Could Change the Rating - Up

Rating upgrades appear unlikely over the near to intermediate term horizon, primarily due to our expectation that KPCo will be challenged to maintain its financial profile in light of its recent plant acquisition. However, KPCo could be considered for a rating upgrade if it were to achieve key financial credit metrics, including CFO pre-WC plus interest over interest of approximately 4.5x and CFO pre-WC to debt of approximately 20% on a sustainable basis.

What Could Change the Rating - Down

KPCo's ratings could be downgraded if the regulatory environment were to take a more adversarial tone, especially; if material progress were not made in the next 12 months in meeting KPCo's post-Big Sandy capacity shortfall; if equity contributions from AEP were not forthcoming in a manner to maintain an appropriate capital structure; if there were a material, sustained decrease in retail sales and revenues (especially from industrial customers); or if there were a sustained deterioration in key financial credit metrics, for instance, a Coverage Ratio below 3.0x or CFO Pre-WC to debt in the low-teens.

Rating Factors

Kentucky Power Company

Regulated Electric and Gas Utilities Industry Grid [1][2]	**Current LTM 9/30/2013**		[3]**Moody's 12-18 Month Forward ViewAs of January 2014**	
Factor 1 : Regulatory Framework (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Legislative and Judicial Underpinnings of the Regulatory Framework	A	A	A	A
b) Consistency and Predictability of Regulation	A	A	A	A
Factor 2 : Ability to Recover Costs and Earn Returns (25%)				
a) Timeliness of Recovery of Operating and Capital Costs	Baa	Baa	Baa	Baa
b) Sufficiency of Rates and Returns	Baa	Baa	Baa	Baa
Factor 3 : Diversification (10%)				
a) Market Position	Baa	Baa	Baa	Baa
b) Generation and Fuel Diversity	Ba	Ba	Ba	Baa
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	3.9x	Baa	3.5x - 3.9x	Baa
b) CFO pre-WC / Debt (3 Year Avg)	18.0%	Baa	14% - 18%	Baa
c) CFO pre-WC - Dividends / Debt (3 Year Avg)	13.5%	Baa	10% - 12%	Baa
d) Debt / Capitalization (3 Year Avg)	43.2%	A	48% - 51%	Baa
Rating:				
Grid-Indicated Rating Before Notching Adjustment		Baa1		Baa2
HoldCo Structural Subordination Notching				
a) Indicated Rating from Grid		Baa2		Baa2
b) Actual Rating Assigned		Baa2		Baa2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 9/30/2013(L); Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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