



Date July 18, 2003

Subject Accounting for Asset Retirement Obligations (ARO)

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This memo documents AEP's approach to determining ARO's, March 2003 ARO related journal entries, related disclosures in the 1st quarter 2003 10-Q, development of ARO data for the five year budget and the issuance of a letter to the FERC dated July 17, 2003 seeking concurrence on the net income effect of transferring generation related removal cost from accumulated depreciation for certain formerly regulated jurisdictions. Its issuance follows completion of D&T's review of the ARO documentation, including this memo.

1. Overview

AEP implemented SFAS 143, "Accounting for Asset Retirement Obligations," effective January 1, 2003. This Standard requires the recordation of a liability at fair value for any legal obligations for asset retirements in the period incurred and the establishment of a corresponding asset which will be depreciated over its useful life. SFAS 143 requires that a cumulative effect of a change in accounting principle be recognized for the cumulative accretion and accumulated depreciation which would have been recognized had SFAS 143 been historically applied. Note that for regulated property that has a legal obligation to remove it, there was no cumulative effect due to the recordation of a regulatory asset. In addition, the cumulative effect of the ARO accounting change is favorably affected for recently deregulated generation property by the reversal of accumulated removal cost that had previously been collected from customers through regulated rates and recorded in depreciation expense for generation property that does not have a legal obligation to remove the property for certain formerly regulated subsidiaries.

The net favorable cumulative effect of the change in accounting principles and the components of the ARO liability as of January 1, 2003 consist of the following (see pages L-8 and L-9 of AEP's 1st Quarter 2003 10-Q for amounts by legal entity):

	Pre-Tax Income (Loss) (in millions)	January 1, 2003 ARO Liability (in millions)
Ash Ponds	(62.8)	69.8
U. K. Plants	(11.0)	22.5
Wind Mills	(.3)	1.6
AEP Coal	0	13.1
Nuclear (Cook & STP)*	0	718.3
Reversal of Cost of Removal on Deregulated Non-ARO Property	472.6	0
	398.5	825.3

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* Refer to information provided below on the ARO liability for Nuclear, which although there was no net income effect because of regulatory assets/liabilities, there was a large ARO liability established due principally to reclassification of certain existing balances provided through rates.

2. Approach to Determining Legal Retirement Obligations

AEP's Legal Department performed a review of AEP's asset retirement obligations (see Exhibit A, February 14, 2003 Legal Department Review of SFAS No. 143 - Accounting for Asset Retirement Obligations)¹ and determined that it had legal removal obligations for ash ponds (including CSP Stuart River Structures and CSP Zimmer Landfill) for five East companies and windmills for two companies. Note that the wind farms are located on leased land and the leases require that the windmills be removed when the wind farms are retired. The Legal Department Review also considered promissory estoppel claims and concluded that "...our review of case law indicates that it is unlikely that a party could successfully assert a significant claim under a theory of promissory estoppel."

See Exhibit B, memo from J F Mainieri/P Amaya to J E Henderson, for a summary of the closure costs for open ash and FGD waste disposal sites (details supporting the estimates are on file in Civil Engineering).

AEP identified (see Exhibit A, Legal Department Review), but did not recognize ARO liabilities related to electric transmission and distribution (T&D) and gas pipeline assets at HPL and LIG, as a result of certain easements on property on which AEP has assets. Generally, such easements are perpetual and require only the retirement and removal of AEP's assets upon the cessation of the property's use. The retirement obligation is not estimable for such easements since AEP plans to use its T&D properties indefinitely. The retirement obligation would only be recognized if and when AEP abandons or ceases the use of specific easements.

The Legal Department Review concluded that there were no AROs associated with generation plants other than the ash pond and environmental retirement obligations discussed herein. In contrast, the Review also determined there was an ARO for underground storage tanks and PCBs in transformer rectifier sets, but the liability could not be estimated; the assets are currently in use, there are no plans to discontinue their usage and the retirement dates are unknown. Any leakage from the underground tanks would be dealt with under AICPA SOP 96-1, Environmental Remediation Liabilities.

Further, the Review determined there was a liability for the Dolet Hills reclamation; however, this liability was established upon acquisition of Dolet Hills for delinquent (remedial) reclamation and AEP views this existing liability comes under AICPA SOP 96-1. Dolet Hills also accrues certain amounts for current reclamation and a final reclamation liability at the rate of 75¢ per ton. These two accruals will be reviewed in a separate memo for SFAS 143 application. It is our expectation that the amounts accrued for final reclamation exceed the preliminary SFAS 143 amounts.

The ARO liability for SWEPCO's Pirkey Mine is disclosed as a guarantee by AEP but it is not AEP's liability. It is recorded by North American Coal Company (NAC) subsidiary Sabine and offset on their general ledger by a receivable from AEP. However, the reclamation costs are accrued monthly by AEP and recorded as a liability to NAC (Sabine). The guarantee is described in the excerpt below from Note 10 of AEP's 2002 10-K:

¹ Because of volume, attachments will not be distributed, but will be kept in the Accounting Policy & Research files.

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As part of the process to receive a renewal of a Texas Railroad Commission permit for lignite mining, SWEPCO has agreed to provide guarantees of mine reclamation in the amount of approximately \$85 million. Since SWEPCO uses self-bonding, the guarantee provides for SWEPCO to commit to use its resources to complete the reclamation in the event the work is not completed by a third party miner. At December 31, 2002 the cost to reclaim the mine is estimated to be approximately \$36 million. This guarantee ends upon depletion of reserves estimated at 2035 plus 6 years to complete reclamation.

Further, AEP has legal retirement obligations for its two nuclear plants, Cook and its partial ownership of South Texas Project. Since AEP recovers its nuclear decommissioning costs in its regulated revenue and thus had accrued for such nuclear retirement obligations (STP liability recorded in account 108 and Cook liability in Account 228), it recognized the cumulative difference in the amount already provided through rates versus the new methodology of SFAS 143 as a regulatory asset (STP) or regulatory liability (Cook). Although AEP Texas Central Company, the owner of AEP's 25.2 % ownership of STP discontinued application of SFAS 71 for generation in 1999, the nuclear decommissioning remains regulated under Texas law. See Exhibits C and D which describe the approach to determining the ARO liability for Cook and STP, respectively. The nuclear ARO liabilities were based on third party costs, and included the effect of the respective actual funding to the nuclear decommissioning trusts. Additionally, the Cook ARO liability was determined using eleven probability weighted decommissioning scenarios from the last rate case together with the effect of a probable license extension of twenty years (we understand that AEP plans to file for a license extension in 2003). In contrast, STP is a fairly recent-vintage plant and is not close to a decision on license extension. AEP utilized a third party market risk premium assumption of zero on the ARO calculations (including nuclear) inasmuch as no basis could be found to estimate the percentage adder necessary to enable a full assumption of the liability to a third party. Paragraph 62 of Concepts Statement 7 states that if a reliable estimate of the market risk premium is not obtainable, the present value of expected cash flows discounted at a risk-free rate may be the best available estimate of fair value.

Except for the transfer of the STP decommissioning liability in Account 108, there were no other transfers of amounts collected through depreciation related to an ARO legal liability, but see Section 3 related to the reversal of removal cost from accumulated depreciation associated with a non-ARO on recently deregulated generation property.

Finally, AEP has legal retirement obligations for certain AEP Coal facilities and for the two U.K. plants. AEP Coal had an existing reclamation reserve available to allow for a reclassification to an ARO liability of pre-acquisition liabilities of \$13.2 million and established an ARO asset/liability of \$.1 million for two sites related to the post-acquisition period. The U. K. ARO (see Exhibit E, memo from T E Mitchell/D J Campbell dated April 4, 2003) was based on a probability-weighted analysis including an 80% weighting on plant closure in 2015, consistent with the current depreciation period. AEP adjusted the recorded liability (from acquisition) to arrive at the unfavorable cumulative effect of about \$11.0 million. AEP did not record a new ARO asset for either AEP Coal or the U.K. plants since these assets had recently been impaired; instead, the ARO asset values are presumed to be a part of the existing asset values.

3. Calculation of Removal Costs to Be Reversed as Non-legal Retirement Obligations

D&T has advised that the SEC has interpreted that any accrued liabilities for non-legal ARO costs must be reversed, unless SFAS 71 is employed (see Exhibit F, D&T e-mail dated January 8, 2003), in which case the regulatory liability must be disclosed (see Exhibit G, D&T e-mail dated January 16, 2003). AEP's Legal Department documented in a letter that there is no obligation to refund to customers the non-legal ARO costs that were reversed (see Exhibit H, Legal Letter). Also see

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Exhibit I for a description of how AEP determined the gross removal costs embedded in accumulated depreciation. The December 31, 2002 accumulated depreciation balances AEP used for determining the eligible removal cost to reverse, excluded the retirement work in progress balances (RWIP). Accordingly, Dave Davis, Owned Asset Accounting, calculated how much removal cost was contained in the RWIP balance and that amount was also reversed as a part of the change in accounting principle. See page four of Exhibit J for the entries related to the reversal of Accumulated Depreciation balances for cost of removal and the reversal of the removal cost included in RWIP balances.

AEP discussed with D&T's National Office (Jan Umbaugh) whether the generation removal cost relating to jurisdictions formerly on SFAS 71 (Ohio, Virginia and Texas) could be reclassified from Accumulated Depreciation as a regulatory liability, but D&T advised that there could be no "embedded regulatory liability" since those jurisdictions were off of SFAS 71. Accordingly, there was no alternative but to reverse the net cumulative removal cost to income for generation property in the following jurisdictions which had deregulated generation: Ohio, Virginia and Texas (SWEPCO and AEP Texas North). The Texas jurisdiction portion of AEP Texas Central was not reversed to income given the 2004 regulatory true-up that includes accumulated depreciation balances for generation.

AEP disclosed the removal cost balances included in accumulated depreciation for its regulated transmission and distribution subsidiaries that have removal cost included in depreciation rates (see Exhibit K) as well as the regulated generation amounts where applicable for the following jurisdictions: Kentucky, Indiana, Michigan, West Virginia, Oklahoma, Louisiana, Arkansas and Texas (TCC).

4. Summary of Initial Journal Entries

See Exhibit L, which summarizes the initial journal entries, and also see Exhibit J that includes the entries made primarily in Owned Asset Accounting, Canton (via the Power Plant software ARO module for those assets that are currently in Power Plant), except for certain nuclear reclassification entries made in the Utility Ledger Group. Unique ARO accounts were utilized in the general ledger using the FERC prescribed ARO accounts (see Exhibit M, FERC Order No. 631, Accounting, Financial Reporting, and Rate Filing Requirements for Asset Retirement Obligations):

<u>Account</u>	<u>Description</u>
1823099	Regulatory Asset - Asset Retirement Obligations
2284005	Nuclear Decomm - ARO Contra
2300001	Asset Retirement Obligations
2540056	SFAS 143 ARO - Excess Provision
4031001	Depreciation Expense - ARO
4111005	Accretion Expense
5240009	Nuclear Decomm Expense - ARO

The entries record the ARO asset (note that new FERC Electric Plant Accounts 317, Asset retirement costs for steam production plant, and 326, Asset retirement costs for nuclear production plant, were established), the related accumulated depreciation and ARO liability as of March 2003, the ARO depreciation and accretion expense, and the cumulative effect for non-regulated jurisdictions. Regulatory assets are recorded for the regulated jurisdictions as appropriate (note that new account 4074001 was established in the 2nd quarter to track ARO Regulatory Credits).

Special accounting was necessary for both Cook and STP, which had existing processes to record the monthly decommissioning cost as an expense (Cook charges account 5240008 and STP charges

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account 4030006). Since the ARO depreciation and accretion are being recorded monthly, the original decommissioning expense entries were reversed to the extent that they were less than the SFAS 143 amounts and any difference affecting income was deferred; STP established a regulatory asset of \$2.2 million for the first quarter 2003 activity which together with the cumulative effect, resulted in a regulatory asset of \$63.8 million as of March 31, 2003. For Cook Plant, as of March 31, 2003, the related regulatory liability is about \$133.1 million.

5. Summary of Discount Rates and Inflation Rates

The following discount and inflation rates were applied to compute the ARO obligations for each asset type:

	Discount Rate	Inflation Rate
	%	%
Ash Ponds excluding Zimmer	7.76	3.18
Zimmer Landfill	7.76	2.5
Wind Mills	8.76	4.5
U. K. Plants	4.48	2.5
AEP Coal	5.12	2.5
Cook Nuclear Plant	6.97	4.50/6.50
STP Nuclear Plant	7.39	4.5

Notes:

- Discount rates generally provided by Finance.
- 3.18% inflation rate was based on the average change in the CPI index 1983-2001.
- 2.50% inflation rate provided by Cinergy.
- 4.5% and 6.5% inflation rates based on MPSC Case No. U-6150.
- For Cook Plant, 4.5% used for Greenfield and Section 50.54(bb) costs; 6.5% used for other costs.

6. Prior Years Pro Forma Disclosure of ARO

Pro forma net income and earnings per share were not presented for the quarter ended March 31, 2002 or the years ended December 31, 2002, 2001 and 2000 because the pro forma application of SFAS 143 would result in pro forma net income and earnings per share not materially different from the actual amounts reported for those periods. See Exhibit N for details of the respective calculations.

7. Ongoing Disclosure of ARO and Related ARO Information

AEP will disclose in its financial statements the reconciliation of the ARO liability by registrant for additions (for accretion) and deductions (for ARO retirement costs incurred); this will be coordinated by Canton Accounting. The fair value of the nuclear trust funds which are legally restricted for purposes of settling the nuclear decommissioning liabilities will be disclosed as well as the line item containing accretion expense (Maintenance and Other Expense).

EITF Issue 02-6, *Classification in the Statement of Cash Flows of Payment Made to Settle an Asset Retirement Obligation within the Scope of FASB Statement No. 143*, requires that a cash payment made to settle an asset retirement obligation be classified as an operating activity in the statement of cash flows. Also, because there is no receipt or payment of cash for increases in assets resulting from capitalizing asset retirement costs, they should not be reflected in the statement of cash flows as cash flows used for investing activities.

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Additionally, AEP will disclose the accumulated removal cost recorded in accumulated depreciation for regulated jurisdictions' amounts (generation, transmission, distribution and general, as applicable), see Exhibit K. We did not reclassify these amounts to a regulatory liability in accordance with guidance in the attached D&T email (see Exhibit G).

We will work with groups like Financial Reporting, Owned Asset Accounting, Corporate Planning and Budgeting, Civil Engineering and AEP Coal to ensure that ARO retirement costs incurred and any new ARO liabilities are handled appropriately.

ARO's will be reassessed annually to determine whether a change in estimate is necessary if there are indicators that the cash flows have changed materially (similar to the approach under FAS 144).

8. Reduction of Depreciation Rates for Those Jurisdictions Whose Generation Was Formerly Regulated and Expensing of Removal Costs

AEP reduced the generation depreciation rates to remove the removal cost element for property in its formerly regulated jurisdictions (Ohio, Virginia and Texas including TCC) for which the accumulated removal cost in accumulated depreciation was reversed as a part of the change in accounting principle.

Effective January 1, 2003, removal cost on generation property for these formerly regulated jurisdictions will be expensed as incurred unless it is related to an established ARO liability such as the East ash pond closures. Dave Davis has worked with IT to program such removal cost to expense. A new account, 5060003, was established for this expense.

9. Accretion Expense Projected for the Future

For Corporate Planning and Budgeting's purposes, Exhibit O indicates the expected accretion expense for the five-year period ended 2008 based on information currently projected for ARO removal cost expenditures.

10. Income Tax Effects

The Tax Department has advised that generally the ARO accounting is offset by specific Schedule M treatment with deferred taxes (see Exhibit P, Tax Department email dated April 23, 2003, which describes the appropriate treatment). See Exhibit Q, Summary of Entries to Record the Implementation of SFAS 143, for the Federal Income Tax and Deferred State Income Tax impact on the cumulative effect of accounting change related to SFAS 143. Also see Exhibit R, Tax Department email dated June 9, 2003, for Schedule M adjustments related to the exclusion of the removal cost element of the depreciation rates for certain formerly regulated jurisdictions (Ohio, Virginia and Texas).

11. Property Taxes on ARO Asset

AEP plans to seek treatment of the ARO asset as an intangible asset. Classification as an intangible asset for property tax purposes will allow AEP to exclude the ARO asset from the assessed property value and avoid overpaying property taxes. This position was also advocated by EEI.

12. FERC Docket No. RM02-7-000, Order No. 631

The subject docket amended FERC regulations to implement SFAS 143 and requires the filing by July 20, 2003 of journal entries by jurisdictional entities for instances where income was affected (i.e.


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a regulatory asset/liability was not recorded). This affects AEP due to the reversal of cost of removal in accumulated depreciation and the cumulative effect of the change in accounting principle for non-regulated generation property in Ohio, Texas and Virginia. Accordingly, AEP wrote the FERC on July 17, 2003 to seek their concurrence since these jurisdictions' operations are included in the annual FERC Form 1, even though they are off of SFAS 71 for GAAP reporting purposes (see Exhibit S).

13. Other Comments

As information, the detailed calculations supporting the initial ARO values which underlie the attachments to this memo will be included in a binder and kept on file in Accounting Policy & Research and Owned Asset Accounting in Canton.



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(W/out Attachments)

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