Pension Funding Options

September 28, 2004

Pension Plan Overview

- *Asset growth has been modest: low returns, high benefit payments*
- *Liabilities have risen: interest rates declined*
- *AOCI balance is expected to increase by approximately $200 million; leverage up .6%*
- *Near term outlook is not promising*
- *Increase in pension contribution of a minimum of $200 million proposed in 2004*
  - *Accelerates contributions needed in next 3 years*
  - *Eliminates AOCI in West plan, leverage reduced by .67%*
  - *Improves 2005 earnings by 2.3¢/share*

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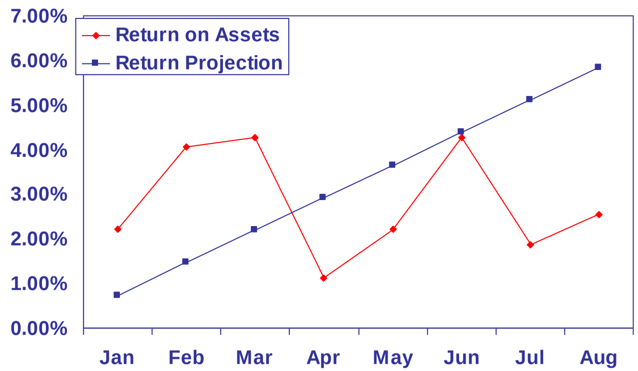
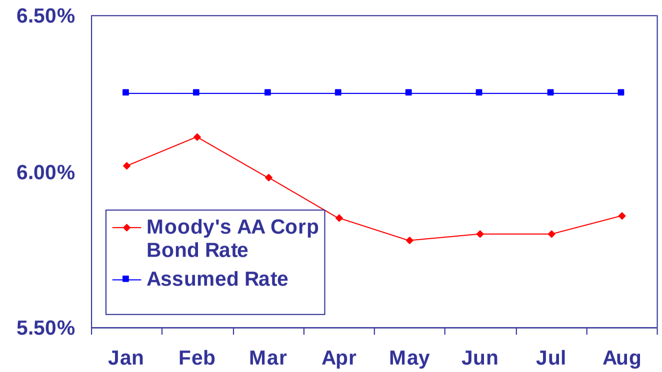
2004 YTD Pension Drivers

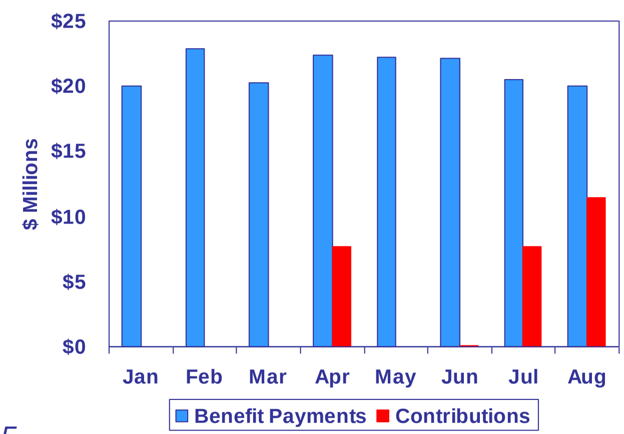
- Asset growth has been modest:



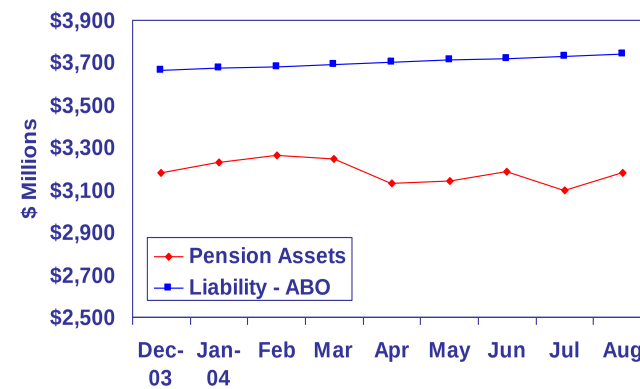
- While long term interest rates have continued to decline:



- Benefit payments have exceeded contributions:



- So liabilities have risen while assets have not:

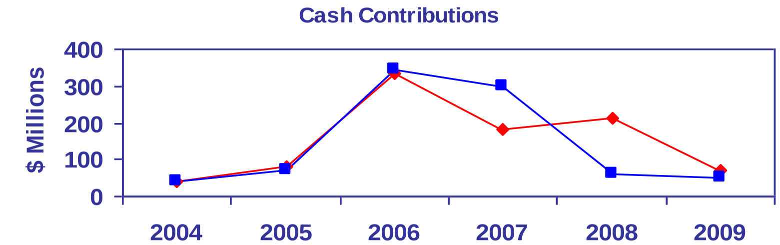


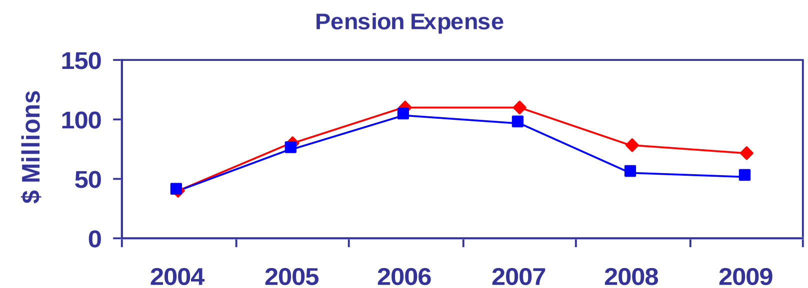
Updated Pension Forecast

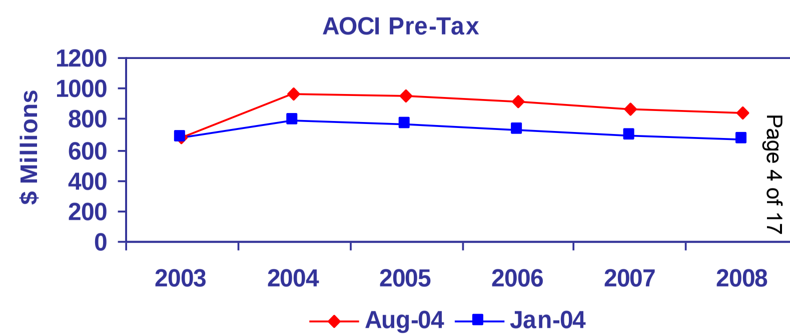
- **_Key changes in assumptions:_**

	Jan 04	Aug 04
Accounting Discount rate	6.25%	6.00%
Return on Assets 2004	8.75%	5.44%

- **_Expense and contributions have only changed slightly from the previous forecast_**
- **_2004 AOCI balance is estimated to be approximately $200 million greater after-tax than year-end 2003 balance_**
- **_Texas power plant employees are included in this forecast_**
  - **_Law requires their inclusion for funding purposes for 2004_**
  - **_220 severed employees will have a very small impact on accounting figures – approximately 1% to 2% reduction_**

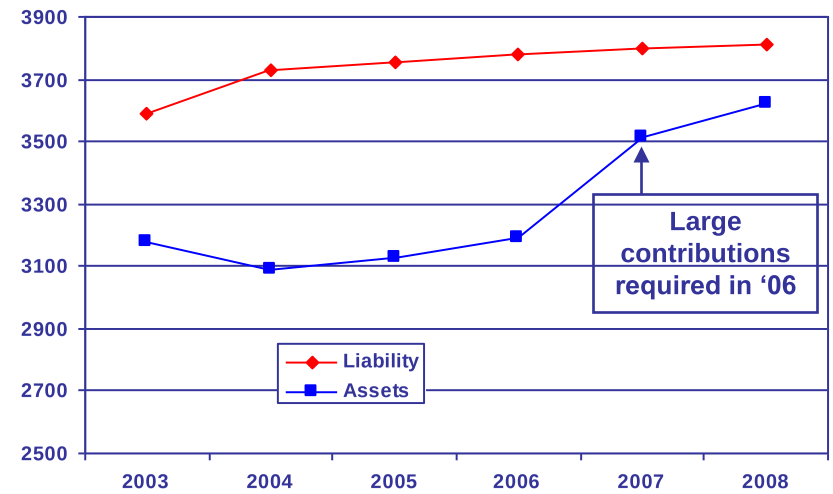






Pension Strategic Outlook

- *Plan remains under funded through 2008*
- *Interest Rates near 40 year low*
  - *Even increased rates won't help much in near term*
- *Traditional investment strategies may not meet investment return goals*
- *Benefit payments remain 8-10% annually of assets*
- *Current economic situation leads many to believe that inflation may heat up*



- *What Can We Do?*
  - *Eliminate low-returning investments*
  - *Increase asset diversification*
  - *Increase contributions*

Increase 2004 Pension Contributions – Options Considered

$ Millions	2004	2005	2006	2004-2009 Total
Base Case: August 2004 Update	$41.2	$79.0	$333.5	$923.0
Option 1: Eliminate West AOCI in 2004	238.0	55.0	251.0	880.0
Option 2: Eliminate West AOCI in 2004, East in 2005	435.0	280.0	14.0	791.0
Option 3: Eliminate both West & East AOCI in 2004	605.0	12.0	14.0	693.0

It would take approximately $600 million additional contribution to completely eliminate AOCI.

Regulatory Impact / Other Issues

- *Currently most states are recovering on the basis of expense during test year.*
- *TX & LA recover expense to the extent they fund trust. Checking on impact of lump sum contribution.*
- *Tax estimates are preliminary. Continuing to finalize tax impact.*

Current Recommendation

- ***Option 1: Increase cash contribution by $200 million in 2004 to eliminate the West AOCI***
- ***Earnings/Expenses – Lowers 2005 expense by $18 million and increases earnings by $9 million or 2.3¢/share***
- ***Balance Sheet – Eliminates West after tax AOCI of $249 million and improves leverage by .67%***

Components of Pension Expense

$ in Millions

		2005		
	2004	Base Case	Option 1	Option 3
Service Cost – the cost of employees earning benefits.	84	91	91	91
Interest Cost – the cost of employees getting closer to the payment of those benefits.	223	225	225	225
Expected Return on Assets – the dollar amount of investment return expected on pension assets. The assets are averaged over five years.	-293	-277	-294	-333
Amortizations – gradually recognizes the difference between expected and actual results.	15	33	33	33
Net Periodic Benefit Cost – the pretax pension expense. The sum of all of the above, plus SERPs.	40	80	62	23
Earnings – 25% capitalized, 35% tax rate	19	38	30	11
EPS	0.05	0.10	0.08	0.03

Pension Forecast 2003 vs. 2004
Impact on AOCI and Leverage

$ in Millions

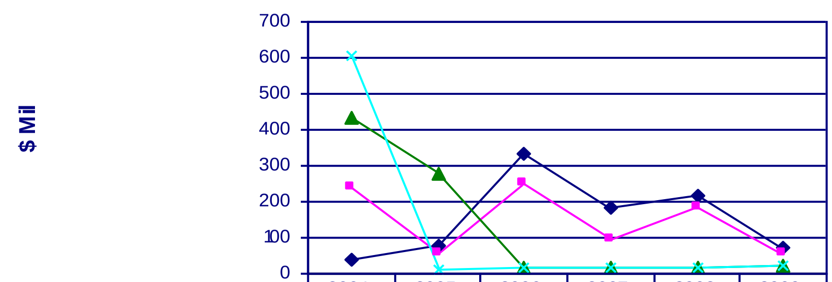
		AOCI (after-tax)	Leverage
	2003 Actual	445	
Base Case:	2004 Forecast	626	
	Net Increase ‘03 – ‘04	181	-0.52%
Option 1:	2004 w/ $200 mm contribution	376	
	Net Increase (Decrease) ’03-’04	(69)	0.19%
Option 3:	2004 w/ $600 mm contribution	14	
	Net Increase (Decrease) ’03-’04	(431)	1.20%

Cash Impact / Contributions

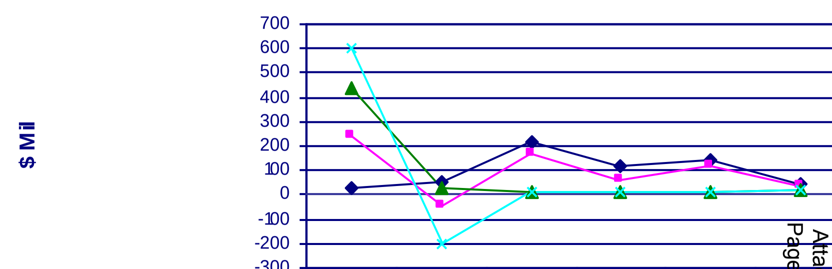
- Accelerates contributions
  - NPV of contributions approx. $650 mil
- Tax Effect
  - 2004 contribution won't impact tax payment until 2005 or after
- Option 1: Cash Impact net change from Base Case

($ Mil)

	2004	2005	2006
Pre-tax	196	(24)	(82)
After-tax	211	(99)	(54)



	2004	2005	2006	2007	2008	2009
Current Forecast (Aug 04)	41.2	79.0	333.5	183.4	214.9	71.0
Elim West AOCI in 04	238.0	55.0	251.0	97.0	182.0	57.0
Elim West AOCI in 04, East in 05	435.0	280.0	14.0	19.0	19.0	24.0
Elim West and East AOCI in 04	605.0	12.0	14.0	19.0	19.0	24.0



	2004	2005	2006	2007	2008	2009
Current Forecast (Aug 04)	26.8	51.4	216.8	119.2	139.7	46.1
Elim West AOCI in 04	238.0	(47.6)	163.2	63.1	118.3	37.1
Elim West AOCI in 04, East in 05	435.0	29.8	9.1	12.4	12.4	15.6
Elim West and East AOCI in 04	605.0	(204.0)	9.1	12.4	12.4	15.6

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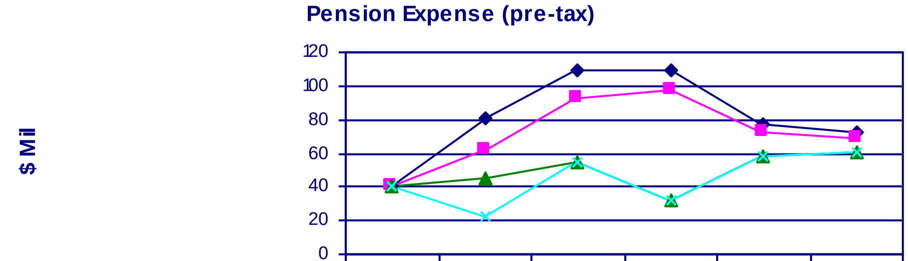
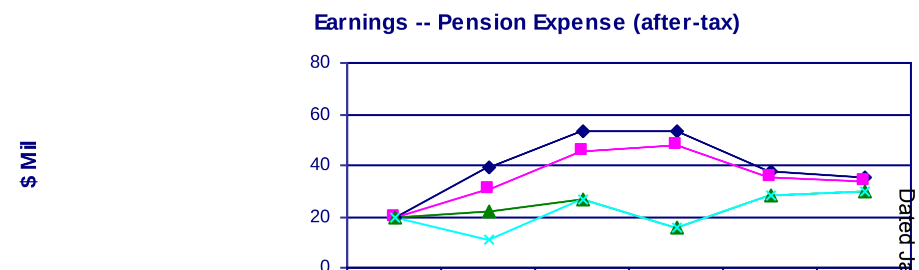
Earnings Impact / Pension Expense

- Base case 2005 over 2004 expense increases by:
  - Pre-tax $41 mil
  - After-tax $20 mil
- Option 1: Lowers 2005 expense by:
  - Pre-tax $18 mil
  - After-tax $9 mil
- Each $200 mil at additional contribution lowers pension expense approximately $20 mil
- After-tax calculation assumes 25% of expense is capitalized



	2004	2005	2006	2007	2008	2009
Current Forecast (Aug 04)	39.8	80.3	109.5	109.6	77.5	72.0
Elim West AOCI in 04	39.8	62.0	93.0	98.0	73.0	69.0
Elim West AOCI in 04, East in 05	39.8	45.0	55.0	32.0	58.0	610
Elim West and East AOCI in 04	39.8	23.0	55.0	32.0	58.0	610



	2004	2005	2006	2007	2008	2009
Current Forecast (Aug 04)	19.4	39.2	53.4	53.4	37.8	[illegible]
Elim West AOCI in 04	19.4	30.2	45.3	47.8	35.6	33.6
Elim West AOCI in 04, East in 05	19.4	219	26.8	15.6	28.3	29.7
Elim West and East AOCI in 04	19.4	112	26.8	15.6	28.3	29.7

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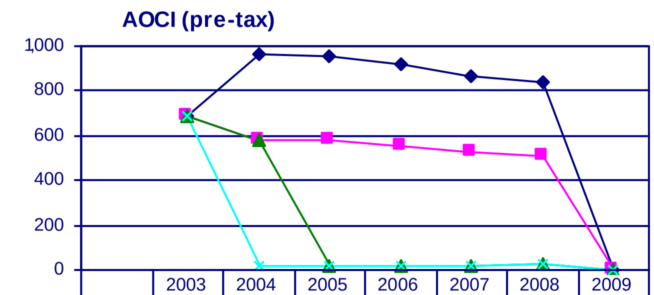
Balance Sheet / AOCI

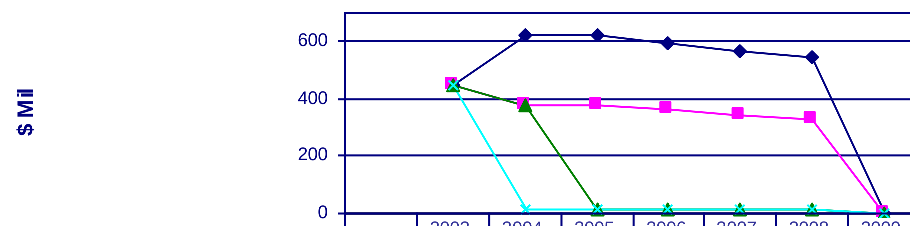
- *Option 1: Elimination of West AOCI is most efficient use of cash. $200 mil additional funding to eliminate:*
  - *Pre-tax $384 mil AOCI*
  - *After-tax $249 mil AOCI*
- *Elimination of East AOCI requires approximately $370 mil more cash to eliminate:*
  - *Pre-tax $557 mil*
  - *After-tax $362 mil*

AOCI (pre-tax)



	2003	2004	2005	2006	2007	2008	2009
Current Forecast (Aug 04)	684.5	962.7	954.0	916.7	870.4	837.8	-
Elim West AOCI in 04	684.5	579.0	579.0	557.0	527.0	507.0	-
Elim West AOCI in 04, East in 05	684.5	579.0	22.0	22.0	22.0	23.0	-
Elim West and East AOCI in 04	684.5	22.0	22.0	22.0	22.0	23.0	-

Equity Reduction -- AOCI (after-tax)



	2003	2004	2005	2006	2007	2008	2009
Current Forecast (Aug 04)	444.9	625.8	620.1	595.9	565.8	544.5	
Elim West AOCI in 04	444.9	376.4	376.4	362.1	342.6	329.6	
Elim West AOCI in 04, East in 05	444.9	376.4	14.3	14.3	14.3	15.0	
Elim West and East AOCI in 04	444.9	14.3	14.3	14.3	14.3	15.0	-

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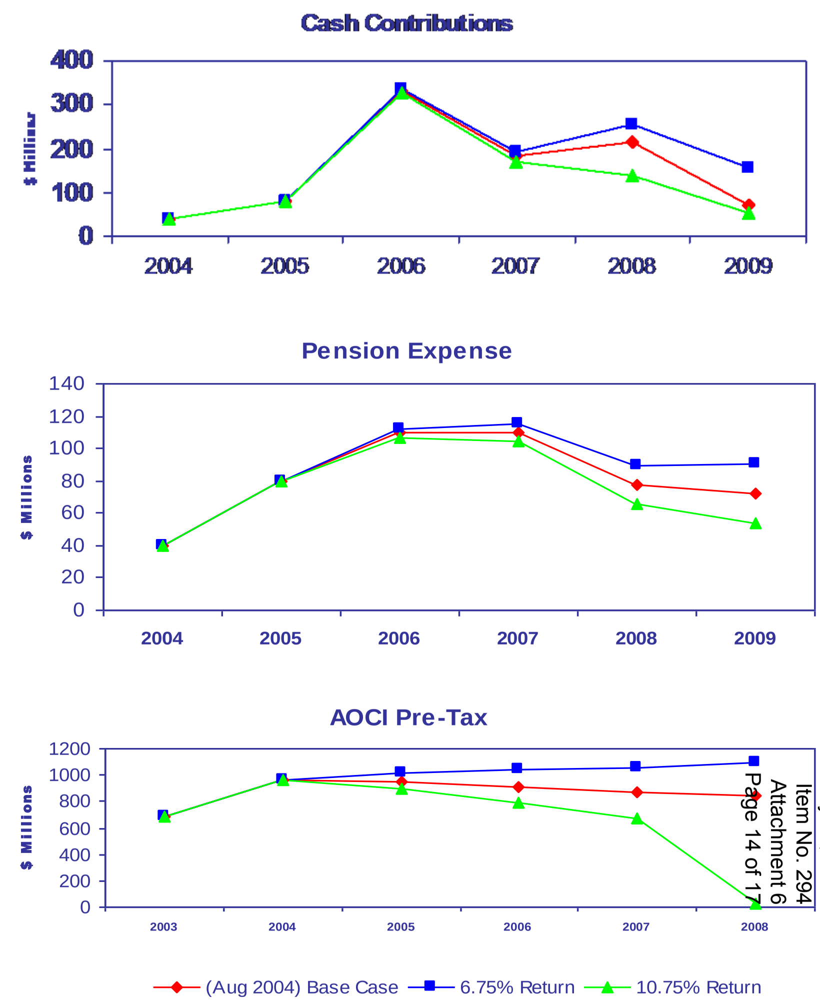
Pension Forecast Sensitivities – Asset Returns

- ***Illustrates forecast sensitivity to projected investment returns***
  - ***The August 2004 Base Case forecast assumes an actual return on investments of 5.44% for 2004 and 8.75% for future years***
  - ***The two cases show the results if the future returns are 2% higher or lower than the Base Case.***
- ***Even with superior investment results:***
  - ***Deficit reduction contributions would still be required in 2006***
  - ***Smoothing of investment results delays the effects on expense***
  - ***AOCI would be remain until 2008***



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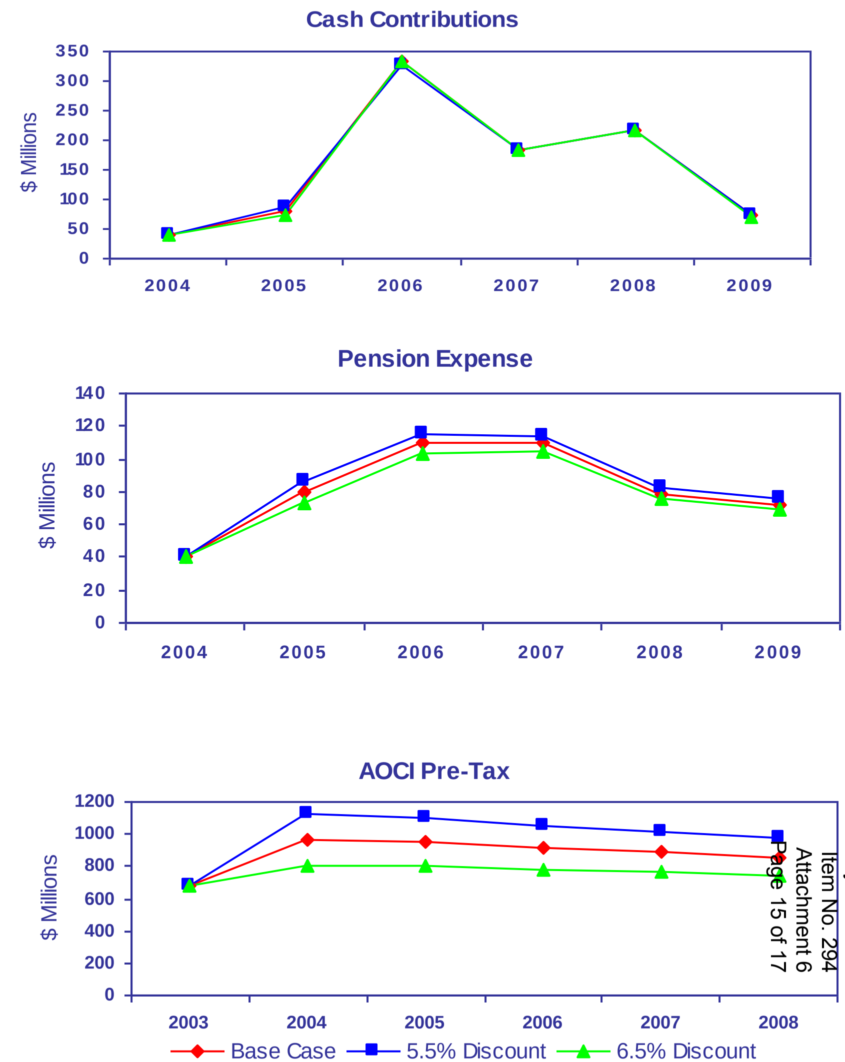
Pension Forecast Sensitivities – Accounting Discount Rate

- ***Illustrates the forecast sensitivity to changes in the accounting discount rate***
  - ***The two sensitivities show the results if the rate is 50 bp higher or lower than the Base Case***
  - ***Accounting discount rate assumption has no effect on contributions and little effect on expense***

- ***AOCI is most affected by changes in the accounting discount rate***
  - ***The plan would remain under funded even with a 50 basis point increase in rates***



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2004 Pension AOCI Sensitivities

2004 AOCI (Pre-Tax)

$ in millions, pre-tax

2004	Accounting Discount Rate		
Return on Assets	**5.75%**	**6.00%**	**6.25%**
3.44%	**$1,103**	**$1,024**	**$946**
5.44%	**$1,042**	**$963**	**$885**
7.44%	**$981**	**$902**	**$824**

Return through July: 1.80%

Remaining 5 months @ 8.75%/year: 3.64%

Total return projected for 2004: 5.44%

Accounting discount rate based on Moody's AA Corp. Bond rate as of Aug 30, 2004: 6.0%, final number set at 12/31 based on actuals Moody's AA rate.

- *A ± 25 bp change in accounting discount rate changes pretax pension AOCI by about ± $80 million*
- *An ± 2% change in return on assets would change assets by about ± $60 million*
- *We would need a 2.3% increase in return on assets to offset a 25 bp decrease in the discount rate*

Funding Discount Rate - Effect of Interest Rate Relief

- *Extending interest rate relief would significantly reduce minimum pension contributions in 2006, while slightly increasing pension expense*
  - *If interest rate relief expires, AEP will have to make Deficit Reduction Contributions to both plans in 2006*
  - *Legislative efforts should continue to be targeted to this area*
- *AOCI would not be affected by a change in the funding interest rate, pension expense would be changed very little*