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June 22, 2007

Honorable Kimberly D. Bose
Secretary
Federal Energy Regulatory Commission
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Re: American Electric Power Service Corporation
Docket No. ER07-__-000

Dear Secretary Bose:

Pursuant to Section 205 of the Federal Power Act ("FPA"), 16 U.S.C. ¶ 824d (2006), and Part 35 of the Commission's Regulations, 18 C.F.R. Part 35 (2006), American Electric Power Service Corporation, on behalf of Public Service Company of Oklahoma ("PSO") and Southwestern Electric Power Company ("SWEPCO") (collectively "AEP" or the "AEP Companies"), submits for filing revised *pro-forma* tariff sheets for the AEP pricing zone under Schedule 1, Addendum 1 to Schedule 1, Attachment H, and Addendum 1 to Attachment H, and Attachment T of the Southwest Power Pool, Inc. ("SPP") Open Access Transmission Tariff ("Tariff"). The revised tariff sheets, which are included in attached Exhibits AEP-101 and AEP-102, seek to establish an up-to-date revenue requirement for transmission services over the facilities of PSO and SWEPCO under the SPP Tariff and implement a transmission cost of service formula rate similar to formula rates that the Commission has accepted for other transmission owners within regional transmission organizations ("RTOs"). AEP requests an effective date of September 1, 2007 for the proposed tariff changes.

The Commission has encouraged transmission owners to file formula rates and it has accepted formula rates, with a nominal suspension.¹ In fact, the

¹ *Promoting Transmission Investment Through Pricing Reform*, Order No. 679, 116 FERC ¶ 61,057 at P 386 (2006) ("Order No. 679") ("[W]e continue to encourage public utilities to explore the benefits of filing transmission-related formula rate"); *order on reh'g*, Order No. 679-A, 117 FERC ¶ 61,345 (2006), ("Order No. 679-A") *Allegheny Power System Operating Cos.*, 106 FERC ¶ 61,003 at P 32 (2004) ("*Allegheny I*") (encouraging the parties to explore whether adopting formula rates for recovery of the costs of both existing and new transmission facilities would be best, and

Commission has encouraged the filing of formula rates within SPP to facilitate timely recovery of transmission related investments.²

AEP requests that the Commission approve the proposed formula rate without a hearing. Alternatively, AEP requests that the Commission suspend the proposed formula rate for a nominal period to permit the requested September 1, 2007 effective date and that the Commission specify in the hearing Order the specific issues or concerns that should be addressed at hearing or in a settlement proceeding.

Similar to other formula rates approved by the Commission, the proposed formula rate is designed to accommodate inputs reflecting incentive rate treatment upon approval of such treatment by the Commission.

I. Background

AEP is a multi-state electric utility holding company system whose operating companies provide electric service at wholesale and retail in parts of eleven states. PSO and SWEPCO are AEP operating companies providing service in Oklahoma, Louisiana, Arkansas and the non-ERCOT portion of Texas. PSO and SWEPCO are transmission-owing members of SPP, which offers open access transmission service pursuant to the SPP Tariff. SPP employs zonal transmission pricing under which each transmission owner can propose rates for transmission service within or terminating in its zone.

specifically noting “that other TOs that we have approved incentive rates for also have formula rates”). Order No. 679-A, 117 FERC ¶ 61,345 (2006), (“Order No. 679-A); *Allegheny Power System Operating Cos.*, 111 FERC ¶ 61,308 at P 51 (2005) (“*Allegheny II*”) (finding that circumstances warranting shorter suspension period exist where the Commission has encouraged utilities to move from stated to formula rates and where customers would also benefit); *Baltimore Gas and Electric Co. and PHI Cos.*, 115 FERC ¶ 61,066 (2006) (“BGE/PHI”) (approving uncontested settlement involving a formula rate for two PJM transmission owners; *Idaho Power Co.*, 115 FERC ¶ 61,281 at P 30 (2006) (nominally suspending a proposed change from stated rates to formula rate); letter order dated December 13, 2006 in Docket No. ER06-1445-000 (accepting formula rate proposed by a PJM transmission owner after nominal suspension); *Duquesne Light Co.* 118 FERC ¶ 61,087 at P 69 (2007) (“*Duquesne*”) (accepting formula rate proposed by a PJM transmission owner.) and, most recently, *Trans-Allegheny Interstate Line Co.*, 119 FERC ¶ 61, 219 (2007).

² *Southwest Power Pool, Inc.*, 111 FERC ¶ 61,118 at P 32 (2005).

II. Description Of Filing

A. Introduction

The annual transmission revenue requirement for each SPP pricing zone is reflected in Attachment H of the SPP Tariff. Each pricing zone's transmission revenue requirement forms the basis for deriving unit charges for Network Integration Transmission Service ("NITS") and Point-To-Point ("PTP") transmission service to load located inside the pricing zone. Historically within SPP, AEP's transmission revenue requirements and the resulting unit charges have been stated rather than formulaic. Under a stated rate approach, AEP's transmission revenue requirement and unit charges for service to load within the pricing zone change only as the result of a Federal Power Act (FPA) Section 205 or Section 206 rate filing. Under the proposed formula rate approach, AEP's transmission revenue requirement will be derived from a cost of service formula which is itself the zonal rate.

Like the formula rate approved in *BGE/PHI*, AEP's formula rate is designed to track increases and decreases 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.³

Both stated rate and formula rate approaches are acceptable methods for determining just and reasonable rates, and both approaches can (and do) co-exist in regions with zonal pricing. AEP has chosen to move from stated rates to a formula rate because, in addition to the Commission's encouragement of such rates, more current cost recovery will assist AEP and SPP in developing needed transmission infrastructure.

In Order No. 679, the Commission stated that "utilities with formula rates will generally be able to flow through transmission investment without concern as to

³ The formula rate sets up the template for implementing the annual true-ups and interest on the difference between the estimated and true-up revenue requirement. To the extent that the revenue requirement resulting from the actual data from the prior year is more or less than revenue requirement used to calculate the rates actually billed, AEP will adjust the revenue requirement for July 1 of the current year through the following June 30 accordingly, adjusted for the time value of money. Exhibit No. AEP-100 at pp.13-14.

the Commission's five-month suspension policy with the exception of the suspension period for approval of initial rates."⁴ In heeding to the Commission's clear direction, AEP has developed a formula rate that is substantially similar to formula rates the Commission has previously accepted with nominal suspensions.

Pursuant to SPP's regional planning process, AEP expects to be undertaking, in the near future, a number of transmission expansion projects and the proposed formula rate approach will closely track AEP's actual cost of service, while ensuring that customers will pay no more than AEP's actual costs. Assuming a September 1, 2007 effective date, the formula rate will reduce the adverse impact of regulatory lag on cost recovery, and reduce the expense and burden to all participants of multiple FPA Section 205 rate filings. Whether AEP's annual transmission revenue requirement will increase or decrease in a given year, however, will depend upon its actual cost of service during a given rate period.

B. Revised Tariff Sheets And Proposed Formula Rate

The revised SPP Tariff sheets for Attachment H have four components. First, Attachment H states the annual transmission revenue requirement for Network Integration Transmission Service. Addendum 1 to Attachment H sets forth how SPP, on behalf of AEP, will charge Network Integration Transmission Service customers in the AEP Zone. Addendum 1 to Attachment H also contains the formula rate implementation protocols that describe how AEP will update the formula in future years, what the review procedures are, how customer challenges will be resolved, and how any changes to the annual rate restatements will be implemented. The final section of Addendum 1 to Attachment H contains the template for the AEP formula rate calculations.

The proposed tariff sheets for Attachment T (Rate Sheets for Point-to-Point Transmission Service) replace the current stated rates for transmission service to points of delivery within the AEP pricing zone. Under the revised language, the zonal charge for the AEP Companies in Zone 1 under these schedules will be determined in conjunction with updates to AEP's net annual transmission revenue requirement under the formula rate and protocols contained in Addendum 1 to Attachment H.

The formula rate reflects inputs from AEP's most recent annual FERC Form No. 1 as well as supplemental cost information from AEP's accounting ledgers, as needed, return on common equity ("ROE"), and new transmission plant additions

⁴ *Order No. 679* at P. 386.

that have gone, or are expected to go, into service in the current calendar year. Initially, these inputs are historical costs from AEP's 2006 FERC Form No. 1, plus projected transmission plant additions for 2007. Charges will not change until costs are trued-up to actual costs and new annual updates are implemented for the next rate period. Under the proposed formula, the initial rate period will be a 10-month period ending June 30, 2008, while each successive rate period will be a 12-month period ending on June 30 of each year. SPP will use the net annual transmission revenue requirement for network transmission service produced by the formula rate, together with the current year's projected zonal 12 coincident peak ("12-CP") load (and the transmission revenue requirement of other transmission owners in the AEP pricing zone), to calculate rates for PTP service for the AEP Companies in Zone 1. SPP will post the rates on its website.⁵

The net annual transmission revenue requirement produced by the formula is the sum of the return on rate base, operation and maintenance expense, administrative and general ("A&G") expense, depreciation expense, taxes other than income taxes, income taxes and revenue credits. Mr. Robert Pennybaker's testimony explains the details of AEP's initial formula rate calculations, and Mr. Dennis Bethel's testimony explains the implementation protocols and the design of the formula, including certain similarities and differences in AEP's proposed formula and the formula approved by the Commission in *BGE/PHI* for PJM and for Westar in SPP.

Following the Commission's guidance in *Duquesne*, AEP proposes to cap the annual rate impact of increases in Post-employment Benefits other than Pensions ("PBOPs") in its formula rate. AEP's proposal adheres to the Commission's order in *Duquesne* by providing that increases to PBOP costs that do not impact AEP's NITS charge by more than \$0.05 per kW per month, as compared to the immediately preceding annual update, may be included in the annual update without the need to make a FPA section 205 or 206 filing. AEP's annual informational filing will support any change within this threshold, consistent with applicable accounting standards.⁶ Consistent with *Duquesne*, AEP proposes to remove the effect of accumulated other comprehensive income (Account 219) from the calculation of the total value of common stock in line 155 of the formula rate.⁷

⁵ Exhibit No. AEP-101 at p.26.

⁶ *Duquesne* at P 75.

⁷ Exhibit Nos. AEP-202 & AEP-203 at p. 4.

C. Construction Work In Progress

AEP has not included in its initial revenue requirement any Construction Work in Progress (“CWIP”), since inclusion in the formula of projected capital additions for the current year should allow relatively timely recovery of the cost of new transmission investments. However, the Commission historically has permitted 50 percent of non-pollution control/fuel conversion construction costs to be included as CWIP in rate base and it has found that this approach balances investor and consumer interests.⁸ In addition, the Commission, in Order No. 679, has indicated that it will allow inclusion of 100 percent of transmission CWIP in rate base as a form of incentive ratemaking.⁹ Consequently, the formula accommodates the inclusion of CWIP if approved by the Commission for particular projects or in response to future requests for such rate treatment.

D. Rate Of Return On Common Equity

Rate of return on common equity (“ROE”) under the formula rate is based on the analysis and recommendations reflected in the testimony and exhibits of Dr. William E. Avera, Exhibit Nos. AEP-400 through 404. The ROE is a stated value that is subject to change only pursuant to a FPA Section 205 or 206 filing. Dr. Avera derives a base ROE of 11.4 percent based on the midpoint of the range of reasonableness (7.4 percent to 15.4 percent) produced by applying the Commission’s Discounted Cash Flow (“DCF”) analysis to a proxy group of electric utilities consistent with the Commission’s recent guidance in *Duquesne*, this proxy group is composed of utilities “with a direct correlation to” SPP or to the “broader RTO markets” with which SPP interacts.¹⁰ The proxy group used by Dr. Avera contains publicly traded transmission owning utilities in SPP, Midwest ISO and PJM. Dr. Avera also recommends a 50 basis point adder to the base ROE, in recognition of AEP’s continued participation in an RTO, resulting in a recommended ROE of 11.9 percent.

For several years, the Commission has encouraged participation in RTOs by granting ROE enhancements to transmission owners participating in RTOs. The

⁸ 18 C.F.R. §35.25 (c) (3) (2006); *Construction Work in Progress for Public Utilities; Inclusion of Costs in Rate Base; Inclusion of Costs in Rate Base*, Order No. 298, FERC Stats. & Regs. ¶ 30,455 (1983), *order on reh’g*, Order No. 298-B FERC Stats & Regs. ¶ 30,524 (1983); *see also Boston Edison Co.*, 109 FERC ¶ 61,300 (2004), *order on reh’g* 111 FERC ¶ 61,266 (2005) (“*Boston Edison*”); and *Northeast Utilities Service Co.*, 114 FERC ¶ 61,089 (2006).

⁹ *Order No. 679* at P 117.

¹⁰ *Duquesne* at P 73.

Commission views incentives related to participation in an RTO as separate from the incentives related to construction of new transmission plant because the ROE incentive for RTO participation is not intended to directly encourage construction.¹¹ The level of ROE incentive for RTO participation is to be determined in relation to the ROE incentives established for transmission owners participating in the same RTO, rather than in relation to an applicant's new transmission projects.¹² Order No. 679 provides that an entity is presumed eligible for an ROE incentive if it demonstrates that it has joined an approved RTO and its membership is on-going.¹³

SPP assumed functional control over AEP's facilities upon its recognition by the Commission as an RTO as of October, 2004.¹⁴ The Commission has determined that other SPP transmission owners are eligible for the 50 basis point adder.¹⁵

Continuation of this specific adder is appropriate because AEP's participation in SPP and its regional planning process is on-going, and Dr. Avera testifies that the 50 basis point adder should be continued for policy and capital attraction reasons, including investor expectations.¹⁶

F. Transmission Construction Program

Congress, in the Energy Policy Act of 2005, and the Commission, in Order 679 and numerous other pronouncements, have stressed the importance of the development of new transmission infrastructure. AEP witness Bernard Pasternack points out the substantial increase in AEP's transmission plant in SPP since AEP's cost of service was last updated, and in addition, describes the ambitious regional transmission expansion expected in SPP over the next several years. AEP's share of this planned investment together with investments in other AEP local transmission and rehabilitation projects is expected to be \$122 million in 2007 alone and exceed \$700 million during the following nine years. The formula rates proposed in this filing will help facilitate these major investments. Mr. Pasternack describes, in particular, two major transmission projects – the Tulsa Area EHV Project and the Northwest Arkansas EHV Project – that AEP is in the process of building and that will improve the reliability of service and lower the cost of delivered power to customers. Although AEP is not seeking explicit rate incentives in connection with

¹¹ *Order No. 679-A* at P 87 and note 143.

¹² *Id.* At P 88.

¹³ *Order No. 679* at P 327.

¹⁴ *Southwest Power Pool, Inc.*, 109 FERC ¶ 61,0110 (2004), *Order on reh'g*, 110 FERC ¶ 61,137 (2005).

¹⁵ *PJM Interconnection, L.L.C.*, 104 FERC ¶ 61,124 at n. 3 (2003).

¹⁶ Exhibit No.AEP-400 at p.8.

these two projects, Dr. William Avera, AEP's cost of equity expert, indicates that the Commission should take these projects into account in its overall determination of AEP's return on equity. AEP may seek rate incentives in the future in connection with the major construction expenditures discussed by Mr. Pasternack, and the formula rate is designed to accommodate such incentives if granted by the Commission.

G. Initial Revenue Requirement

Subject to true-up, the first year annual transmission revenue requirement for network service under the proposed formula is approximately \$140 million. The increase in the revenue requirement relative to the \$88.7 million revenue requirement approved in AEP's last rate case, based on a 1996 test year, is largely due to the increase in rate base as a result of numerous investments that the company has made, or will make by the end of 2007, in transmission related plant. For example, the projected gross plant balance in the first year of the formula rate represents an increase of approximately \$463 million above the plant balance at the end of 1996.

III. Testimony and Exhibits

AEP is submitting the testimony and exhibits of the following witnesses in support of this filing:

1. Mr. Dennis Bethel (Exhibit Nos. AEP 100-102) gives a general overview of the filing and description of the proposed formula rate template
2. Mr. Robert L. Pennybaker (Exhibit Nos. AEP 200-204) explains the details of the formula rate and presents the cost of service analysis for the initial rate period.
3. Mr. Bernard M. Pasternack (Exhibit Nos. AEP 300-309) explains SPP's regional planning process and AEP's current and proposed transmission projects.
4. Mr. William E. Avera (Exhibit Nos. AEP 400-402) develops the required ROE.

IV. Materials Submitted With This Filing

AEP submits herewith an original and five copies of this transmittal letter and each of the following:

- (a) Revised SPP Tariff sheets showing the proposed changes to Schedule 1, Addendum 1 to Schedule 1, Attachment H, Addendum 1 to Attachment H, and Attachment T of the SPP OATT (Exhibit No. AEP-101);
- (b) Clean versions of the SPP Tariff sheets referred to above (Exhibit No. AEP-102);
- (c) Direct Testimony and Exhibits of Dennis W. Bethel, Robert L. Pennybaker, Bernard M. Pasternack, and William E. Avera.

V. Requested Effective Date

AEP requests that the revised tariff sheets become effective on September 1, 2007. The Commission has encouraged transmission owners to adopt formula rates such as the one proposed herein. Consistent with this encouragement, the Commission's practice is to permit such formula rate filings to become effective after a nominal suspension period.¹⁷ AEP requests that the Commission adhere to its established practice.

Customers are protected from paying rates in excess of AEP's cost of service because the formula rate, including the protocols, is modeled after formula rates previously approved by the Commission and is subject to true-up to actual costs. Customers are protected by the protocols which provide procedures for interested parties to review, challenge and seek additional information from the company following submission of each annual update.¹⁸

VI. The Proposed Formula Rate Should be Approved Without Hearing

AEP requests that the Commission approve the proposed formula rate without a hearing. In responding to the Commission's encouragement to move from stated to formula rates, AEP has proposed a formula rate, including the protocols for review and challenge by interested parties, that is modeled after formula rates previously approved by the Commission. In the few instances where AEP's

¹⁷ See note 1 above.

¹⁸ While AEP is requesting that the Commission approve the proposed formula rate without hearing review, as discussed in Section VI of this transmittal letter, if the Commission decides to accept and nominally suspend the proposed rate subject to hearing, customers will have refund protection as well.

proposal differs from formula rate provisions previously approved by the Commission, AEP has explained and supported its proposal.

AEP has supported the ROE component of its proposed formula rate through the testimony of a respected cost of capital expert. Dr. Avera has applied the Commission's traditional DCF analysis to a proxy group developed by following the same general approach previously approved by the Commission for transmission owners in New England.¹⁹ The proxy group used by Dr. Avera follows the Commission's recent guidance in *Duquesne* that a proxy group for a PJM transmission owner should be composed of utilities "with a direct correlation to PJM or to the broader RTO markets with which PJM interacts."²⁰ Dr. Avera has adapted this approach to SPP by including utilities with a direct correlation to SPP and to the broader RTO markets with which SPP interacts.

Because the proposed filing adheres closely to Commission precedent and guidance, and because the interests of customers are protected, AEP requests that the Commission approve the proposed filing, effective September 1, 2007, without setting the filing for evidentiary hearing. If, however, the Commission determine that a hearing is needed, AEP requests that the hearing order specify the issues set for hearing and that the Commission not permit parties to litigate formula rate provisions previously approved by the Commission for other transmission owners.

VII. Requested Waivers

To the extent that this filing requires waivers of Section 35.13 of the Commission's regulations in addition to the waiver of notice discussed above,²¹ AEP respectfully requests such waivers, including waivers of the full Period I-Period II data requirements, waiver of attestation concerning Period II submissions required by Section 35.13(c)(6), and waiver of the requirement in Section 35.13(a)(2)(iv) to determine if and the extent to which a proposed change constitutes a rate increase based on Period I-Period II rates and billing determinants. The abbreviated statements and testimony accompanying this filing, together with AEP's published FERC Form No. 1, provide ample support for the reasonableness of the proposed formula rate.

In the event any other waivers are required in connection with this filing, the Commission should grant waivers given the benefits of updating costs and rates under the proposed formula approach.

¹⁹ See *Bangor Hydro Electric Company*, Opinion No. 489, 117 FERC 61,129 (2006)

²⁰ *Duquesne* at P 73.

²¹ 18 C.F.R. § 35.13 (2006).

VIII. Persons On Who This Filing Is Being Served

Pursuant to Section 35.2(d) of the Commission's regulations, a copy of this filing is being served on SPP, the Arkansas Public Service Commission, New Mexico Public Utility Commission, Missouri Public Service Commission, Kansas Corporation Commission, Louisiana Public Service Commission, Oklahoma Public Service Commission and the Public Utilities Commission of Texas. Copies of the filing are also being made available on AEP's website at: <http://www.AEP.com/go/OAT>. AEP has also served a copy of this filing transmittal letter, and the proposed SPP Tariff sheets on all SPP customers, SPP members, and independent power producers connected to the AEP system not already SPP customers or members. AEP requests waiver of the requirement to post by mailing complete paper copies of the filing to the aforementioned entities.

IX. Miscellaneous

No agreement is required by contract for the filing of this rate filing. There are no costs included in this filing that have been alleged or adjudged in any administrative or judicial proceeding to be illegal, duplicative, or unnecessary costs, nor has any expense or cost been demonstrated to be the product of discriminatory or employment practices, within the meaning of Section 35.13(d)(3).

X. Persons to Whom Correspondence Should Be Addressed

Persons to whom correspondence and communications regarding this filing should be addressed are as follows:

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Please acknowledge receipt of this filing by date stamping the enclosed extra copy of this transmittal letter in returning it in the enclosed postage prepaid envelope. Any questions concerning this filing may be directed to me.

Respectfully,



Kevin F. Duffy

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