

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

AMERICAN ELECTRIC POWER COMPANY, INC.

Administrative Proceeding
File No. 3-11616

**OPENING BRIEF
OF
AMERICAN ELECTRIC POWER COMPANY, INC.**

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Pursuant to the Commission's June 7, 2005 Amended Order in the above-captioned proceeding and Rule 450 of the Commission's Rules of Practice, 17 § C.F.R. 201.450 (2005), American Electric Power Company, Inc. ("AEP") submits its Opening Brief in the above-captioned matter. AEP demonstrates in this Brief that the Commission should reverse the finding in the May 3, 2005 Initial Decision in this proceeding ("Initial Decision" or "ID") that the AEP system is not an integrated public-utility system because it is not confined in its operations to a "single area or region."

I. STATEMENT OF THE CASE

This case is before the Commission on remand from the decision of the United States Court of Appeals for the District of Columbia Circuit in *Nat'l Rural Elec. Coop. Ass'n v. SEC*, 276 F.3d 609 (D.C. Cir. 2002) ("*NRECA v. SEC*"). In that case, the Court was reviewing the Commission's order approving AEP's acquisition of the securities of Central and South West Corporation ("CSW") and related transactions under Section 10 of the Act. *American Electric Power Co., Holding Co.* Act Release No. 27186, 54 S.E.C. 697 (June 14, 2000) ("2000 Order").

Pursuant to the 2000 Order, AEP consummated the acquisition on June 15, 2000, and has been operating as a Registered Holding Company under the Act since that time.

The Court remanded portions of the 2000 Order that addressed the interconnection and single area or region requirements of Section 2(a)(29)(A) of the Act. It found that the Commission failed to address whether the contract transmission rights acquired by AEP to interconnect the AEP and CSW systems (the “Combined System”) were sufficient to achieve system interconnection under Section 2(a)(29)(A). The Court also found that the Commission failed to provide separate factual findings on the requirement of Section 2(a)(29)(A) that the Combined System must operate within a “single area or region.”

By order dated August 30, 2004, the Commission ordered an evidentiary hearing on the issues remanded by the Court. Following the submission of testimony, a hearing was held on January 10, 2005. The Hearing Officer issued an Initial Decision on May 3, 2005. The Initial Decision holds that the contract transmission rights acquired by AEP are sufficient to meet the Act’s physical interconnection requirement. ID at 11-12. However, it also holds that the Combined System does not operate within a single area or region. *Id* at 20-23. On the basis of the latter holding, the Initial Decision concludes that the Combined System is not an “integrated public-utility system” as defined in Section 2(a)(29)(A) of the Act and therefore that AEP’s request for approval of the proposed acquisition of CSW should be denied. ID at 23.

II. SUMMARY OF ARGUMENT

The Act’s definition of integrated public-utility system includes a requirement that all holding company systems operate within a single area or region. The Initial Decision presumes that an acceptable area or region must be confined to a fairly small geographic region based on what it contends is the “traditional” use of the term. In fact, the definition imposes no such limitation. The appropriate limitation based on the statutory language is that the area or

region cannot be so large as to impair, considering the state of the art, effective management, effective regulation, or efficient operations.

The explicit limitations in the “impair” clause of the definition of integrated public-utility system tie the single area or region requirement to the objectives of the statute and provide the Commission a meaningful context in which to interpret the statutory language. The relevant statutory objective is set forth in Section 1(b)(4) of the Act: To prevent “the growth and extension of holding companies that [bear] no relation to economy of management and operation or the integration and coordination of related operating properties.” The Commission has already found that the Combined System can be operated efficiently as a single system and can be effectively managed and regulated. AEP’s testimony in this proceeding confirms these findings in relation to the area in which the Combined System operates.

The Initial Decision also misconstrues Commission precedent. The Commission has never suggested that the single area or region requirement means that holding company systems must be geographically consigned to the “Southeast” or “Midwest,” or other similar colloquial regions. Since 1945, the Commission has evaluated the single area or region requirement in light of the statutory objectives of ensuring that holding company systems can be operated efficiently as an integrated system, effectively managed and effectively regulated. Moreover, the Commission has consistently held that it should analyze all components of the definition of integrated public utility system in light of changes in technology and regulation that have eliminated the purely local character of electric utility systems. In any event, several decades ago the Commission recognized that the AEP system is located in both the “Midwest and the South” - a characterization that remains valid with the addition of the CSW system.

AEP presented substantial evidence that advances in technology and regulation have made it possible to integrate electric utility systems across broad geographic areas. Since the Act was passed, the electric transmission grid has been expanded via extra-high voltage interconnections that permit utilities to coordinate their operations. The expansion of the electric grid has also created greater interdependence among electric systems, and the entire eastern half of the United States (and some of Canada) is now operated as a single machine. In addition, government policy has promoted the formation of ever larger marketing areas for electricity, with the intent that utility systems across broad geographic areas can share generating capacity reserves and transact for capacity and energy in lieu of relying on local generation assets.

In light of the current state of the electric industry, AEP presented testimony that demonstrates, from four different perspectives, that the combined AEP and CSW system is within the same area or region for purposes of the Act.. First, AEP showed that the combined system is within the Eastern Interconnection -- the electrical area across the eastern half of the United States and parts of Canada in which all generation is synchronized and electrically tied together into a single grid.¹ Second, AEP showed that the geographic area that the Commission has used as the relevant geographic market in which to review the competitive effects of mergers (based on the merging utility systems and their first tier interconnected neighbors) constitutes, in this case, a coherent region that is tied together by a robust transmission network. Third, AEP showed that the combined system (with the exception of the Texas properties noted above) is

¹ A small amount of Texas utility property previously owned by CSW is not in the Eastern Interconnection. The Commission has previously found that these properties are part of CSW's integrated public-utility system, and no evidence was presented in this case as to why that conclusion should be revisited.

within the marketing area comprised of three FERC-approved RTOs, in light of FERC directives that the three RTOs coordinate their operations to facilitate the establishment of a single, common market for electric power trading. The testimony showed that the Combined System operates within a single electricity market. Finally, AEP presented testimony from a regional economist, who showed that the area in which the combined system operates is within a single “functional” region as defined by non-electric economic interactions and infrastructure development.

Ultimately, the Initial Decision rejected AEP’s and the Division’s positions on the single area or region issue because the areas or regions they identified were too big from the Judge’s “traditional” viewpoint. But, as shown above, neither the statutory text nor the objectives of the statute demand or support such a “traditional” interpretation of the single area or region requirement. The Initial Decision was simply wrong.

III. THE INITIAL DECISION IMPOSES LIMITATIONS ON THE “SINGLE AREA OR REGION” REQUIREMENT THAT ARE NOT FOUND IN THE STATUTORY LANGUAGE, NOT CONSISTENT WITH STATUTORY OBJECTIVES, AND NOT REQUIRED BY PRIOR COMMISSION DECISIONS

A. The Initial Decision’s Analysis of the Single Area or Region Requirement

The Initial Decision finds that the Commission has “traditionally” evaluated the “single area or region” requirement predominantly based on “geography” and to a lesser extent on “other factors such as socioeconomics and geology” ID at 21. It faults AEP for relying on what the Initial Decision refers to as “broad-based economic considerations” to define a single area or region. *Id.* It rejects the testimony of AEP’s economic witness because it did not conform to “traditional considerations for applying the region requirement.” *Id.* at 22. It rejects AEP’s other testimony, which addressed the single area or region requirement based on the

current state of the electric power industry, because the definition of area or region supported by such testimony encompasses areas “not traditionally considered part of the same geographic region.” *Id.* The Initial Decision concludes that defining area or region as AEP proposes would create regions that are too large and thus “would significantly redefine and expand traditional notions of this concept.” *Id.* at 23.

The Initial Decision therefore focuses repeatedly on the concept of “tradition,” and uses this concept to conclude that the term “area or region” under the Act must consist of relatively small “geographic” sections of the United States. *Id.* at 21-22. It rejects the positions advanced by AEP and the Division of Investment Management (“Division”), both of which focus on the current state of the electric industry, because they result in identifying an area or region that is too large in relation to the Initial Decision’s concept of the traditional use of this statutory term.

B. The Limitations Applied in the Initial Decision Are Not Found in the Language of the Statute

As in all cases of statutory construction, the Commission should begin its analysis by considering the language employed by Congress.² The statutory term “integrated public-utility system” is defined in Section 2(a)(29)(A) of the Act. The relevant portion of this definition states that an electric holding company system must be:

...confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation;

² See *Caminetti v. United States*, 242 U.S. 470, 490 (1917).

The statute uses the words “area or region” denoting that satisfaction of either term is sufficient. The word “area” is defined by Webster’s to include “a region or territory ... consisting of a large part of a state *or country or several states or countries*, or embracing an entire continent or parts of more than one continent....”³ Accordingly, the statutory language does not require the Commission to restrict the appropriate and lawful size of an electric holding company system to so-called “traditional” colloquial designations of sub-regions, such as “Southeast” that are limited in size. *Id.* at 21. The Initial Decision’s repeated reliance on “traditional” uses of the term “region” engrafted onto this statutory language a limitation that is not contained in the words Congress chose. In fact, as shown below, the statute directs the Commission to interpret this provision in light of the “state of the art” in the electric industry.

Even if the Initial Decision’s focus on what it defines as “traditional” could be squared with the statutory language, this focus is unhelpful as a standard for interpretation. North America is a “traditional” designation of a geographic area or region. So are “Northwest DC” and “Suburban Maryland.” Thus, references to so-called traditional uses of the words “area or region” can refer to very large geographical areas or fairly small ones. The Initial Decision simply chose one among many notions of “tradition” without explanation of why this particular notion is required by the statute or appropriate in the circumstances.⁴

The Initial Decision’s repeated references to “geography” are similarly unhelpful. No one has suggested that “area or region” should be defined without reference to a geographic

³ Webster’s Third New International Dictionary, Unabridged (Copyright 1981).

⁴ A possible reading of the Initial Decision is that the Hearing Officer’s repeated references to “tradition” and “geography” were merely intended to reflect the Hearing Officer’s reading of Commission precedent. AEP reviews applicable Commission and court decisions below and shows that the Hearing Officer misconstrued the precedents.

location. AEP's testimony addressed the area or region requirement in terms of geography; the Initial Decision simply chose to apply a different (and much narrower) geographic designation, based on the Hearing Officer's preconceptions. AEP, for example, presented testimony showing that the "Eastern Interconnection" can be identified as a relevant area or region for purposes of this case. In the electric industry, the Eastern Interconnection is a universally-recognized description of a relevant geographic area, and thus satisfies the Hearing Officer's own criteria. In the end, the Initial Decision's use of "tradition" and "geography" as the defining elements of the statutory term leave the Commission with no meaningful standard to apply.

C. The Statutory Language Sets Forth Standards for the Commission to Apply in Defining an Acceptable Area or Region That the Initial Decision Did Not Consider

Although the Initial Decision ignores them, the statutory definition of integrated public-utility system includes clear standards for the Commission to apply in this context. First, the holding company system must be in a "single" area or region. The word "single" in this context means the same or common, which is consistent with the dictionary definition of the term.⁵ AEP's evidence identified various indicia that the Combined System operates in a single area or region, but the Initial Decision chose to disregard this evidence. Specifically, nothing in the statute requires the Commission to divide the country into distinct geographic regions (such as "Southeast") and then determine whether each holding company is within one such region.⁶ Moreover, requiring that the country be divided into specific regions in order to apply Section

⁵ Webster's Third New International Dictionary, Unabridged (Copyright 1981).

⁶ In contrast, Section 202(a) of the Federal Power Act, 16 USC §824a(a) (2000), directs the FERC to "divide the country into regional districts" for purposes of promoting coordination and interconnection of electric systems.

2(a)(29)(A) would not make sense. If the Commission chose the Southeast as the applicable region, for example, a utility in Maryland could not merge with a utility in Virginia, even though the two might be contiguous and strongly interconnected. Nor could a utility in Pennsylvania merge with a utility in Illinois, even though they are now in the same Regional Transmission Organization (“RTO”).⁷

Second, Congress provided that the single area or region where the holding company system operates can be in “one or more states.”⁸ Rather than limiting the acceptable size of a holding company, this language indicates that Congress was amenable to the existence of holding company systems that encompass multiple states. Congress did not say “one or two states” or even “one or a few states”. It left to the Commission’s discretion whether a holding company system may operate in multiple states. Thus, contrary to the Initial Decision (ID at 21), the fact that the Combined System operates in several states is not a basis for holding that the Combined System fails to satisfy the single area or region requirement.

Third, the definition of integrated public-utility system includes a size limitation directly related to the achievement of statutory objectives. Section 2(a)(29)(A) provides that the area or region shall not be “so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation.” This statutory language ties the statutory requirement of a “single

⁷ RTOs are FERC-approved transmission system operators that are required to make decisions affecting the electric markets in an independent manner. *Regional Transmission Organizations*, Order No. 2000, 65 Fed. Reg. 809 (Jan. 6, 2000), FERC Stats. and Regs. ¶31, 003 (2000), *order on reh’g*, Order No. 2000-A, 65 Fed. Reg. 12,088 (March 8, 2000), FERC Stats. & Regs. ¶61, 092 (2000), *petitions for review dismissed sub nom. Pub. Util. Dist. No. 1 of Snohomish County Washington, v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

⁸ Section 2(a)(29)(A) of the Act.

area or region” to the harms that Congress was trying to prevent in limiting the acceptable size of holding company systems. Thus, Congress did not merely insert the words “single area or region” into the statute for abstract application without reference to statutory objectives. Rather, it directed that holding company systems operate within single areas or regions of such a size that the evils it was trying to eliminate would not occur.

The legislative history of the Act shows that Congress was concerned about a phenomenon called “scatteration,” in which holding company systems consisted of electric operating properties scattered across the United States and tied together solely by the financial arrangements created by the ultimate owners of the holding company system.⁹ In the context of the fragmented industry that existed at the time,¹⁰ these systems were not, and could not be, coordinated and integrated in their operations, and there were no operational efficiencies associated with tying the systems together.¹¹ The operating utility properties were managed from distant financial centers by persons with no interest in or ties to the local communities where the operating systems were located.¹² And, Congress was concerned that the creation of these complex, far flung holding company systems interfered with the ability of regulatory authorities to effectively regulate the operating utility properties comprising the holding company system.

⁹ See e.g. *Report of National Power Policy Committee on Public Utility Holding Companies*, (1935) H. R. Doc. No. 74-137, at 4.

¹⁰ AEP witness Paul Johnson described the electric industry as it existed at the time the Act was passed. He explained that electric systems in the U.S. were not interconnected to the extent they are today, and therefore, it was not possible to operate electric utility systems as a coordinated unit across large geographic areas. AEP Exhibit No. 2 at 10.

¹¹ Senate Hearings, pp. 771-72 (Statement of Senator Couzens (during questioning of John Benton, General Solicitor, National Association of Railroad and Utility Commissions (April 29, 1935))).

¹² Senate Hearings, p. 170 (April 18, 1935).

Thus, it directed that holding company systems operate in a region of such limited geographic size that the systems could be efficiently operated, locally managed and effectively regulated.

These very same concerns are reflected in Section 1(b) of the Act, which lists the problems identified by Congress that required legislative action. The pertinent concern is:

(4) when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties . . . ¹³

The Court in *NRECA v. SEC* noted that the Commission divided the definition of integrated public-utility system into four distinct components, one of which is the “single area or region” requirement. 276 F.3d at 611. However, the Court could not have intended that this mode of analysis required that the Commission analyze the single area or region requirement without reference to the rest of the provision in which this language appears, or without appropriate consideration of the purposes of the statutory provision being interpreted. In fact, if it were to attempt to analyze the single area or region requirement independently of the remaining language in the provision (and statutory objectives), the Commission would leave itself no standards to apply in determining what constitutes an acceptable area or region of operation for a holding company system. This may indeed have been at the heart of the problem with the Commission’s analysis that the Court identified in *NRECA v. SEC*. By simply concluding that the Combined System met the single area or region requirement because it satisfied three other prongs of the definition of a single integrated system, the Commission failed

¹³ In this case, the Commission has already found that the merger of AEP and CSW should result in over \$2 billion of economies and efficiencies of management and operation. 2000 Order, at 748-49. This finding was left undisturbed by the decision of the Court of Appeals. 276 F.3d at 619.

to give the Court the necessary analysis of what the single area or region requirement means. It should have construed this clause in the context of the provision in which it appears and in the context of the Act as a whole, and then applied this meaningful construction of the statutory language to the facts of the case.

Accordingly, a sound reading of the statutory language shows that the phrase “single area or region” was not intended to be construed independently of the clause that follows it, but rather is modified by the words “not so large as to impair...”, such that the two clauses, when read together, provide a meaning to the single area or region language that carries out the purposes of the statute as set forth in Section 1(b) and in the legislative history. This interpretation conforms to the statutory text and provides the Commission a logical standard -- consistent with the purposes of the provision and the Act -- in which to determine whether the statutory requirement has been satisfied.¹⁴

¹⁴ It is not significant whether the Commission concludes now that this interpretation means that the statutory definition of integrated public utility system requires a four-part test as it has in the past, or should now be considered as requiring a three-part test. It may well be appropriate to characterize the “not so large as to impair” clause as both modifying the single area or region language that precedes it and as a separate element of the definition of an integrated public utility system. The important factor is that the words “single area or region” should be construed in connection with the entire provision in which it appears and consistent with the purposes of the Act. Indeed, AEP made essentially the same point in its original merger application:

Although the integrated utility system requirement has been interpreted to involve a four-part test, Applicants submit that the requirement can be fairly interpreted to involve only a three-part test. The plain reading of the integration requirement suggests the last two tests should be read as one test There is no "and" inserted between "single area or region" and "not so large as to impair" leading to the conclusion that there are two distinct tests which the "system" must meet. Rather, the sentence construction leads to the conclusion that it is the "single area or region" which must not be so large as to result in the specified impairments.

(Continued ...)

In addition, the language used in the “not so large as to impair” clause shows that Congress did not intend to freeze the Commission’s consideration of this standard to the circumstances that existed at the time the Act was passed. The clause provides that it should be interpreted in light of “the state of the art” of electric industry management, operations and regulation. The words “state of the art” unambiguously direct the Commission to consider the condition of the electric industry at the time of its review, and they contradict the notion that “tradition” or obsolete precedents should control. The Commission is not bound by interpretations it may have made 40, 50 or 60 years ago, but rather is directed to reconsider them if circumstances in the industry have changed.

As described in Section III below, AEP’s evidence in this case demonstrates that the Combined System operates within a common area or region defined in several different ways, and therefore satisfies the Act’s requirements. Moreover, the Commission already found in the 2000 Order that the Combined System can be efficiently operated, and nothing in the record adduced at hearing suggests that the Combined System operates in an area or region that is so large as to conflict with this finding. Indeed, the Combined System has been operated efficiently since the merger occurred, and hundreds of millions of dollars in savings have been passed back to electric consumers as a result. AEP Exhibit No. 5 at 4. The Commission also found in the 2000 Order that the Combined System can be effectively managed. There is no evidence in the record of this proceeding suggesting that the Combined System operates in an area or region that makes effective management difficult. Finally, there has been no suggestion

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by any regulatory authority or customer, and no evidence presented in this proceeding, that the Combined System encompasses an area or region so large that it cannot be effectively regulated at either the state or federal level.¹⁵

D. Commission and Court Precedent Do Not Support the Initial Decision's Narrow Interpretation of the Single Area or Region Requirement

The Initial Decision disagrees with AEP and the Division that the Commission has previously construed the Act in terms of relevant current technological, commercial and regulatory conditions. ID at 20-21. Ignoring the cases cited by AEP, it references a few decisions from early in the Act's administration that addressed the single area or region requirement, noting that the Court had referred to them as well. ID at 20-21 and at n. 17. The Initial Decision misreads the early cases. It also fails to consider at least one relevant decision involving AEP that is inconsistent with its reading of precedent. Finally, it fails to reflect that the Commission has not had occasion to consider the single area or region standard in a contested setting in several decades. For example, in the more recent decisions cited in the Initial Decision, *Conectiv Inc.* and *CP&L Energy*, the Commission may have colloquially referred to geographic regions in describing where the merging companies operated, but it did not analyze the single area or region standard because the matter was not contested.¹⁶ In addition, the Initial Decision fails to cite to at least one case in which the Commission approved a holding company system that the Commission described as being in more than one such region.

¹⁵ Indeed, the SEC found that the merger would have no adverse impact on regulation. 2000 Order, 54 S.E.C. at 706-708.

¹⁶ *Id.* at 21, citing *Conectiv, Inc.* 66 SEC Docket 1812 1817 (Feb. 25, 1998) and *CP&L Energy, Inc.*, 54 S.E.C. 996, 1022 (2000)

See American Electric Power, 46 S.E.C. 1299, 1312 (1978) {"1978 AEP Decision"}(observing that the AEP system was "located in the Middle West and the South").

1. The 1944 and 1945 Middle West Decisions

The Initial Decision relies heavily on a 1944 Commission decision in *Middle West Corporation*. (Holding Co. Act Release No. 4846, 15 S.E.C. 309 (1944)) ("1944 Middle West Decision") in which the Commission addressed the single area or region requirement in the context of the former CSW system. The 1944 Middle West Decision found that CSW was in two separate regions, based in part on an analysis of geography. However, the 1944 Decision was only preliminary with respect to most of the system integration issues before the Commission. The final decision in the *Middle West Corporation* case was rendered in 1945 (Holding Co. Act Release No. 5606; 18 S.E.C. 296 (1945)) ("1945 Middle West Decision"), and it partially reversed the 1944 Decision based on an analysis that is consistent with the one advocated by AEP in this case. The Initial Decision did not refer to the 1945 decision.

The Commission was having difficulty concluding in the 1944 Decision that two parts of what became the CSW system each met the integrated system requirement of the Act due to the size of each and because the Staff had opposed such findings. It was in connection with addressing this difficulty that the Commission interpreted the single area or region requirement in the context of the types of "geographic," "geologic" and "socioeconomic" factors on which the Initial Decision relied in this case. ID at 22. Thus, the 1944 Decision includes language to the effect that:

Section 2 (a) (29) requires in addition that the properties be confined in their operations "to a single area or region." To find that an aggregation of the properties of Southwestern Light, Public Service and Southwestern Gas constitutes a single system, we must find that an area 400 miles north-to-south and 350 miles east-to-west embraces but a single area or region. In well-settled and economically developed territory such a finding might be

impossible. But the geographical characteristics of the territory encompassed by this sector of properties are fairly homogeneous. The area is more or less typical throughout, relying largely on oil and other minerals, agriculture, and relatively light industry for its subsistence. The rendition of satisfactory service in arid and sparsely-settled areas frequently requires the stretching of lines over long distances to connect small population centers with generating facilities strategically placed near suitable water and fuel supplies. In view of these facts we believe that the properties in question lie within a single area or region.¹⁷

One could conclude from the *1944 Middle West Decision* that: (1) the Commission considered the individual parts of the CSW system each to be at the outer limits of the acceptable size of a holding company, and (2) that the single area or region requirement was satisfied because of the characteristics of the system geography, geology and economies.

However, when the Commission reconsidered the integration requirement for the CSW system as a whole a year later, in 1945, it looked at the issue quite differently. It focused first on new evidence that significant opportunities existed for coordination of operations between the two systems that was not before it when it made its decision in 1944.

Our tentative view that there were two systems was largely motivated by our conclusion from the prior record that, notwithstanding the interconnections, normal operations did not require substantial coordination of both systems. However, the record has been expanded on several doubtful points. It has been demonstrated that there exists at present substantial operational coordination between the properties of both systems

From the operational point of view, our greatest difficulty in finding that the properties were one single system lay in our

¹⁷ *1944 Middle West Decision*, 15 S.E.C. at 336. The Commission used similar reasoning in 1944 to determine that the second portion of the CSW system was also in a single area or region. *Id.* at 337. Additionally, the Commission expressed skepticism as to whether the two separate parts of the system together would be in a single area or region, but specifically reserved that issue for a future ruling. *Id.* at 339.

difficulty in finding that substantial normal coordination of the systems was possible through the power connections ... However, ...there is at present substantial interchange through the connections between West Texas and the Western Division.¹⁸

The evidence that the Commission considered in its 1945 Middle West Decision was comparable to the evidence that AEP presented in this case. It showed the substantial capability for and actual coordination between the two parts of the Combined System. Moreover, and perhaps more importantly for present purposes, the *1945 Middle West* decision shows that the Commission interpreted the single area or region requirement as being tied to the “impairment” clause that follows it in the definition:

In our prior opinion we discussed the size and geophysical conditions of the territory. The territory is a large one. However, as we have noted, it is unique in various respects. . . . Neither localized management nor efficient operation nor the effectiveness of regulation (considered as relative standards depending for their content on the state of the art, the area or region affected, and the demonstrated disadvantages of lack of coordination) is impaired in the sense which we believe was intended in Section 2 (a) (29) (A) particularly in the light of demonstrated disadvantages of lack of coordination in this case.¹⁹

The Commission’s 1945 interpretation of the single area or region requirement is fully consistent with AEP’s position in this case. Rather than relying solely on “geographic” factors, as the Initial Decision concludes (based on the 1944 Decision alone) the Commission analyzed the acceptable size of the CSW system in light of the rest of the definition of a single integrated system, and in light of the purposes of the Act, including the substantial evidence of coordination between parts of the CSW system at the time.

¹⁸ *1945 Middle West Decision*, 18 S.E.C. at 298. The Commission also found that the system used a combined dispatcher. *Id.* at 299.

¹⁹ *Id.*, at 299.

2. The 1978 AEP Decision

The Commission's 1978 Decision approving AEP's acquisition of Columbus and Southern Ohio Electric Company ("CSOE") under Section 10 of the Act also supports AEP's position in this case and is completely at odds with the Initial Decision's approach to the single area or region issue.

The 1978 AEP Decision addressed the acceptable "size" of a holding company system under Section 2(a)(29)(A) of the Act,²⁰ which is particularly relevant here since "size" was the critical factor driving the Hearing Officer's rejection of AEP's and the Division's positions in this case. ID at 22-23. Opponents of the CSOE acquisition argued that the Commission had determined in orders issued in 1945 and 1946 that the AEP system had already reached the allowable size limit for a holding company system under Section 2(a)(29)(A).²¹ The Commission held that, regardless of its earlier decisions, Congress had granted it broad discretion to consider the statutory requirements in light of the abuses identified by Congress; specifically the "growth and extension of holding companies [that] bear no relation to economy of management and operation or the integration and coordination of related operating properties." *Id.* at 1309, *quoting* Section 1(b)(4) of the Act. Moreover, the Commission held that Congress had directed it to act "on the basis of all the circumstances, not on the basis of preconceived notions of size." *Id.* The Commission also emphasized the requirement of Section 2(a)(29)(A) to consider the "state of the art," and applying this language found that since the end of World War II there had been "important changes in the technology of electric generation and

²⁰ 46 S.E.C. at 1307-1312

²¹ *Id.* at 1307.

distribution which have, in turn, brought about significant changes in the economics and structure of the electric utility industry.” *Id.* at 1310. It went on to contrast the situation in 1978 with the one that prevailed when the Act was passed and concluded that “there are [now] technological justifications for large systems spanning many states.” *Id.*²²

Accordingly, the Initial Decision is incorrect in concluding that the Commission has bound itself to “traditional” determinations of what constitutes an acceptably sized area or region. It also errs in choosing not to credit evidence of changes in the industry that justify defining the area or region requirement more expansively than in the past. And, it errs in failing to interpret the geographic size requirements of the Act in light of the harms that Congress was trying to eliminate; specifically, those set forth in Section 1(b)(4) of the Act.

3. Recent Merger Decisions

The Commission’s approach to interpreting the integrated public-utility system requirement is further reflected in a series of recent merger decisions in which the Commission relied on regulatory and commercial changes in the electric industry to approve mergers of holding companies that are not in the same “traditional” area or region using the definition endorsed by the Initial Decision here. Thus, the Commission approved the merger of Colorado

²² The Commission’s findings on changes in the electric industry are consistent with the testimony of AEP witness Paul Johnson in this case. AEP Exhibit No. 2 at 8-14. Both, for example, reference the fact that technological changes made it possible to build large generating stations and to deliver the output of such generating stations to distant load centers using high voltage transmission. AEP Exhibit No. 2 at 11-12; 46 S.E.C. at 1310. These changes rendered the concept of local utility systems in each community “technologically obsolete.” 46 SEC at 1310.

Public Service Company with Southwest Public Service located in Texas and New Mexico,²³ and later approved the resulting company's acquisition of Northern States Power Company, located in Minnesota and Wisconsin.²⁴ The Commission also approved the merger of Commonwealth Edison located in Chicago with PECO Energy located in Philadelphia.²⁵ The decisions approving these merger transactions are replete with references to recent changes in the electric industry which permit utilities to coordinate their operations over longer distances. The Commission could not have approved these merger transactions involving under the single area or region standard adopted in the Initial Decision.

4. Relevant Court Decisions

The Court in *NRECA v. SEC* did not constrain the Commission to adopt the Initial Decision's narrow interpretation of the single area or region requirement as the Initial Decision suggests. The Court acknowledged that the Commission has broad discretion to interpret the single area or region provision and "may make its own decision regarding the meaning of the region requirement." The Court "accepted as true" the Commission's statements that "the terms 'area' and 'region' are 'by their nature . . . susceptible of flexible interpretation,'" and that "recent institutional, legal and technological changes have reduced the relative importance of geographical limitations' on utility systems." *Id.* at 617-18. Nor did the Court disagree with the

²³ *New Century Energies, Inc.*, Holding Co. Act Release No. 26748, 53 S.E.C. 54, 59 (Aug. 1, 1997)

²⁴ *New Centuries Energy, Inc.*, Holding Co. Act Release No. 27212 (August 16, 2000).

²⁵ *Exelon Corporation*, Holding Co. Act Release No. 27265 (October 19, 2000). At the time the Commission approved this merger, the two companies were not members of the same Regional Transmission Organization as they are now.

Commission's position that the single area or region requirement should be interpreted in light of current economic and technological conditions. *Id.*

In fact, the courts have consistently held that agencies may consider recent changes in an industry and make appropriate adjustments to their interpretations of the statutes they administer to ensure their interpretations reflect current conditions. The Supreme Court "has rejected the argument that an agency's interpretation 'is not entitled to deference because it represents a sharp break with prior interpretations' of the statute in question." *Rust v. Sullivan*, 500 U.S. 173, 186 (1991) (quoting *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 862 (1984)). Rather, "an administrative agency's entitlement to deference is not limited to its initial interpretation of a statute." *Strickland v. Comm'r, Maine Dep't of Human Servs.*, 48 F.3d 12, 18 (1st Cir. 1995).²⁶ The Supreme Court made the same point in a decision issued just this past month.²⁷

Thus, in *Chevron*, the Supreme Court ruled that the EPA was allowed to shift its interpretation of the term "source" under the Clean Air Act in order to properly implement congressional policy "in a technical and complex arena." 467 U.S. at 863.

"The fact that the agency has from time to time changed its interpretation of the term 'source' does not . . . lead us to conclude that no deference should be accorded the agency's interpretation of

²⁶ See also, e.g., *Southern Utah Wilderness Alliance v. Dabney*, 222 F.3d 819, 828 (10th Cir. 2000) ("An agency is free to change the meaning it attaches to ambiguous statutory language, and the new interpretation may still be accorded *Chevron* deference."); *Nat'l Home Equity Mortg. Ass'n v. Office of Thrift Supervision*, 373 F.3d 1355, 1360 (D.C. Cir. 2004) ("An agency's interpretation of a statute is entitled to no less deference . . . simply because it has changed over time"); *Lovilia Coal Co. v. Harvey*, 109 F.3d 445, 452 (8th Cir. 1997) (same); *Himes v. Shalala*, 999 F.2d 684, 690 (2d Cir. 1993) (same).

²⁷ *Nat'l Cable & Telecommunications Ass'n v. Brand X Internet Servs.*, 524 U.S. ____, No. 04-277, slip op. at 9 (June 27, 2005).

the statute. . . . On the contrary, . . . the fact that the agency has adopted different definitions in different contexts adds force to the argument that the definition itself is flexible”

Id. at 863-64.

Likewise, in *American Trucking Associations, Inc. v. Atchison, Topeka & Santa Fe Railway Co.*, the Supreme Court recognized the Interstate Commerce Commission’s need to modify its regulations in response to changes in the trucking industry. 387 U.S. 397, 404 (1967). In affirming the ICC’s change of position, the Supreme Court dismissed the argument that the agency was bound to its prior interpretation of the statute:

“[F]aced with new developments or in light of reconsideration of the relevant facts and its mandate, [the Commission] may alter its past interpretation and overturn past administrative rulings and practice. . . . In fact, . . . *this kind of flexibility and adaptability to changing needs and patterns of transportation is an essential part of the office of a regulatory agency.*”

Id. at 416 (emphasis added).²⁸

Accordingly, the Commission should continue its practice of analyzing Section 2(a)(29)(A) of the Act in accordance with current conditions in the electric industry and in light of the Act’s purpose, which is to prevent the establishment of disjointed holding company

²⁸ *Accord EEOC v. Seafarers Int’l Union*, 394 F.3d 197, 205 (4th Cir. 2005) (“[A]gencies should remain free to administer their organic statutes to meet the regulatory needs of changing conditions”); *see also Peoples Fed. Sav. & Loan Ass’n v. Comm’r of Internal Revenue*, 948 F.2d 289, 303 (6th Cir. 1991) (changed agency interpretation made, in part, based on evolving economic considerations deserved deference); *United States Air Tour Ass’n v. FAA*, 298 F.3d 997, 1007 (D.C. Cir. 2002) (agency may change interpretation of how it determines whether “natural quiet” is disturbed in national park based on “more data” and “additional research”); *United States v. Deaton*, 332 F.3d 698, 711 (4th Cir. 2003) (Army Corps of Engineers reasonably changed interpretation of “navigable” waters under Section 404 of Clean Water Act to include tributaries based on its “understanding of the best way to [implement] the CWA . . . [o]ver the years”).

systems that cannot be operated efficiently, managed effectively or appropriately regulated. In making this determination, the Commission is not required to apply the statute as if the electric industry has not changed since 1944.

IV. AEP PRESENTED SUBSTANTIAL EVIDENCE DEMONSTRATING THAT THE COMBINED SYSTEM OPERATES WITHIN A SINGLE AREA OR REGION BASED ON CURRENT INDUSTRY CONDITIONS

The Court in *NRECA v. SEC* remanded the single area or region issue because it found that the Commission failed to make separate evidentiary findings on this requirement. 276 F.3d at 617. The Court was looking for the application of the statutory standard to evidence. AEP has now provided substantial evidence to the Commission in the form of expert and factual testimony by three witnesses. As shown below, AEP's evidence identified four distinct representations of multi-state areas or regions in which the Combined System operates. AEP's was the only testimony presented on the single area or system requirement.²⁹ In light of the fact that this issue was remanded because of insufficient factual findings, the opposing intervenors' decision to present no evidence on this issue was telling.

A. Changes in the Electric Industry and the U.S. Economy Since the Act Was Passed.

The U.S. Supreme Court recently made clear that the New Deal era statutes enacted to regulate the electric power industry should be interpreted in light of current conditions in the electric industry. Referring to the Federal Power Act, which was enacted contemporaneously with the Act, the Court said:

²⁹ Public Citizen presented two witnesses who addressed the interconnection issue in the case and attempted to broadly define "integration" for purposes of the Act. These witnesses did not provide relevant evidence on the single area or region requirement.

Since 1935 ... [t]echnological advances have made it possible to generate electricity efficiently in different ways and in smaller plants. In addition, unlike the local power networks of the past, electricity is now delivered over three major networks, or "grids," in the continental United States. . . . As a result, it is now possible for power companies to transmit electric energy over long distances at a low cost. . . .

Our evaluation of the extensive legislative history . . . is affected by the importance of the changes in the electricity industry that have occurred since the FPA was enacted in 1935. . . . [T]here is no evidence that if Congress had foreseen the developments to which FERC has responded, Congress would have objected to FERC's interpretation of the FPA.

. . . Whether or not the 1935 Congress foresaw the dramatic changes in the power industry that have occurred in recent decades, we are persuaded, as was the Court of Appeals, that FERC properly construed its statutory authority.

New York v. FERC, 535 U.S. 1 at 7-8, 23, 5 (2002).³⁰

AEP presented testimony describing these industry changes. The most significant changes have included the ability to transmit bulk quantities of electricity over long distances, and the broadening of the areas in which electric utilities coordinate their operations and engage in power transactions. This has occurred as a result of dramatic advances in transmission technology and the expansion of the transmission infrastructure as described by AEP witness Paul Johnson (AEP Exhibit No. 2 at 5-15), together with far-reaching changes in the regulatory and commercial setting of the industry as described by AEP witness J. Craig Baker. (AEP

³⁰ It is worth noting that the Commission's 1978 AEP Decision (discussed earlier) uses similar language to describe the changes in the electric industry that had already taken place between passage of the Act in 1935 and 1978. AEP's testimony in this case shows that the industry has continued to change dramatically since that time. AEP Exhibit No. 2 at 12-24 (Johnson); AEP Exhibit No. 5 at 11-12, 23-36 (Baker). The Commission recognized these further dramatic changes in recent merger decisions. *E.g.*, *CP&L Energy, Inc.*, 54 S.E.C. 996 (2000)

Exhibit No. 5 at 20-31). Accordingly, fair consideration of the “single area or region” requirement in the context of the electric power industry today should recognize that an appropriate area or region can be much broader than existed when the Act was passed and when the Commission last reviewed this requirement nearly a half century ago in the cases the Hearing Officer relied upon.

The same is true for the economy as a whole. AEP witness Dr. David Harrison described in his Prepared Direct Testimony the significant expansion of economic interactions between areas of the country that has occurred since the Act was passed, in large part because of modernization and expansion of critical infrastructure that permits the transportation of key commodities across broader areas. AEP Exhibit No. 1 at 13-14, 21-22, 26-28, 31-33, 36-37. Unquestionably, the U. S. economy is significantly more interdependent than it was in 1935 when the Act was passed.

B. The Eastern Interconnection Is a Well-Defined and Universally-Recognized Area or Region of Operations in the Electric Utility Industry.

As the Supreme Court explained in *New York v. FERC*, “unlike the local power networks of the past, electricity is now delivered over three major networks, or “grids,” in the continental United States....” 535 U.S. at 7. One of these is the “Eastern Interconnect[ion],” which consists of the synchronized electric system that encompasses most of the eastern half of the United States. *Id.* The Eastern Interconnection covers a discrete geographic area bounded by the interconnected electric transmission and distribution lines that operate in synchronism in the area east of the Rocky Mountains (excluding some of Texas). AEP Exhibit No. 2 at 7; AEP Exhibit No. 3, page 1. The Eastern Interconnection is universally recognized in the electric power industry as a distinct area of electric power system operations. AEP Exhibit No. 2 at 14.

The Eastern Interconnection also exhibits the attributes of a single region because there is interdependence among all of the participants in the Eastern Interconnection. As Mr. Johnson explained, because the Eastern Interconnection operates synchronously, utilities throughout the interconnection must coordinate their activities to maintain system reliability, and events occurring at locations within the interconnection affect power flows throughout the Eastern Interconnection. *Id.* at 17-22. The August 14, 2003, blackout, in which wires touching a tree in Ohio triggered cascading outages that blacked out huge areas in several states and Canada, is an example of this interdependence. *Id.* at 20-23. Indeed, the blackout affected frequency throughout the Eastern Interconnection. *Id.* at 21.

At the time the Act was passed, the Eastern Interconnection could not have been described accurately as a single area or region. The Eastern Interconnection did not exist in its present form when the Act was passed or at the time the Commission addressed the single area or region requirement in 1944. As AEP witnesses Johnson and Baker testified, advances in technology, the economies and efficiencies that result from interconnection and coordination of electric utilities, plus changes in the law intended to promote interconnection, have driven the industry to become increasingly interconnected. AEP Exhibit No. 2 at 22-24 (Johnson); AEP Exhibit No. 5 at 22-29, 36-37 (Baker). At the time of the Act, this process had just begun and three separate interconnections covered only a limited portion of the area now covered by the Eastern Interconnection. AEP Exhibit No. 2 at 8-11. As the years passed and transmission technology advanced, these three interconnections were tied together, and additional utility interconnections were constructed, forming the Eastern Interconnection, which now operates, in the words of the United States Department of Energy, as “the world’s largest synchronized machine.” *Id.* at 22.

Mr. Baker explained that these changes were also accomplished as a result of federal laws and policies that promoted increased interconnection, coordination and competition. AEP Exhibit No. 5 at 22-32. These changes are related directly to the matter at issue because the Act's single area or region requirement exists because of concerns over the ability of utilities to operate as integrated systems over broader geographic areas. However, the expansion of utility interconnections since 1935 has made it possible to achieve operating economies through coordinated, single-system planning and operation, enabling systems to be integrated over large distances. AEP Exhibit No. 5 at 5-9.

The FERC has acted over the past 10 years to expand the capability to trade electric power across the Eastern Interconnection. First, by establishing open access to transmission in Order No. 888 it eliminated ownership of transmission as a barrier to transacting in electricity across multiple electric systems within each interconnection. AEP Exhibit No. 5 at 25-26. Second, by establishing RTOs, it further facilitated enhanced trading across broad areas throughout the Eastern Interconnection by transferring operational authority to independent entities that are required under FERC rules to establish broad regional markets for electric power. AEP Exhibit No. 5 at 26-28. Third, the FERC has taken steps to eliminate "seams" between RTOs that would inhibit trading. It has moved toward the elimination of additive transmission rates (known as rate pancaking), which makes it economical to buy and sell electricity at very great distances across multiple electric systems and multiple RTOs. And, it has recently approved joint operating agreements between RTOs, including PJM, MISO and SPP (in which most of the Combined System operate) to facilitate trading across great distances. AEP Exhibit No. 5 at 29-31. The Commission has recognized these same policy changes in

approving merger transactions between utilities located several hundred miles apart. *See, e.g., CP&L Energy, Inc.*, 54 S.E.C. 996 (2000).

As Mr. Johnson testified, the expansion of the scope of electric markets "...takes advantage of the Eastern Interconnection's 'oneness' to foster greater economic benefits to entities within the eastern footprint." AEP Exhibit No. 2 at 24. Mr. Baker therefore testified that, from an electrical standpoint, the Eastern Interconnection forms a 'single area'." AEP Exhibit No. 5 at 21. In terms apt for the present purpose of determining whether AEP's operations are within a "single" area or region, the FERC has emphasized that:

From an electric engineering perspective, each of the three interconnections in the United States (the Eastern, the Western, and ERCOT) operates as a single 'machine.'³¹

Based on all of the foregoing characteristics, the Eastern Interconnection can be identified as a single area or region for purposes of the Act. All of AEP's non-ERCOT operations are entirely within the Eastern Interconnection and, therefore, are within a single area or region for purposes of the Act. The ERCOT and non-ERCOT portions of the former CSW are directly interconnected and the Commission has already found that the ERCOT and non-ERCOT portions of the former CSW system are integrated,³² so it is proper to consider the ERCOT portion of CSW as being in the same area of region. In addition, even if the ERCOT portion of CSW were not integrated with the rest of the Combined System, AEP would be permitted to retain this part of the system pursuant to Sections 11(b)(1)(A) - (C) of the Act. The ERCOT

³¹ *Regional Transmission Organizations*, Notice of Proposed Rulemaking, 64 Fed. Reg. 31,389 (June 10, 1999), FERC Stats. & Regs. ¶ 32,541 at 33,697 (1999).

³² *See Central and South West Corp., Holding Co.* Act Release No. 22439; 47 S.E.C. 754, 757 (Apr. 1, 1982).

portion of the Combined System cannot be operated as an independent system without the loss of substantial economies as set forth in subpart (A). Mr. Baker testified that operating the ERCOT portion of the Combined System separately would entail lost economies in excess of \$50 million per year. AEP Exhibit No. 5 at 21-22.³³

The Initial Decision rejects AEP's testimony concerning the Eastern Interconnection solely because he thought this area was too big. ID at 22-23. However, as discussed above, since at least 1978 the Commission has rejected a *per se* size limit in applying the integration standard. The only size limit that the Act imposes on an acceptable area or region is that it not be so large as to impair the ability of the holding company system to be operated efficiently, and to be effectively managed and regulated. See Section 2(a)(29)(A) of the Act. The Act also requires the Commission to consider the "state of the art" in the electric industry in making this determination. *Id.*

C. The Service Territories of the Combined System and the Utilities Directly Interconnected to It Constitute a Single Area or Region that the Commission Has Identified as Relevant for Other Purposes Under the Act.

For purposes of its analysis of competition under Section 10(b)(1) of the Act, the Commission has defined the relevant area or region of operation using the concept of the service areas of "first-tier utilities." In its 1993 order approving Entergy Corporation's proposed acquisition of Gulf States Utilities, the Commission adopted and approved Entergy's proposal that the appropriate region to consider under Section 10(b)(1) be defined by the first-tier

³³ There is no legitimate issue over whether the Combined System would meet the two remaining prongs of Section 11(b)(1). Subpart (B) is satisfied because the states comprising the Combined System are contiguous as shown in AEP Exhibit No. 11. As discussed above, the Commission has already made the findings required under subpart (C). See page 11, *supra*.

interconnections of the merging companies (that is, the relevant region consisted of the Entergy and Gulf States operating territories, plus all the utilities directly interconnected with either of them). Analyzing the competitive effects of the merger in light of this definition of the relevant region, the Commission found that the merger “would not significantly change the relationship between the size of the Entergy system and the rest of the electric utility industry in the region.”³⁴

In *Entergy* the Commission cited Section 2(a)(29)(A) in support of the proposition that the Commission must “exercise its best judgment under Section 10(b)(1) as to the maximum size of a holding company in a particular *area*.”(emphasis added.)³⁵ And, in *Northeast Utilities, Holding Co.* Act Release No. 25221 (Dec. 21, 1990), the Commission stated that “Section 10(b) allows the Commission to exercise its best judgment as to the maximum size of a holding company in a particular *area*, considering the state of the art and the *area or region* affected.”³⁶ AEP also used the “first-tier utility” method to define the relevant area of operations under Section 10(b)(1) in its application to acquire CSW. The Commission found that this transaction satisfied the requirements of Section 10(b)(1), and that finding was not challenged on appeal.

The Commission’s definition of the relevant area or region for purposes of Section 10(b)(1) of the Act provides a reasonable and appropriate definition of the same term for

³⁴ *Entergy Corp., Holding Co.* Act Release No. 25952 (Dec. 17, 1993), *request for reconsideration denied*, Holding Co. Act Release No. 26037 (Apr. 28, 1994), *remanded sub nom. Cajun Elec. Power Coop. Inc. v. SEC*, 1994 WL 704047 (D.C. Cir. Nov. 16, 1994), *on remand*, *Entergy Corp., Holding Co.* Act Release No. 26410 (Nov. 17, 1995) (citations omitted) (emphasis added).

³⁵ *Entergy Corp., Holding Co.* Act Release No. 25952 at n.34 (Dec. 17, 1993)(emphasis added).

³⁶ See also, e.g., *Sierra Pacific Resources, Holding Co.* Act Release No. 24566 (Jan. 28, 1988); *Eastern Utilities Associates, Holding Co.* Act Release No. 24245 (Nov. 21, 1986).

purposes of Section 2(a)(29)(A). In order to administer its responsibilities to review mergers under the Act, the Commission must identify the appropriate area or region in which holding companies operate for two purposes -- competition and operation as an integrated system -- and there is no reason why it would be inappropriate under the Act to use the same definition for both purposes. In fact, because competition has become increasingly central to the way in which electric utilities are required to structure their operations and manage their business, it makes sense that the definition of area or region used by the Commission to assess competitive conditions be used to establish whether holding companies operate in a single area or region for purposes of Section 2(a)(29)(A).

AEP's evidence included a map (AEP Exhibit No. 11) showing that the Combined System and its first-tier interconnected utilities fall within a single area or region in that the area created using this formulation is a single seamless area, devoid of any attributes of gerrymandering or "scatteration." This would not necessarily be the case for other merging companies. The area or region relevant here is a function of the proximity of the merging utilities, the large number of interconnections in the region, and their being situated within a highly developed transmission grid. AEP Exhibit No. 5 at 36-37. AEP Exhibit No. 11 shows that the area or region has a well-developed transmission system that interweaves and binds this region together and supports its function as an economic unit.

The Initial Decision rejects the use of AEP Exhibit No. 11 to define the area or region in which the Combined System operates for the same reason it rejects use of the Eastern Interconnection; the Hearing Officer thought it was too big. And, its conclusion in this instance was equally invalid.

D. The PJM, MISO and SPP Regional Transmission Organizations Form a Single Market Area as a Result of FERC Regulatory Policies

AEP's testimony showed that the non-ERCOT portion of the Combined System operates within the footprint of three Regional Transmission Organizations (RTOs) approved by the FERC: PJM, MISO and SPP. These RTOs operate within the synchronized Eastern Interconnection. AEP Exhibit No. 2 at 15. The FERC has directed that each of these RTOs enter into joint operating agreements to eliminate "market seams" between them and facilitate the integration of the markets operated by the three RTOs. These three RTOs form a region in which the combination of FERC rules and electric infrastructure facilitate commercial activity and interdependence among its electric power participants. AEP Exhibit No. 5 at 31-32. They already constitute a single market area for purposes of electricity trading. *Id.* at 33.

AEP's testimony showed that in recent years FERC has pursued a policy of expanding the scope and scale of electric industry institutions and markets. The first phase of this effort began with FERC Order No. 888, which essentially made interstate transmission systems common carriers. AEP Exhibit No. 5 at 11-12. This action, by itself, greatly expanded the interaction of electric utilities and the use of the interstate transmission grid. *Id.* Electric transmission systems, which once were used principally by vertically-integrated electric utilities to serve their local customers, became increasingly used for commerce between and among utilities. *Id.* at 24.³⁷

A second phase of FERC's electric market restructuring involved the formation of RTOs under its Order No. 2000 to broaden the geographic scope of unified electric markets and

³⁷ The Commission recognized these same changes in *CP&L Energy, Inc.*, 54 S.E.C. 996 (2000) and *Exelon Corp., Holding Co.* Act Release No. 27256 (Oct. 19, 2000)

eliminate discrimination in the provision of transmission services. AEP Exhibit No. 5 at 26-27. RTOs formed under Order No. 2000 must both control and operate the combined transmission systems of their members and manage centralized wholesale electricity markets. *Id.* at 27-28. PJM, MISO and SPP are FERC-approved RTOs that cover the area encompassed by the Combined System (excluding ERCOT) and beyond.³⁸ In fulfillment of conditions imposed by the FERC on approval of the Merger, the AEP east zone operating companies have become members of PJM and its non-ERCOT west zone companies have become members of SPP. *Id.* at 29-30.

The third phase of FERC's policy initiatives began with its issuance of a Notice of Proposed Rulemaking proposing a Standard Market Design for the nation.³⁹ AEP Exhibit No. 5 at 28-29. Among other things, the SMD NOPR envisioned the creation of geographically large electricity markets with standard market rules, employing centralized dispatch of generation resources, and tying together RTOs through joint operating agreements and joint and common markets. *Id.*

In July 2002, FERC imposed conditions on AEP's (and others') decision to join PJM that emphasized FERC's desire to bring PJM and MISO together into one energy market.⁴⁰ *Id.* at 29-

³⁸ See AEP Exhibit No. 9.

³⁹ *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design*, Notice of Proposed Rulemaking, FERC Stats. & Regs. ¶ 32,563 (2002), 67 Fed. Reg. 55451 (Aug. 29, 2002), 67 Fed. Reg. 58751 (Sept. 18, 2002), 67 Fed. Reg. 63327 (Oct. 11, 2002) ("SMD NOPR").

⁴⁰ *Alliance Companies*, 100 FERC ¶ 61,137 (2002), *order on clarification*, 102 FERC ¶ 61,214 (2003), *order on reh'g and clarification*, 103 FERC ¶ 61,274 (2003), *order denying reh'g and granting clarification*, 105 FERC ¶ 61,215 (2003); *appeal docketed sub nom., American Electric Power Serv. Corp. v. FERC*, No. 03-1223 (D.C. Cir. Aug. 1, 2003).

30. As a result, the practice of charging additive (in FERC parlance “pancaked”) transmission rates for transactions throughout the combined PJM/MISO footprint was eliminated, effective December 1, 2004. *Id.* In addition, as directed by FERC, PJM and MISO began this spring to be operated pursuant to a common set of market rules that implement the FERC’s Standard Market Design. A MISO/PJM joint operating agreement (“JOA”) has been negotiated and accepted by FERC and is now in operation. *Id.* The JOA is a state-of-the-art agreement providing for a higher level of operational coordination and cooperation than had ever existed between or among existing RTOs, utilities or control areas. *Id.*

SPP is being brought into this single, coordinated market as a result of orders issued in 2004 by FERC which granted RTO status to SPP.⁴¹ *Id.* at 30-31. FERC’s approval of the SPP as an RTO was based on SPP’s creation of a joint and common market with MISO and the negotiation of a JOA between SPP and MISO. *Id.* FERC has accepted a JOA addressing the first stage of coordinated operations and ordered SPP and MISO to negotiate and file a mutually agreeable JOA for more advanced operations by December 1, 2004.⁴² *Id.* The latter was filed with the FERC in December 2004, and accepted for filing by FERC in January 2005, subject to certain modifications.⁴³

These FERC actions tie the Combined System to the electricity coordination and market area encompassed by the three coordinated RTOs, establishing that by operating within these three RTOs, the Combined System lies within a single area or region from the standpoint of

⁴¹ *Southwest Power Pool, Inc.* 106 FERC ¶ 61,110 (2004); *order on compliance filing*, 108 FERC ¶ 61,003 (2004).

⁴² *Southwest Power Pool, Inc.* 109 FERC ¶ 61,008 (2004).

⁴³ *Southwest Power Pool, Inc.* 110 FERC ¶ 61,031 (2005).

electric power institutional arrangements, common markets and functional interactions relating to electricity. It is expected that the actions taken by FERC to create the three RTOs, and to eliminate market barriers and inefficiencies between them, will reduce variations in the wholesale price of electricity, increase bulk power trading activity and produce a more efficient distribution of energy resources. AEP Exh. 5 at 28-31.

Further in support of this definition of “area or region,” Mr. Baker testified that the AEP east zone (located in PJM) and west zone (located in SPP) are part of the same wholesale power market by virtue of the fact that the Combined System’s operators trade power by transmitting it across the contract path connecting the two zones on a daily and hourly basis based on market demand and prices. AEP Exhibit No. 5 at 32. This applies to both the ERCOT and non-ERCOT portions of the Combined System. *Id.* at 33.

The Division agrees that, based on the evidence of record, the Combined System is operating within a single market.⁴⁴ However, the Initial Decision rejects this definition of area or region based on an argument presented by the Associations⁴⁵ to the effect that the three RTOs cannot comprise a single region because the word “regional” in RTO indicates that each RTO is a separate region. *See* ID at 21-22. It therefore finds that AEP’s evidence indicated that the Combined System is in four different regions (including ERCOT). *Id.* However, the Court in *NRECA v. SEC* already dispensed with this argument:

⁴⁴ Post-Hearing Statement of Position of the Division of Investment Management at 31-44 (Feb. 15, 2005); Post-Hearing Reply Brief of the Division of Investment Management . at 14-17 (Feb. 29, 2005).

⁴⁵ The Associations are the American Public Power Association and the National Rural Electric Cooperative Association. Both are intervenors in this proceeding and were petitioners before the Court of Appeals.

While the *Commission* could potentially point to boundaries identified by ... FERC as evidence that a utility system is confined to a single region, [*the Associations*] may not point to such boundaries as evidence that a utility system is not so confined. The Commission may make its own decision regarding the meaning of the region requirement

276 F.3d at 617 (emphasis in original). In order for the Commission to “make its own decision,” and satisfy the Court, the Commission needed a factual record, and this is presumably one reason why the Commission set this issue for an evidentiary hearing. AEP made this record, demonstrating that the combined RTOs have evolved into a single coordinated market area. The Initial Decision does what the Court admonished should not be done. It simply points to a regional boundary identified in another context and draws broad conclusions for purposes of the Act without supporting evidence or analysis.

E. The Combined System Lies Within a Single Functional Area or Region Defined by Significant Non-Electric Economic Interactions .

AEP also presented evidence from a regional economist that demonstrated that the Combined System is within a single area or region as defined with regard to economic factors unrelated to the electric power industry. Dr Harrison, an expert in the field of regional economics, testified that regions are identified by regional economists on two general bases: “(1) homogeneous regions demarcated on the basis of internal uniformity []; and (2) functional regions based upon areas that exhibit more interaction with one another than with outside areas based upon some criteria.”⁴⁶ AEP Exhibit No. 1 at 3-4. Dr. Harrison testified that “one means of defining homogeneous regions would be in terms of the location of common types of facilities,”

⁴⁶ Citing Hoover, E. M. and F. Giarratani. *An Introduction to Regional Economics*. Third Edition, 1999) University of Pittsburgh. URL: <http://www.rri.wvu.edu/WebBook/Giarratani/main.htm>.

while “functional regions are characterized by economic interdependence.” *Id.* at 4. Dr. Harrison explained that economic interdependence consists of the movement of goods and services and other measures of transactions within the region, including transportation infrastructure. *Id.* at 4 and 7.⁴⁷

Dr. Harrison showed that the Combined System is part of a single area or region on the basis of both homogeneous and functional attributes. The predominant homogeneous characteristics of this region were derived from the location of manufacturing and employment centers. AEP Exhibit No. 1 at 4. Dr. Harrison testified that the following processing and manufacturing centers were evidence of a homogeneous economic region: petroleum, machinery (excluding electric), fabricated metals and instruments. January 10, 2005 Hearing Tr. 17:12-18:22. Most of Dr. Harrison’s testimony identified functional attributes, demonstrated by trade flows and infrastructure, which further support the finding of an economic region. Dr. Harrison testified that, “[t]ransportation infrastructure is crucial to the determination of the geographic scope of a functional region.” AEP Exhibit No. 1 at 7.

Dr. Harrison pointed to infrastructure and related trade flows that were vital to the economic interdependence of the region that have developed considerably over the past 70 years

⁴⁷ Defining regions on the basis of both homogeneity and functional interdependence is not inconsistent with the analyses of this issue by the Commission in the 1940s and 1960s. For example, in its 1944 and 1945 *Middle West* orders, the Commission appeared to focus on attributes of homogeneity in identifying a single area or region. *1944 Middle West*, 15 S.E.C. 309, 339; *1945 Middle West*, 18 S.E.C. 296, 305. Likewise, in its 1966 *American Natural Gas* order, the Commission appeared to focus on functional attributes in determining that the subject gas properties were in a single area or region. 43 S.E.C. 203, 206. Among the circumstances present that the Commission noted before making its finding were “such factors as industrial, marketing and general business activity [and] transportation facilities” around the Great Lakes, which are functional characteristics as defined by Dr. Harrison.

and lowered transactional and commercial costs. These include: natural gas pipelines (*Id.* at 8-14), crude oil pipelines (*Id.* at 14-22), road networks (*Id.* at 22-28), waterways (*Id.* at 28-33), railways (*Id.* at 33-37). Dr. Harrison testified to the significant trade flows that illustrate the linkages among parts of the region:

The substantial infrastructure that connects the AEP East and AEP West states facilitates a substantial amount of trade between them. In 1997, AEP West states exported over \$65 billion worth of goods to AEP East states and AEP East states exported almost \$95 billion worth of goods to AEP West states.

Id. at 37. To interpret these results and compare them with trade flows from other areas, Dr. Harrison developed linkage coefficients using equations accepted by regional economists. *Id.* at 39 (citing Hoover, E. M. and F. Giarratani. *An Introduction to Regional Economics*. (Third Edition, 1999), University of Pittsburgh). Dr. Harrison described the process and results as follows:

I considered linkages among the four U.S. Census regions, using information on domestic trade flows from the Bureau of Transportation Statistics. [There are] four U.S. Census regions – the Northeast, the Midwest, the South, and the West.⁴⁸ ... [T]he linkage coefficients ... indicate that the Midwest and South regions (which consist of three and eight AEP states, respectively) are the most closely connected of the four Census regions. This suggests that these two Census regions are in a broad economic region, encompassing much of the center of the country.

⁴⁸ Using the Census configuration of regions, three of the AEP states (Ohio, Indiana and Michigan) are located in the Midwest region and the remaining eight (West Virginia, Virginia, Kentucky, Tennessee, Arkansas, Louisiana, Oklahoma and Texas) are located in the South region. Even the pre-merger AEP system operated in three states in the Midwest and four states in the South.

Id. at 39-40. The coefficient linkage for the Midwest and South⁴⁹ was 0.51, the next highest was 0.36 (the coefficient linkage for the South and Northeast). *Id.* at 41.

In summarizing the significance of the analytical evidence that is reviewed in his testimony, Dr. Harrison concluded:

The totality of the evidence indicates to me that the AEP combined system is located within a broader region. This broader area includes key infrastructure -- including pipelines, waterway, railroads, and highways -- that functionally tie the parts of the region together. Trade flows and product price relations provide additional indicates of the usefulness of identifying this broad area for purposes of the Act.

AEP Exhibit No. 1 at 42. No party in the case attempted to rebut Dr. Harrison's testimony. It is even more significant that no party, including those who appealed from the Commission's previous order approving this merger, offered any evidence in support of an alternative analytical approach to defining area or region outside the electric industry context.

The Initial Decision faults Dr. Harrison's analysis because it does not include any analysis of electric markets. ID at 18. However, the Initial Decision never explains why the Act requires this. In fact, the purpose of Dr. Harrison's testimony was to provide an economically justified alternative definition of area or region (in addition to the three discussed above that are based on electric markets) without reference to the electric industry in the event the Commission believed that this was appropriate. This was consistent with the Commission's 1966 decision in *American Natural Gas Company*, in which the Commission referred to "a common economic

⁴⁹ The Combined System is situated exclusively within the Midwest and South, as the Commission found in the 1978 AEP Decision.

and geographic region” including “industrial, marketing and general business activity” in order to assist in defining an area or region under the Act. 43 S.E.C. 203, 206.

The Initial Decision also faults Dr. Harrison’s analysis because it shows that there are certain dissimilarities in the territory covered by the Combined System. *Id.* The Initial Decision does not explain why the existence of a few specific dissimilarities within an area means that a geographic area cannot be considered to be in the same economic region. Nor did the Initial Decision even address Dr. Harrison’s careful explanation of the term “functional” regions, which does not rely on homogeneity to define a single economic region. Dr. Harrison’s expert conclusion that the Combined System operates within a single functional region remains unchallenged.

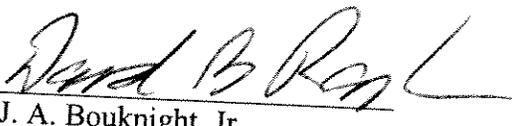
V. CONCLUSION

For all of the foregoing reasons, AEP requests that the Commission find that the Combined System satisfies the single area or region requirement contained in Section 2(a)(29(A) of the Act. Based on this finding, the Commission should reaffirm its approval of AEP's application to acquire CSW.

Respectfully submitted,


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July 7, 2005

**CERTIFICATE OF COMPLIANCE
WITH TYPE-VOLUME LIMITATION**

This brief complies with the length limitation set forth in Rule 450(c) of the Commission's Rules of Practice because it contains 10,501 words, as calculated using the word count function of Microsoft Word 2002, excluding the parts of the brief exempted by Rule 450(c).

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