ADMINISTRATIVE PROCEEDING
FILE NO. 3-11616

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:	**DIVISION OF INVESTMENT MANAGEMENT'S STATEMENT OF POSITION AND SUMMARY OF THE CASE**
AMERICAN ELECTRIC POWER COMPANY, INC.	:	

PRELIMINARY STATEMENT

Pursuant to the Court's October 6, 2004, Scheduling Order, the Division of Investment Management (the "Division") hereby submits its Statement of Position on the issues on remand concerning the application of American Electric Power Company, Inc., ("AEP") for approval of the acquisition of Central and South West Corporation ("CSW"), together with its summary of the case.

On August 30, 2004, the Securities and Exchange Commission ("Commission") ordered this hearing[1] on a remand from the United States Court of Appeals for the District of Columbia[2] to supplement the existing administrative record concerning AEP's application under the Public Utility Holding Company Act of 1935, as amended ("Act") to acquire CSW.[3] The Commission's order directs that the hearing be held:

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[1] Notice and Order for a Hearing, Holding Co. Act Release No. 27886 (Aug. 30, 2004).

[2] *National Rural Electric Cooperative Association v. SEC*, 276 F.3d 609 (D.C. Cir. 2002) ("*NRECA v. SEC*").

[3] Order Authorizing Acquisition of Registered Holding Company and Related Transactions, Holding Co. Act Release No. 27186 (June 14, 2000) ("*AEP/CSW* Order").

> for the purpose of determining whether the AEP and CSW systems are interconnected, through a unidirectional contract path or otherwise, and whether the resulting combined system operates in a single area or region, and hence satisfy the requirements of sections 10(c)(1) and 11(b)(1) of the [Public Utility Holding Company] Act....

The hearing in this matter is set to commence on January 10, 2005.

STATEMENT OF THE DIVISION'S POSITION AND SUMMARY OF THE CASE

In light of the hearing order, the Division anticipates that the evidence at the hearing will be tightly focused on whether the combined AEP and CSW utility properties are (1) "physically interconnected or capable of physical interconnection," and (2) "confined in [their] operations to a single area or region" in accordance with the Act's requirements.[4] Preliminarily, as the D.C. Circuit's opinion recognizes, these are two of the four prerequisites to the necessary determination that a holding company's utility assets constitute an "integrated public-utility system" – the other two focusing on the ability economically to coordinate and operate the system and the benefits of localized management, efficient operation and the effectiveness of regulation. As the D.C. Circuit's opinion recognizes, the Commission has typically treated these as four distinct requirements, and the Division presumes that it will continue to do so in this case.

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[4] Section 2(a)(29)(A) of the Act defines an electric "integrated public-utility system" to mean:

> [A] system ... whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system 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.

However, it is important to recognize that these requirements are fundamentally a part of the broader requirement that a holding company system be efficient, interconnected and capable of being regulated – a requirement intended to avert the evils identified in section 1 of the Act regarding the excessive growth, inefficient operation and scatteration of holding companies' utility assets. Given this, there is bound to be some overlap in the types of evidence and the nature of the findings that go into determining whether each of these requirements is independently satisfied.

The Division also recognizes that it is the applicant's burden to establish that the statutory requirements at issue in this matter are met. Because AEP has not yet formally introduced all the evidence it will use in its attempt to establish the statutory criteria, but rather has only identified in general terms broad categories of evidence it intends to introduce,[5] it is premature for the Division to state whether it believes that the interconnection and single region requirements are satisfied in this matter. Thus, this Statement of Position is devoted largely to identifying the types of evidence that the Division believes are relevant to showing that these requirements are met. The Division intends to participate in the hearing to review and, when necessary, develop and test the evidence submitted and will formulate its final position after making its own independent evaluation of the complete record.

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[5] *See, e.g.,* Narrative Summary of the Case Submitted by AEP, Inc. ("AEP's Narrative Summary"). The Division does note, however, that some of the relevant evidence in this matter – namely, that submitted by AEP and CSW prior to the Commission's issuance of its June 2000 order approving the merger – is already a part of the record in this proceeding and will continue to be relevant to the determinations to be made in this proceeding.

The following briefly discusses the Division's preliminary views on these requirements, and in particular, the types of evidence it believes are likely relevant to the two determinations required to be made in this proceeding.

A. Interconnection Requirement

The court of appeals, in discussing the Act's interconnection requirement, construed that language to require a "mutual connection," a connection that provides for "two-way transfers of power."[6] After observing that the interconnection between the AEP and CSW systems consisted of a unidirectional 250-megawatt transmission service contract with Ameren Corporation ("contract path"), the court of appeals stated that, "[a]bsent some explanation from the Commission, we cannot understand how a system restricted to unidirectional flow of power from one half to the other can be operated" as an interconnected system. *Id.*[7]

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[6] *NRECA v. SEC,* 276 F.3d at 615.

[7] In the sentence preceding that quote, the court of appeals order could be read to suggest that the "interconnection" requirement also implied that the system was "coordinated" as that term is used in the Act. *See NRECA v.* SEC, 276 F.3d at 615 ("In addition, PUCHA itself requires that the interconnected system be one 'which under normal conditions may be economically operated as a single interconnected and coordinated' whole"). Such a reading, however, would risk collapsing two separate inquiries under section 2(a) (29) (A), namely "interconnection" and "coordination." The Commission analyzes four distinct factors before finding that a proposed combination of utility properties will result in an integrated system:

- the combined utility assets must be physically interconnected or capable of physical interconnection (the "interconnection requirement");
- the combined utility assets, under normal conditions must be economically operated as a single interconnected and coordinated system (the "economic and coordinated operation requirement");
- the system must be confined in its operations to a single area or region (the "single area or region requirement"); and
- the the system must not be so large as to impair (considering the state of the art and the area or region affected) the advantages of localized

It is true that the Commission has traditionally found geographically separate utility systems to be integrated on the basis of bi-directional contract paths. However, the Commission has never imposed a blanket requirement that discontiguous utility assets in a holding company system must be interconnected through a bi-directional contract path. Indeed, as outlined in more detail below, we believe that the Commission's cases clearly demonstrate that it has generally looked for evidence that electric power can be moved on a regular basis between the various parts of a utility system so that economic transfers of power between those parts can actually be made. When holding companies have been able to demonstrate that this is the case, the Commission has generally found that their utility properties are interconnected (or capable of interconnection) for purposes of the statute.[8] While a bi-directional path may be the easiest way to demonstrate that such transfers are possible, the Division does not believe that it is the only way that a utility system could show that the interconnection requirements are met.

There is already significant evidence in the record on this issue. Based on that evidence, the Commission initially determined that the statutory requirement was satisfied. AEP already states that it has firm transmission service to transfer 250

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management, efficient operation, and the effectiveness of regulation (the "no impairment requirement")

AEP/CSW Order (citing *Environmental Action, Inc. v. SEC*, 895 F.2d 1255, 1263 (9th Cir. 1990) (citing *Electric Energy Inc.*, 38 SEC 658, 668)). Consequently, interconnection is the first inquiry, and coordination the second inquiry, in this four-part analysis.

[8] Most notably, as discussed in more detail below, the Commission has found that a demonstration that a holding company can move power between parts of its utility system through the ability to purchase transmission capacity from third parties on a non-discriminatory basis is sufficient to show that the interconnection requirement of the Act is satisfied.

megawatts through Ameren Corporation's system from AEP's East Zone (the former AEP system) to its West Zone (the former CSW system), a path consistent with historical and anticipated needs of the combined utility system.[9] In order to supplement this unidirectional contract path, AEP could introduce other relevant evidence showing that the two parts of its system are interconnected in both directions.

For example, AEP has stated that the contract path includes the option for AEP to transfer electricity from the West Zone to the East Zone (i) on a non-firm basis at any time, and (ii) on a firm basis.[10] Such facts, if demonstrated at the hearing, would clearly be relevant to a determination of whether the systems are interconnected – that is, there may well be relevant evidence that while the contract path was primarily intended to be unidirectional (from East Zone to West Zone), based on the historical and perceived needs of the combined system, the path is in fact reversible (permitting transfers from West Zone to East Zone), and interconnection exists through the contract path.

In addition, evidence that non-firm point-to-point transmission service has existed since the time of the merger that would be sufficient for any necessary power transfers from the West Zone to the East Zone[11] would clearly be relevant. The Division believes

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[9] The Division understands that the contractual reservation provides firm point-to-point transmission service from AEP's Breed-Casey interconnection with the Ameren Corporation system to CSW's MOKANOK line interconnection with Ameren.

[10] AEP states that, as anticipated at the time of the merger, there has been little need for movement of capacity from west to east since 2000. *See*, AEP's Narrative Summary at 5. Nevertheless, the evidence may well show that the system is capable of two-way transfers both through the contract path and otherwise.

[11] The record shows that AEP and CSW could use their rights to nominate secondary points of receipt and delivery under their transmission agreements with Ameren and with Western Resources, Inc. *See*, AEP's Application, Item 1.B.3.c. AEP's Application also indicates that quantities in excess of the 250 MW could be moved within the combined system in any given hour by using non-firm transmission rights. *Id.*

that the existence of non-firm transmission service is an important aspect of evaluating interconnection. This is particularly true given the manner in which the Federal Energy Regulatory Commission ("FERC") has been encouraging the development of open access to transmission by participants in the electric industry – an approach that discourages the use of firm, contractual transmission paths in favor of a first-come, first-served system with transparent tariffs. In assessing whether the interconnection requirement is satisfied – a requirement that has always fundamentally focused on the ongoing ability to move electricity between the various parts of a utility system – the Division believes that regulatory changes affecting the transmission of electricity should not be ignored and that the Act's statutory requirements must be interpreted in light of such developments.[12]

Indeed, in recent years, as the transmission industry has changed in response to changing FERC regulation and other market factors, the Commission has repeatedly recognized that interconnection of noncontiguous utility properties can occur *solely* by means of the legal right to purchase available transmission capacity from third parties on non-discriminatory terms.[13]

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[12] As the Commission observed in the AEP/CSW Order, section 2(a)(29)(A) of the Act expressly directs the Commission to consider the "state of the art" in the industry – *i.e.*, contemporary realities – so that the Commission's interpretation and application of the Act's integration requirements continue to evolve in tandem with developments in the industry.

[13] *See CP&L Energy, Inc.*, Holding Co. Act Release No. 27284 (Nov. 27, 2000) (firm contract path unnecessary to show interconnection between two non-contiguous parts of utility system where adequate transmission capacity is available through open access and other transmission arrangements); *Exelon Corp.*, Holding Co. Act Release No. 27256 (Oct. 19, 2000) (combination of a firm contract path in one direction and adequate transmission capacity in the other direction sufficient to interconnect noncontiguous properties of two utilities). For the most recent application of this approach, see *Exelon Corp.*, Holding Co. Act Release No. 27904 (Oct. 28, 2004) (approving a system interconnected by PJM Interconnection LLC, a regional transmission organization).

Because of the nature of today's transmission markets, the Division firmly believes that cases such as *CP&L Energy* and *Exelon Corp.* are appropriate interpretations of the interconnection requirement. The Division, therefore, believes that evidence focusing on the availability of non-firm and open access transmission between the various parts of the AEP system is highly relevant to determining whether the AEP system as a whole is interconnected. This evidence will be fundamental to AEP's ability to show that its system is fully interconnected through the existence of a contract path combined with the availability of other types of non-firm transmission.

B. Single Area or Region Requirement

The second issue for this hearing is whether the combined AEP and CSW utility properties are "confined in its operations to a single area or region." Act, section 2(a)(29)(A). In its decision remanding this matter to the Commission, the court of appeals stated that it was unable to find evidence in the existing record that the combined utility operated in a single area or region.[14] The Division expects that much of the evidence relevant to the single area requirement will be introduced into the record for the first time at the hearing.

The Commission has traditionally approached the "single area or region" requirement on a case-by-case basis, in terms of practical considerations. The determination of whether a utility system is in a single area or region cannot be based on seemingly "common sense" notions of what parts of the country "go together," but rather must be based on a careful analysis of the totality of the circumstances in which the

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[14] *NRECA v. SEC,* 276 F.3d at 618-19.

combined system is located, including the nature of the electricity markets and infrastructure underlying the combined system, supplemented in appropriate cases by other economic, demographic and geographic factors that may be relevant to the determination whether the combined system is located in the same region for the purposes of the Act.[15] Like the "no impairment" requirement of section 2(a)(29)(A) and the provisions of sections 10(b)(1) and 10(c)(2) of the Act, the "single area or region" requirement implicitly requires consideration of the size of the system that would result from an acquisition, even though the Act imposes no precise limitations on holding company size.[16] The Commission has found that the single area or region test should be applied flexibly when doing so does not undercut the policies of the Act against scatteration – the ownership of widely dispersed utility properties. For example, the

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[15] *See, Vermont Yankee Nuclear Power Corporation*, Holding Co. Act Release No. 15958 (Feb. 6, 1968), rev'd and remanded on other grounds (relying on the existing state of the art of generation and transmission and the economic advantages of the proposed arrangement to find that the entities involved were within the same area or region).

[16] "[T]he determination of whether to permit enlargement of a system by acquisition is to be made on the basis of all the circumstances, not on the basis of preconceived notions of size." *American Electric Power Co.*, 46 SEC 1299, 1309 (1978). The Commission has also stated that:

> We do not, in applying particular size standards, lose sight of the objectives of other criteria. There must be a reconciliation of all objectives to the end of accomplishing a satisfactory administration of the Act. Thus we do not disregard operating efficiency in our determination of whether size is excessive from the viewpoint of localized management or effectiveness of regulation.

Commonwealth & Southern Corp., Holding Co. Act Release No. 7615 (Aug. 1, 1947). Congress directed the Commission in section 1(c) of the Act to interpret all of the provisions of the Act to address the problems and carry out the purposes identified in section 1(b) of the Act, including "the proper functioning" of public-utility holding company systems.

Commission has not required that combining systems be contiguous for that requirement to be met.[17]

In the Division's view, whether or not a combined utility system is located in a single area or region could properly be illuminated through a consideration of a wide spectrum of evidence – including the market structure and infrastructure for electrical power, the specific physical and generational capacity and scale of the combined utilities, and the ability effectively and economically to serve the region in which it is located – facts which may, when considered in their totality, demonstrate that the combined system will be an efficient and interconnected system that is capable of being regulated in accordance with the Act's goals.

Given the changes that have occurred in the electric industry since the 1930s and 1940s, evidence showing the current structure of electricity markets in the United States and the AEP system's placement within those markets will be relevant to determining whether the system is within a single area or region. In particular, the Division believes that the development of the Eastern and Western Interconnects, along with the later development of open access transmission tariffs, regional transmission organizations (RTOs), electricity trading hubs, the merchant generation business, and other factors, has

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[17] See *Conectiv, Inc.*, Holding Co. Act Release No. 26832 (Feb. 25, 1998); cf. *New Century Energies*, Holding Co. Act Release No. 26748 (Aug. 1, 1997) (finding that electric utilities located in two different power pools, in two different reliability councils, in both the Eastern and Western Interconnects, and with a physical separation of 300 miles were in the same area or region); *Electric Energy Inc, 38 SEC 658, 668,* Holding Co. Act Release No. 13871 (Nov. 28, 1958) (utility assets were within the same area or region as the acquirer's service area despite a distance of 100 miles crossing two states); *Mississippi Valley Generating Co.*, Holding Co. Act Release No. 12794 (Feb. 9, 1955) (single area or region test met where generating station was located 150 air miles from the territory served by the acquiring company).

had the effect of creating a number of overlapping electricity markets within the United States. The existence and extent of these markets is a significant factor in determining whether a particular utility system is within a single area or region for purposes of the Act. Evidence showing that AEP's system is largely within a single market for the generation, transmission and trading of electric power may well prove sufficient to demonstrate that the system is in a single area or region. Evidence related to the existence and scope of specific electricity markets is, therefore, highly relevant. Consequently, we agree with AEP that evidence concerning RTOS, Interconnects, joint operating agreements and similar features of electricity markets in the United States will be important evidence for the purposes of making the single region determination.

Evidence regarding electricity markets and infrastructure may be supplemented by more traditional inquiries regarding the demographics and geographical features of the area in which the combined system is located as well as evidence regarding trade flows and other economic factors that characterize the area. Placed in the context of facts concerning the specific markets for electricity in the United States, evidence of this type could be relevant to demonstrating that the combined utility system is located in a single region -- efficient, interconnected, and capable of being regulated, in accordance with the Act's purposes.

In its submission, AEP identifies a number of categories in which it intends to present evidence to support its conclusion that the combined AEP/CSW utility operations are confined to a single area or region. Specifically, AEP has stated that it will introduce evidence regarding: 1) the trade flows and infrastructure within the combined system's region; 2) the combined system's location primarily within the Eastern Interconnection;

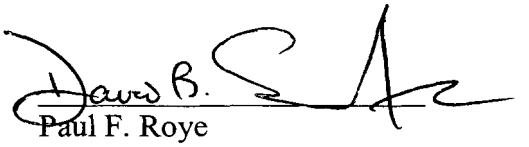
3) the location of the combined system within the soon-to-be-formed alliance of three RTOs; and 4) the location of the combined utility within first-tier interconnections. [18] While other evidence may also ultimately be relevant to determining whether the AEP system is in a single area or region, the Division broadly agrees that evidence of the type suggested by AEP will be relevant to the ultimate determination.

CONCLUSION

The Division looks forward to the hearing on January 10, 2005. The Division will review and, where necessary, participate in and test the evidence submitted at the hearing. After the hearing, the Division will analyze the entire record and will provide the Court with its final position regarding the existence of the "interconnection" and "single region" requirements in this case.

Dated: November 30, 2004

Respectfully submitted,



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[18] AEP Narrative Summary, at 15-23.