

## SECURITIES AND EXCHANGE COMMISSION

(Release No. 35-27963; 70-10251)

**Allegheny Energy, Inc., et al.**

**Order Authorizing Financing Transactions, Payment of Dividends, Subsidiary Reorganization and Capitalization Changes, System Money Pool, and Certain Exemptions From At-Cost Requirements; Reserving Jurisdiction**

**April 29, 2005**

Allegheny Energy, Inc. ("Allegheny"), a registered holding company; Allegheny Energy Supply Company, LLC ("AE Supply"), a registered holding company and public-utility company subsidiary of Allegheny; Allegheny Energy Service Corp. ("AESC"), the system service company; four other wholly-owned public-utility subsidiaries of Allegheny -- Monongahela Power Company ("Monongahela"), Mountaineer Gas Company ("Mountaineer"), The Potomac Edison Company ("Potomac Edison"), West Penn Power Company ("West Penn") and Allegheny Generating Company ("AGC") (Monongahela, Potomac Edison and West Penn, collectively, "Operating Utilities," and with Mountaineer and AGC, "Utility Applicants"); and the current and future nonutility subsidiaries of Allegheny ("Nonutility Applicants") (Allegheny, AE Supply, AESC, the Utility Applicants, and the Nonutility Applicants, collectively "Applicants"), all of Greensburg, Pennsylvania, have filed an application-declaration, as amended ("Application"), with the Securities and Exchange Commission ("Commission") under sections 6, 7, 9(a), 10, 12(b), 12(c), and 13 of the Public Utility Holding Company Act of 1935, as amended ("Act"), and rules 43, 45, 46, 54, 86, 87, 90 and 91 under the Act.

The Commission issued a notice of the Application on January 24, 2005 (Holding Co. Act Release No. 27941). The Commission received comments and a request for a

hearing from Harbert Distressed Investment Master Fund, Ltd. (“Harbert”), which describes itself as an investor in securities of various companies in the electric power industry, including Allegheny and AE Supply and the Operating Utilities.<sup>1</sup> The Public Service Commission of West Virginia filed a motion to intervene on February 17, 2005.<sup>2</sup>

Applicants seek authority for various financings and other transactions to facilitate their operations and those of their subsidiaries through November 30, 2007 (“Authorization Period”). Applicants request authority to engage in these transactions through June 30, 2006, and ask the Commission to reserve jurisdiction over transactions during the remainder of the Authorization Period, pending completion of the record. The requested order would replace and supersede all existing authority granted through prior orders<sup>3</sup> issued in S.E.C. File Nos. 70-7888, 70-9897 and 70-10100.

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<sup>1</sup> Harbert filed additional comments on April 1, 2005 (“Additional Comments”) in which, among other things, Harbert asks that any Allegheny amendments be noticed so that Harbert can submit additional comments. Rule 23(c) under the Act requires notice of an original application. Additional supplementary notices are only issued if amendments make additional requests for authority that require notice. In this case, the Applicants amended the Application and made one material change that could have required a supplemental notice; however, the Applicants later amended the Application a second time to remove that material change. Therefore, a second notice was not necessary.

Allegheny filed a response (“Response”) to Harbert’s Request as Exhibit H-5 to its Application.

Harbert has separately filed an application requesting an order under section 3(a)(4) of the Act exempting Harbert from registration in connection with the ownership of more than 10% of the outstanding voting securities of a public-utility company, the reorganized NorthWestern Corporation, in exchange for previously contracted debt of the utility. *See* S.E.C. File No. 70-10259 and the notice of the filing (Holding Co. Act Release No. 27909 (Nov. 9, 2004)). Under section 3(c) of the Act, Harbert enjoys a “good faith” exemption from registration pending disposition of the application.

<sup>2</sup> The Public Service Commission of West Virginia requested that it be granted intervenor status but did not make any comments in its filing.

<sup>3</sup> The orders of the Commission that have established the Applicants’ current financing authority include: Holding Co. Release Nos. 27486 (Dec. 31, 2001) (“Original 2001 Financing Order”), as supplemented by 27521 (Apr. 17, 2002), 27579 (Oct. 17,

I. Background

A. Applicants

Allegheny conducts its retail utility operations through five direct and indirect utility subsidiaries. Mountaineer is a gas utility that delivers natural gas to approximately 230,000 customers in West Virginia.<sup>4</sup> Monongahela, Potomac Edison and West Penn<sup>5</sup> are electric utilities that serve approximately 1.6 million customers in parts of Maryland, Ohio, Pennsylvania, Virginia and West Virginia.

Two other subsidiaries, AE Supply and AGC, are electric utility companies within the meaning of the Act, but are not state-regulated. AE Supply is the principal electric generating company for the Allegheny system.<sup>6</sup> By contract, AE Supply provides power to West Penn, Potomac Edison and Monongahela to serve their retail customers in Pennsylvania, Maryland, Virginia and Ohio and to serve the retail load of Potomac Edison in West Virginia. The contracts represent a significant portion of the normal

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2002), 27652 (Feb. 21, 2003) (“2003 Capitalization Order”), 27701 (July 23, 2003) (“2003 Trust Preferred Securities Order”), 27780 (Dec. 22, 2003), 27796 (Feb. 3, 2004) (“February 2004 Order”), 27797 (Feb. 3, 2004) (“2004 Guarantees Order”), 27840 (Apr. 29, 2004) (“April 2004 Order”), 27878 (July 27, 2004) (“July 2004 Order”), and 27920 (Dec. 3, 2004) (“December 2004 Order”).

<sup>4</sup> Allegheny announced on August 4, 2004, that it had entered into an agreement to sell Mountaineer and all of Allegheny’s West Virginia gas assets. *See* S.E.C. File No. 70-10270.

<sup>5</sup> Mountaineer is a direct subsidiary of Monongahela. It is subject to the regulation of the state public-utility commission of West Virginia. Monongahela is regulated by the public-utility commissions of West Virginia and Ohio. Potomac Edison is regulated by the public-utility commissions of Maryland, West Virginia and Virginia. West Penn is regulated by the public-utility commission of Pennsylvania. The Operating Utilities and Mountaineer collectively do business as “Allegheny Power.”

<sup>6</sup> During 1999 and 2000 in response to deregulation legislation in Maryland, Virginia and Pennsylvania, West Penn and Potomac Edison transferred generating assets (6,600 megawatts) to AE Supply. In 2001 Monongahela transferred generating assets (352 megawatts) associated with its Ohio customers to AE Supply.

capacity of AE Supply's generating assets and a substantial majority of the power requirements of West Penn and Potomac Edison. AGC is jointly owned by Monongahela and AE Supply. Its sole asset is a 40% undivided interest in a pumped-storage hydroelectric station in Bath County, Virginia. All of AGC's revenues are derived from power sales to Monongahela and AE Supply from its share of this facility's generating capacity.

The current Nonutility Applicants are Allegheny Energy Solutions, Inc.; Allegheny Ventures, Inc.; Mountaineer Gas Services, Inc. and The West Virginia Power & Transmission Company (collectively, "Existing Nonutility Subsidiaries"). They are referred to below, collectively with other nonutility subsidiaries that may be formed or acquired after the date of the Application, as the Nonutility Applicants.

B. Financial Status

Allegheny and AE Supply entered a severe downward financial decline in 2001 that became worse in 2002 and 2003. The primary cause was investments in merchant generating and energy marketing and trading businesses.<sup>7</sup> By the summer of 2003, press reports indicated that AE Supply might be forced to declare bankruptcy. During this period, Allegheny's Board of Directors effected a change in management and announced, on June 9, 2003, the election of a new chairman, president and chief executive officer. Shortly thereafter, Allegheny's new management asked the Commission for authority to carry out a plan to return the company to financial strength, which included selling

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<sup>7</sup> Allegheny was not alone; its distress during this period was shared by many energy and utility companies.

certain troubled merchant generating and energy marketing assets and issuing specific amounts of debt and equity financing.

During 2003 and 2004, the Commission authorized various transactions to enable Allegheny to address its liquidity and other financial issues. During this time Allegheny's common equity ratio was below 30% so it could not rely on its omnibus financing order issued in 2001.<sup>8</sup> Allegheny, consistent with its plan, has sought to improve its liquidity through cash management, sales of non-core assets, cutting costs and expenses, extending debt maturities and obtaining a revolving credit facility. It appears from financial information provided by the company that Allegheny has made significant progress toward solving its financial problems.

Specifically, the following information, taken from Allegheny's most recent Form 10K, AE Supply's annual report and information provided for this Application, shows improvements in the following areas:

1. Operating revenue

	<u>2003</u>	<u>2004</u>
Allegheny:	\$2.18 billion	\$2.76 billion
AE Supply:	\$688 million	\$1.27 billion

AE Supply's operating revenue increased by \$582.3 million during 2004, due primarily to a decrease in energy trading losses in 2004 as a result of AE Supply's exit from speculative energy trading activities. Meanwhile, Allegheny's operating income increased by \$785.7 million for 2004, primarily as a result of a \$516.4 million increase in

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<sup>8</sup> Original 2001 Financing Order. *See* footnote 3 above for orders issued subsequent to this order during 2002, 2003 and 2004.

wholesale and other revenues, a \$211.8 million decrease in operating expenses and a \$66.1 million increase in retail electric revenues. Wholesale revenues increased due to the reduction in energy trading losses.

2. Operating Income/Losses

In 2004, on a consolidated basis, Allegheny produced \$129.7 million in income from continuing operations. This was a substantial improvement over the loss of \$308.9 million from continuing operations in 2003, the year Allegheny's new management team was put into place. Net losses at AE Supply were \$490.4 million for 2003 and \$373.6 million for 2004.

The \$116.8 million decrease in net losses for AE Supply for 2004 was primarily due to a \$776.7 million increase in operating income. In 2003, AE Supply reported an operating loss of \$(480.9) million. In 2004, the company reported an operating income of \$295.8 million. The company attributed this increase in operating income to increased operating revenue, lower operations and maintenance expenses, and a \$30.3 million decrease in interest expenses (primarily due to interest expense savings of \$50.2 million, resulting from lower interest rates and lower average debt outstanding).

3. Credit ratings

Effective February 2005, both Moody's Investment Services ("Moody's") and Standard and Poor's Ratings Group ("S&P") upgraded the credit of AE Supply senior secured debt from B1 to Ba3 (Moody's) and from B+ to BB- (S&P). As of March 7, 2005, Fitch Investor Service ("Fitch") rated all secured debt as BBB and rated all unsecured debt of Monongehala, Potomac Edison and West Penn as BBB-. As of the same date, S&P's corporate credit rating for Allegheny was B+ (a one-half grade increase

from single B as of May 8, 2003), and S&P rated the unsecured debt of both Allegheny and AE Supply at B- (a one-half grade increase over the CCC+ rating as of May 8, 2003).

See Appendix A for a chronology of activity by the ratings agencies that shows improvement since 2003.

In a February 2005 press release, Moody's cited the following reasons for its upgrades:

- [Allegheny's] continued progress in reducing debt, and the expectation that the company will achieve its stated debt reduction target of at least \$1.5 billion by year end 2005;
- [Allegheny's] improved liquidity profile;
- A significant anticipated increase in consolidated funds from operations in 2005, and the expectation that [Allegheny] will continue to have a sustainable increase in its cash flow relative to its adjusted debt; and
- Management's "back to basics" strategy to focus on the lower risk core utility business, which has already resulted in the sale of a number of assets.

Moody's also stated that it had placed the ratings of Monongahela, Potomac Edison and West Penn under review for further upgrade. S&P stated that its "upgrades reflect the declining balance of AE Supply's outstanding secured debt as proceeds from asset sales were used to pay down debt."

#### 4. Allegheny Stock Price

\$8 (6/30/2003)      \$20 (12/31/ 2004)      \$22 (4/7/05)

Allegheny's stock price has been above \$15 since last September.

#### 5. Cash Flow

At December 31, 2004, AE Supply had on hand cash and cash equivalents of \$89.9 million. AE Supply also had \$202.2 million of restricted cash balances as of December 31, 2004, including collateral deposits posted as security related to certain contractual obligations. Cash flow from operating activities for 2004 was comprised of

(a) \$190 million, consisting of \$571.6 million of discontinued operations and non-cash charges, reduced by AE Supply's net loss of \$(373.6) million, and \$8 million in changes in the value of certain assets and liabilities; and (b) \$187.4 million of proceeds from the sale of various assets. The company expects continued improvement in its cash flow mainly from continuing profitable utility operations.

6. Liquidity

On a consolidated basis, Allegheny produced in 2004 \$506.7 million of cash from internal operations, which was almost double the amount used to fund its 2004 capital expenditure investment program of \$265.6 million.

7. Common Equity Capitalization Ratio

The company currently projects that Allegheny will have close to a 30% common equity capitalization ratio at the end of 2005.

The new management has reduced debt by more than \$1.2 billion since 2003 (almost 21% of all debt it had outstanding at the end of December 2003) and expects to exceed its commitment to repay at least \$1.5 billion of debt by the end of 2005.

Allegheny intends to continue its debt reduction efforts by applying some of its cash flow from operations and proceeds from asset sales to the repayment of debt.<sup>9</sup>

The equity capitalization ratios of the Operating Utilities have remained near or above the ratios reported since 2002:

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<sup>9</sup> The aggregate amount of debt issued by AE Supply during 2004 was \$2.322 billion. AE Supply retired \$2.719 billion of debt during 2004. In 2004, the Allegheny system redeemed \$3.553 billion of debt securities and issued \$2.842 billion of new debt securities. Allegheny itself redeemed \$382 million of debt securities in 2004 and issued \$225 million of new debt. AE Supply redeemed \$2.719 billion of debt securities, issuing \$2.322 billion of new debt. The operating utilities redeemed \$332.7 million of debt securities, issuing \$295 million of new debt.

	12/31/02	12/31/03	12/31/04
West Penn	45.1	50.9	62.3
Potomac Edison	48.3	49.4	49.0
Monongahela	35.7	37.8	36.2

Despite the system's progress toward regaining financial health, Allegheny's and AE Supply's equity capitalization ratios are still below 30%, due in large part to write-downs required in connection with the sale of merchant generating assets.<sup>10</sup> As a result of these charges, the unaudited common equity ratios for Allegheny and AE Supply decreased to 17.4% and 10.3%, respectively, as of September 30, 2004. Allegheny's ratio has improved to 21% as of December 31, 2004, and since its recent issuance of approximately \$152 million of common stock. AE Supply's common equity ratio improved to 16% as of December 31, 2004.

The Applicants state that, although these asset sales have had "a temporary negative impact on Allegheny's balance sheet," they have greatly improved the Applicants' longer-term prospects because the businesses that have been eliminated were producing losses, negative cash flows and volatility to earnings per share. Also, the

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<sup>10</sup> In the third quarter of 2004, Allegheny recorded a \$427.5 million consolidated net loss from discontinued operations that included:

- A non-cash asset impairment charge of \$209.4 million pre-tax (\$129.2 million after tax) from the announced sale of the Lincoln generating facility.
- A non-cash asset impairment charge of \$35.1 million pre-tax (\$20.7 million after tax) associated with the announced decision to sell the West Virginia natural gas operations.
- Non-cash asset impairment charges of \$445.4 million pre-tax (\$274.7 million after tax) as a result of the announced decision to sell the Gleason and Wheatland generating facilities.
- An after-tax loss of \$2.9 million from operating results of discontinued operations.

proceeds from all sales were used to pay down debt at AE Supply and Allegheny, thus improving their capitalization ratios. The company believes that it can continue to improve its capital structure by selling additional equity, as proposed, and using the proceeds to pay down debt and by exercising a mandatory conversion provision in the convertible trust preferred securities that it has issued.

The Commission believes that the requested authority will meet the Applicants' specific needs as management continues to reduce debt, improve credit ratings and improve Allegheny's and AE Supply's equity capitalization ratios. At the same time, the reservation of jurisdiction over transactions after June 30, 2006, does not afford Allegheny the same latitude that would be available to a company that had all of the indicia of financial strength, including the 30% capitalization ratio.

C. Summary of Requested Authority

The Applicants now request the following authorizations:

(1) Authority (i) for Allegheny to issue and sell directly additional common stock or options, warrants, equity-linked securities or stock purchase contracts convertible into, or exercisable for, common stock, and preferred stock or to buy or sell derivative securities to hedge the interest rate risk associated with these transactions; and (ii) for Allegheny and AE Supply to issue and sell, directly or indirectly through one or more financing subsidiaries, forms of preferred securities, other than preferred stock, including, without limitation, trust preferred securities or monthly income preferred securities (collectively, "Preferred Securities"), all of which in the aggregate will not exceed \$1.55 billion ("External Equity Cap"). Allegheny and AE Supply request that the Commission authorize them to issue and sell securities described in (i) and (ii) above through June 30, 2006, in an aggregate amount up to \$1 billion and further request that the Commission reserve jurisdiction over the remaining balance of the External Equity Cap amount, pending completion of the record.

During the Authorization Period, Allegheny will issue common stock to the public in an amount up to \$350 million, as previously authorized by the Commission.<sup>11</sup> In addition, Allegheny proposes to issue common stock in the

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<sup>11</sup> See February 2004 Order.

following amounts for other purposes: (i) up to \$205 million in connection with Allegheny's employee pension plan, and (ii) up to \$300 million in connection with the conversion of convertible trust preferred securities previously authorized by the Commission.<sup>12</sup>

(2) Authority for (i) Allegheny, AE Supply, AGC, and the Nonutility Applicants to issue and sell to non-associate third parties short- and long-term debt, both secured<sup>13</sup> and unsecured, and (ii) for Allegheny, AE Supply and the Utility Applicants to engage in short-term debt financing in connection with the system money pool ("Money Pool") and for general corporate purposes, all of which in the aggregate will not exceed \$4.575 billion ("External Debt Cap") and all of which will be used to refinance existing debt. Applicants seek authority to engage in issuances not to exceed \$3.350 billion through June 30, 2006, and request the Commission to reserve jurisdiction over the remainder of the External Debt Cap, pending completion of the record.

The Application states that Allegheny has stated in several public forums that the holding company is committed to reducing debt and improving earnings.<sup>14</sup> No refinancing of existing debt under the requested authority would be undertaken unless it would result in an improvement in terms, conditions, and cost of capital for the Allegheny system. No funds from the sale of securities by the Utility Applicants will be used to fund AE Supply;

(3) Authority (i) for Allegheny, AE Supply and the Utility Applicants to enter into guarantees, obtain letters of credit, extend credit, enter into guarantee-type expense agreements or otherwise provide credit support and guarantees of contractual obligations with respect to the obligations of their direct or indirect subsidiaries, and (ii) for the Nonutility Applicants, to the extent not exempt under rule 45 or 52, to provide guarantees on behalf of other Nonutility Applicants, in an aggregate amount not to exceed \$1.0 billion at any time outstanding;

(4) Authority for Allegheny, AE Supply and, to the extent not exempt under rule 52, for the Utility Applicants and the Nonutility Applicants (i) to enter into hedging transactions with respect to their indebtedness in order to manage and minimize interest rate costs and (ii) to enter into hedging transactions with respect

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<sup>12</sup> See 2003 Trust Preferred Securities Order.

<sup>13</sup> Allegheny and the Nonutility Applicants request a reservation of jurisdiction over issuances of secured long-term debt securities, pending completion of the record.

<sup>14</sup> See, e.g., the presentation prepared by Allegheny for its New York investor meetings held on March 7 and 8, 2005, which can be found at: [http://media.corporate-ir.net/media\\_files/NYS/AYE/presentations/nyinvmeetingsmar05.pdf](http://media.corporate-ir.net/media_files/NYS/AYE/presentations/nyinvmeetingsmar05.pdf) and the presentation prepared for a conference in Boston on March 24, 2005, which can be found at: <https://library.corporate-ir.net/library/87/874/87440/items/143279/032405WilliamsPres.pdf>.

to anticipatory debt issuances in order to lock-in current interest rates and/or manage interest rate risk exposure;

(5) Authority for Allegheny, AE Supply and the Nonutility Applicants to engage in intrasystem financings among themselves, to the extent not exempt under rules 45 or 52, in an aggregate amount not to exceed \$1.0 billion any time outstanding, with a reservation of jurisdiction over these transactions by AE Supply, pending completion of the record;

(6) Authority for AE Supply, the Utility Applicants and the Nonutility Applicants to pay dividends out of capital and unearned surplus in an amount up to \$2.0 billion ("Dividend Cap") and for the Nonutility Applicants to acquire, retire, or redeem their securities that are held by any associate company, affiliate, or affiliate of an associate company, to the extent permitted under applicable law and the terms of any credit arrangements to which they may be parties. AE Supply, the Utility Applicants and the Nonutility Applicants seek authority to pay dividends out of capital and unearned surplus in an aggregate amount not to exceed \$1.75 billion through June 30, 2006, and request the Commission to reserve jurisdiction over the remaining balance of the Dividend Cap, pending completion of the record;

(7) Authority for Allegheny and AE Supply to change the terms of the authorized capitalization of a Nonutility Applicant's capital stock or equivalent ownership interests;

(8) Authority (to the extent not otherwise exempt) for Allegheny and AE Supply to transfer securities or assets of existing and new direct or indirect Nonutility Applicants to other direct or indirect Nonutility Applicants or to liquidate or merge Nonutility Applicants;

(9) To the extent not exempt under rule 90(d), authority for Nonutility Applicants to perform certain services for each other, as described below, and to sell goods to each other at fair market prices, without regard to "cost," as determined in accordance with rules 90 and 91; and

(10) Authority for Allegheny, AE Supply, the Utility Applicants and AESC to continue the Money Pool.

## II. Financing Parameters for Requested Authorizations

The proposed financing transactions will be subject to the following terms and conditions:

### A. Effective Cost of Money on Debt Securities and Borrowings under Credit Agreements

The effective cost of capital on any security issued by Allegheny or AE Supply will not exceed competitive market rates available at the time of issuance for securities having the same or reasonably similar terms and conditions issued by similar companies of reasonably comparable credit quality; provided that in no event will (a) the interest rate on any debt securities issued under a bank credit facility exceed the greater of (i) 500 basis points over the comparable term London Interbank Offered Rate or (ii) the sum of 4%, plus the prime rate as announced by a nationally recognized money center bank, and (b) the interest rate on any debt securities issued to any other financial investor exceed the sum of 4%, plus the prime rate as announced by a nationally recognized money center bank.

### B. Maturities

The maturity of long-term debt will be between one and 50 years after the issuance. Preferred securities and equity-linked securities will be redeemed no later than 50 years after the issuance, unless converted into common stock. Preferred stock issued directly by Allegheny may be perpetual in duration.

### C. Issuance Expenses

The underwriting fees, commissions, and other similar remuneration paid in connection with the issuance of any security will not, in the case of a competitive issuance, exceed prevailing market rates for similar companies of reasonably comparable

credit quality, and, in the case of a non-competitive issuance, will not exceed the greater of (a) 5% of the principal or total amount of the securities being issued, or (b) issuances expenses that are paid at the time with respect to the issuance of securities having the same or reasonably similar terms and conditions issued by similar companies of reasonably comparable credit quality.

D. Use of Proceeds

The proceeds from the sale of securities in external financing transactions will be added to the respective treasuries of the issuing parties and subsequently used principally for (a) the financing of capital expenditures; (b) the financing of working capital requirements; (c) the repayment and/or refinancing of debt; (d) the acquisition, retirement, or redemption of securities previously issued by the issuing party; (e) the funding of Allegheny's pension plan with common stock; and (f) other lawful purposes, including direct or indirect investment by Allegheny in energy-related companies, within the meaning of rule 58 ("Rule 58 Companies"), other subsidiaries approved by the Commission, and exempt wholesale generators ("EWGs").<sup>15</sup>

Allegheny and AE Supply commit that at any time their ratios of common equity to total capitalization are less than 30%, neither they nor any of their subsidiaries will invest or commit to invest any funds in any new projects that qualify as EWGs under the

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<sup>15</sup> In the Original 2001 Financing Order, Allegheny received authority to exceed the rule 53(a) aggregate investment amount and to utilize a portion of the proceeds of the equity issuances, short-term debt, long-term debt and guarantees in any combination to increase its "aggregate investment" in EWGs and foreign utility companies ("FUCOs") up to \$2 billion. Allegheny currently has no FUCO investments and will not make any investments in FUCOs unless the common equity ratios of Allegheny and AE Supply are at least 30%. Allegheny's ability to invest in EWGs is subject to certain restrictions described in this section as long as its common equity ratio is less than 30% of total capitalization.

Act; provided, however, that Allegheny may increase its investment in EWGs as a result of the qualification of existing projects as EWGs, and Allegheny may make additional investments in an existing EWG to the extent necessary to complete any project or desirable to preserve or enhance the value of Allegheny's investment in the EWG. Allegheny requests that the Commission reserve jurisdiction over any additional investment by Allegheny and its subsidiaries in EWGs and FUCOs during the period that Allegheny's common equity ratio is below 30%.

Allegheny and AE Supply further commit that at any time their ratios of common equity to total capitalization are less than 30%, neither it nor any of its subsidiaries will invest or commit to invest any funds in any new Rule 58 Companies; provided, however, that Allegheny may increase its investment in an existing Rule 58 Company to the extent necessary to complete any project or desirable to preserve or enhance the value of Allegheny's investment in the company. In addition, Allegheny and AE Supply request authority to invest in one or more new Rule 58 Companies which may be created in connection with the restructuring and/or reorganization of the existing energy trading business of AE Supply and its subsidiaries. Allegheny requests that the Commission reserve jurisdiction pending completion of the record over any additional investment by Allegheny and its subsidiaries in Rule 58 Companies during the period that Allegheny's common equity ratio is below 30%.

E. Investment Grade Rating

Applicants state that reestablishing investment grade for all of the Applicants' debt securities is a part of Allegheny's overall plan for returning to financial health. They note, however, that the receipt of investment grade ratings is not within their control and

that upgrades may lag behind actual financial performance. At this time, Applicants are seeking to obtain investment grade ratings for their debt by the end of 2007.

F. Common Equity Capitalization Ratio

Other than with respect to the Money Pool, Applicants submit to a reservation of jurisdiction over all authority granted in this order during any portion of the Authorization Period when: (1) the common stock equity ratio of Allegheny, on a consolidated basis, falls below 21% of total capitalization, (2) the common stock equity ratio of AE Supply, on a consolidated basis, falls below 16% of its total capitalization,<sup>16</sup> (3) the common stock equity of any of the Operating Utilities falls below 30% of total capitalizations, or (4) in the event Allegheny, AE Supply, a Utility Applicant, Allegheny Energy Solutions, Inc., or Allegheny Ventures, Inc. is in bankruptcy.

III. Financing Requests

A. Common Stock

Allegheny seeks authority to issue and sell common stock and options, warrants, equity-linked securities, or other stock purchase rights exercisable for common stock and to buy or sell derivative securities to hedge these transactions. Allegheny will not engage in speculative transactions. The aggregate amount of financing obtained by Allegheny during the Authorization Period from the issuance and sale of common stock will not cause Allegheny to exceed the External Equity Cap. Common stock financings may be

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<sup>16</sup> These common stock ratios are based on the 2004 Form 10-K for Allegheny and the 2004 Annual Report of AE Supply. Applicants calculated the ratio of common stock equity to total capitalization as follows: common stock equity divided by the sum of gross debt (long-term and short-term), preferred stock, and common stock equity. Common stock equity includes common stock, *i.e.*, amounts received equal to the par or stated value of the common stock, additional paid-in capital, retained earnings, and minority interests.

effected through underwriting agreements of a type generally standard in the industry. Public distributions may be effected through private negotiation with underwriters, dealers, or agents, as discussed below, or through competitive bidding among underwriters. In addition, sales may be made through private placements or other non-public offerings to one or more persons. All sales of common stock will be at rates or prices and under conditions negotiated or based upon, or otherwise determined by, competitive capital markets.

During the Authorization Period, Allegheny will issue common stock to the public in an amount up to \$350 million, as previously authorized by the Commission.<sup>17</sup> In addition, Allegheny will issue common stock in the following amounts for other purposes: (i) up to \$205 million in connection with Allegheny's employee pension plan, and (ii) up to \$300 million in connection with the conversion of convertible trust preferred securities, as previously authorized by the Commission.<sup>18</sup> The balance of the requested authority covered by the External Equity Cap would be used to issue equity securities, other than common stock, as warranted by circumstances.

Common stock may be offered to the public either through an underwriting syndicate (which may be represented by a managing underwriter or underwriters designated by Allegheny) or directly by one or more underwriters acting alone. The

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<sup>17</sup> See February 2004 Order.

<sup>18</sup> See 2003 Trust Preferred Securities Order. The requested authority is in addition to stock issuances authorized under Allegheny's employment compensation plans. See Holding Co. Act Release No. 27892 (Sep. 22, 2004) (authorizing issuance of 300,000 shares of common stock to outside directors under a Non-Employee Director Stock Plan), Holding Co. Act Release No. 27869 (June 30, 2004) (authorizing issuance of 4.5 million shares of common stock to employees under Stock Unit Plan), Holding Co. Act Release No. 27858 (June 17, 2004) (authorizing issuance of 5 million shares of common stock under an Employee Stock Ownership and Savings Plan).

aggregate price of the common stock being sold through any underwriter or dealer shall be calculated based on either the specified selling price to the public or the closing price of the common stock on the day the offering is announced. The offering would be effected according to an underwriting agreement of a type generally standard in the industry. Allegheny may grant the underwriters a "green shoe" option to purchase additional shares at the same price then offered to the public solely for the purpose of covering over-allotments (provided that the total number of shares offered initially, together with the number of shares issued under any option, shall not exceed the number of shares authorized by the Commission).<sup>19</sup> It is also possible that common stock will be sold by Allegheny through dealers, agents, or directly to a limited number of purchasers or a single purchaser. If dealers are utilized in the sale of any common stock, Allegheny will sell that common stock to the dealers as principals. Any dealer may then resell the securities to the public at varying prices to be determined by the dealer at the time of resale.

B. Preferred Stock, Preferred Securities, and Equity-Linked Securities

Allegheny and AE Supply seek the flexibility to issue preferred stock and Preferred Securities, directly or indirectly, through one or more financing subsidiaries ("Capital Corps") organized specifically for this purpose.<sup>20</sup> The aggregate amount of

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<sup>19</sup> The aggregate amount of the additional common stock for which authorization is sought also takes into account the permitted increase in the size of the offering that could occur under rule 462(b) of the Securities Act of 1933 through an automatically effective amendment to an Allegheny registration statement.

<sup>20</sup> In the Original 2001 Financing Order, the Commission authorized Allegheny, AE Supply and their subsidiaries, other than West Penn, Monongahela and Potomac Edison, to form one or more Capital Corps as direct or indirect subsidiaries to serve as financing entities and to issue debt and equity securities, including trust preferred securities to third parties. In addition, Allegheny and AE Supply and the Nonutility Applicants received

financing obtained during the Authorization Period from the issuance and sale of preferred stock, Preferred Securities, and equity-linked securities will not cause Allegheny and AE Supply to exceed the External Equity Cap.

Preferred stock or Preferred Securities may be issued in one or more series with rights, preferences, and priorities as may be designated in the instrument creating each series, as determined by the board of directors of the Applicant undertaking the issuance. Dividends or distributions on preferred stock and Preferred Securities will be made periodically and to the extent funds are legally available for this purpose, but may be made subject to terms that allow the issuer to defer dividend payments for specified periods.

Equity-linked securities, including units consisting of a combination of incorporated options, warrants, and/or forward equity purchase contracts with debt, preferred stock, or Preferred Securities, will be, either mandatorily or at the holder's option, exercisable or exchangeable for, or convertible into, common stock or indebtedness. Alternatively, equity linked securities will allow the holder to surrender to the issuer or to apply the value of a security issued by Allegheny, as approved by the Commission, to the holder's obligation to make a payment on another security of Allegheny issued under Commission authorization.<sup>21</sup>

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authorization: (a) to issue debentures or other evidences of indebtedness to Capital Corps in return for the proceeds of the financing, (b) to acquire voting interests or equity securities issued by Capital Corps, and (c) to guarantee the obligations of Capital Corps.

<sup>21</sup> For example, Allegheny may issue common stock or common stock warrants linked with debt securities. The holder will be obligated to pay to the issuer an additional amount of consideration at a specified date for the common stock but is authorized to surrender the linked debt security to, or for the benefit of, the issuer in lieu of the cash payment.

Any convertible or equity-linked securities will be convertible into or linked to common stock, Preferred Securities, or unsecured debt that Allegheny is otherwise authorized by Commission order to issue directly, or indirectly, through Capital Corps.

Allegheny and AE Supply request authorization to issue and sell securities subject to the External Equity Cap through June 30, 2006, in an aggregate amount of up to \$1 billion. They request the Commission to reserve jurisdiction over the remaining balance of the External Equity Cap, pending completion of the record.

C. Long-Term Debt

Allegheny and AE Supply, on their own behalf and, to the extent not otherwise exempt, on behalf of the Nonutility Applicants and AGC request authorization to issue during the Authorization Period secured and unsecured long-term debt securities in an aggregate principal amount outstanding at any time that will not cause Allegheny, AE Supply, the Nonutility Applicants or AGC to exceed the External Debt Cap. Allegheny and the Nonutility Applicants request the Commission to reserve jurisdiction over issuances of secured debt, pending completion of the record.<sup>22</sup>

Allegheny, AE Supply, the Nonutility Applicants and AGC may issue unsecured long-term debt directly, or, in the case of Allegheny, AE Supply and the Nonutility Applicants, through one or more Capital Corps, in the form of bonds, notes, medium-term notes, or debentures under one or more indentures, or long-term indebtedness under agreements with banks or other institutional lenders. Each series of long-term debt issued directly by Allegheny, AE Supply, the Nonutility Applicants, and AGC will have

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<sup>22</sup> The requested authority includes outstanding debt held by AE Supply that is secured and will be secured in connection with future financings by substantially all of its assets, including cash, generation assets, accounts receivables, and its power sales and lease agreements with the Operating Utilities.

designation, aggregate principal amount, maturity, interest rate(s) or methods of determining the same; terms of payment of interest; redemption provisions; sinking fund terms; and other terms and conditions as the company may determine at the time of issuance.

If applicable, the terms of the long-term debt will be designed to parallel the terms of the security issued by any Capital Corp to which the long-term debt relates. Any long-term debt (a) may be convertible into any other securities of Allegheny, AE Supply, the Nonutility Applicants or AGC; (b) will have maturities up to 50 years; (c) may be subject to optional and/or mandatory redemption, in whole or in part, at par or at a premium above the principal amount; (d) may be entitled to mandatory or optional sinking fund provisions; (e) may provide for reset of the coupon according to a remarketing arrangement; (f) may be subject to tender or the obligation of the issuer to repurchase at the election of the holder or upon the occurrence of a specified event; (g) may be called from existing investors by a third party; and (h) may be entitled to the benefit of affirmative or negative financial or other covenants.

The maturity dates, interest rates, redemption and sinking fund provisions, tender or repurchase and conversion features, if any, with respect to the long-term debt of a particular series, as well as any associated placement, underwriting or selling agent fees, commissions and discounts, if any, will be established by negotiation or competitive bidding. Allegheny, AE Supply, the Nonutility Applicants and AGC will determine the specific terms of any long-term debt at the time of issuance and will comply in all regards with the financing parameters set forth above.

D. Short-Term Debt

Allegheny, AE Supply and, to the extent not otherwise exempt, the Nonutility Applicants seek authorization to issue directly or indirectly, through a Capital Corp, commercial paper, promissory notes and other forms of short-term indebtedness having varying maturities not to exceed one year but which may be subject to extension to a final maturity not to exceed 390 days<sup>23</sup> ("Short-Term Debt") in an aggregate amount that will not cause them to exceed the External Debt Cap. Proceeds will be used to make loans to subsidiaries and for corporate purposes.

Allegheny, AE Supply and the Utility Applicants, other than AGC, request authority to issue Short-Term Debt to fund the Money Pool. The Utility Applicants also seek authority to issue Short-Term Debt for general corporate purposes. In no case will the issuance of Short-Term Debt cause any of these companies to exceed the External Debt Cap. The Utility Applicants seek Short-Term Debt authority in amounts itemized below. Maturities will be determined at the time of issuance in light of market conditions, the effective interest costs, and the issuer's anticipated cash flow, including the proceeds of other borrowings.

Commercial paper will be sold in established domestic or European commercial paper markets. It will be sold directly or to dealers at the discount rate or the coupon rate per annum prevailing at the date of issuance for commercial paper of comparable quality and maturities sold directly or to commercial paper dealers generally. Applicants expect

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<sup>23</sup> The ability to extend the maturity of commercial paper notes is a feature of an extendible commercial notes program. The maturity of commercial paper notes issued under an extendible commercial notes program is 365 days or less; however, if the principal of any commercial paper note is not paid at maturity, the maturity of the commercial paper note will be automatically extended to 390 days from the date of original issuance.

that the dealers that acquire commercial paper from Allegheny, AE Supply, any Capital Corp or the Nonutility Applicants will re-offer the paper at a discount to corporate and institutional investors. Institutional investors are expected to include commercial banks, insurance companies, pension funds, investment trusts, foundations, colleges and universities, finance companies, money market funds and other funds.

Allegheny and AE Supply propose that they, the Utility Applicants, the Nonutility Applicants and any Capital Corp may establish and maintain back-up credit lines with banks or other institutional lenders to support their commercial paper program(s) and to establish other credit arrangements and/or borrowing facilities as are generally available to borrowers with comparable credit ratings, as each of them may deem appropriate in light of its needs and existing market conditions. Allegheny and AE Supply propose, in general, to utilize the most economical means available at any time to meet their short-term financing requirements and commit that the Utility Applicants, the Nonutility Applicants, and any Capital Corp will do likewise.

Allegheny, AE Supply, the Utility Applicants, the Nonutility Applicants and any Capital Corp may engage in other types of short-term financing generally available to borrowers with comparable credit ratings, as each of them individually may deem appropriate in light of its needs and market conditions at the time of issuance.

AE Supply and the Utility Applicants seek the flexibility to issue secured short-term debt as circumstances warrant to provide maximum flexibility for their financial operations. As noted above, AE Supply currently has debt that is secured by substantially all of its assets, including cash, utility assets, accounts receivables, and its power sales and lease agreements with the Operating Utilities. Any secured short-term debt issued by

the Utility Applicants would similarly be secured by the respective Applicant's cash or accounts receivable.

No refinancing of existing debt under the requested authority would be undertaken unless it would result in an improvement in terms, conditions, and cost of capital for the Allegheny system. Any secured short-term debt issued by the Nonutility Applicants would be secured by cash, accounts receivable and operating assets. As noted above, with respect to the replacement of debt that has expired by its terms, the ability of the Applicant to obtain more advantageous provisions will depend, in part, on general market conditions affecting all borrowers. This situation, therefore, necessarily represents a potential exception to the Applicants' commitment.

E. Credit Enhancement

Allegheny, AE Supply, the Utility Applicants and the Nonutility Applicants request authority to obtain credit enhancement for securities. Credit enhancement could include insurance, a letter of credit, or a liquidity facility. Allegheny, AE Supply, the Utility Applicants, and the Nonutility Applicants anticipate that they may be required to provide credit enhancement if they issue floating rate securities, while credit enhancement would be a purely economic decision for fixed rate securities. Allegheny, AE Supply, the Utility Applicants, and the Nonutility Applicants anticipate that if they are required to pay a premium or fee to obtain credit enhancement, it is likely that they would realize a net benefit through a reduced interest rate on the new securities. Allegheny, AE Supply, the Utility Applicants, and the Nonutility Applicants will obtain credit enhancement only if it is economically beneficial, taking into consideration fees required to obtain the product and market conditions.

#### F. Hedging Transactions

Allegheny, AE Supply, the Utility Applicants, and the Nonutility Applicants may enter into interest rate hedging transactions with respect to existing indebtedness ("Interest Rate Hedges"), subject to the limitations and restrictions set forth here, in order to reduce or manage interest rate cost or risk. Interest Rate Hedges would only be entered into with counterparties ("Approved Counterparties") with senior debt ratings, as published by S&P's Ratings Group, equal to or greater than BBB, or an equivalent rating from Moody's or Fitch. Interest Rate Hedges will involve the use of financial instruments and derivatives commonly used in today's capital markets, such as interest rate swaps, options, caps, collars, floors and structured notes (*i.e.*, a debt instrument in which the principal and/or interest payments are indirectly linked to the value of an underlying asset or index), or transactions involving the purchase or sale, including short sales, of U.S. Treasury obligations (collectively, "Instruments"). The transactions would be for fixed periods and stated notional amounts. In no case will the notional principal amount of any interest rate swap exceed that of the underlying debt instrument and related interest rate exposure. Allegheny, AE Supply, the Utility Applicants and the Nonutility Applicants will not engage in speculative transactions. Fees, commissions, and other amounts payable to the counterparty or exchange (excluding the swap or option payments) in connection with an Interest Rate Hedge will not exceed those generally obtainable in competitive markets for parties of comparable credit quality.

Allegheny, AE Supply, the Utility Applicants and the Nonutility Applicants also propose to enter into interest rate hedging transactions with respect to anticipated debt offerings ("Anticipatory Hedges"). Allegheny, AE Supply, the Utility Applicants and the Nonutility Applicants would enter into these transactions only with Approved

Counterparties and subject to certain limitations and restrictions as set forth here.

Anticipatory Hedges would be used to fix and/or limit the interest rate risk associated with any new issuance through (i) a forward sale of exchange-traded U.S. Treasury futures contracts, U.S. Treasury obligations and/or a forward swap (each, "Forward Sale"); (ii) the purchase of put options on U.S. Treasury obligations ("Put Options Purchase"); (iii) a Put Options Purchase in combination with the sale of call options on U.S. Treasury obligations ("Zero Cost Collar"); (iv) transactions involving the purchase or sale, including short sales, of U.S. Treasury obligations; or (v) some combination of a Forward Sale, Put Options Purchase, Zero Cost Collar, and/or other derivative or cash transactions, including, but not limited to structured notes, options, caps, and collars, appropriate for the Anticipatory Hedges. Anticipatory Hedges may be executed on-exchange ("On-Exchange Trades") with brokers through the opening of futures and/or options positions traded on the Chicago Board of Trade or the Chicago Mercantile Exchange, the opening of over-the-counter positions with one or more counterparties ("Off-Exchange Trades"), or a combination of On-Exchange Trades and Off-Exchange Trades. Allegheny, AE Supply, a Utility Applicant, or a Nonutility Applicant will determine the optimal structure of each Anticipatory Hedge transaction at the time of execution. Allegheny, AE Supply, the Utility Applicants, and the Nonutility Applicants may decide to lock in interest rates and/or limit exposure to interest rate increases.

Allegheny, AE Supply, the Utility Applicants and the Nonutility Applicants represent that each Interest Rate Hedge and Anticipatory Hedge will be treated for accounting purposes under generally accepted accounting principles ("GAAP").

Allegheny, AE Supply, the Utility Applicants, and the Nonutility Applicants will comply

with Statement of Financial Accounting Standard ("SFAS") 133 (Accounting for Derivative Instruments and Hedging Activities) and SFAS 138 (Accounting for Certain Derivative Instruments and Certain Hedging Activities) or other standards relating to accounting for derivative transactions as are adopted and implemented by the Financial Accounting Standards Board ("FASB"). Allegheny, AE Supply, the Utility Applicants and the Nonutility Applicants also will comply with any future FASB financial disclosure requirements associated with hedging transactions.

G. Guarantees

Allegheny, AE Supply and the Utility Applicants request authority to enter into guarantees directly or, in the case of the Allegheny and AE Supply, indirectly through one or more Capital Corps, obtain letters of credit, support or expense agreements, or otherwise provide credit support with respect to debt securities or other contractual obligations of any of their direct or indirect subsidiaries from time to time through the Authorization Period ("Applicant/Utility Applicant Guarantees") in an amount not to exceed \$1 billion ("Aggregate Guarantee Limitation"), based on the amount at risk at any one time. The amount of any parent guarantees respecting the obligations of any subsidiaries also will be subject to the limitations of rule 53(a)(1) or rule 58(a)(i), as applicable. Allegheny, AE Supply and the Utility Applicants also request authority to guarantee the performance obligations of their direct or indirect subsidiaries as may be appropriate or necessary to enable the subsidiaries to carry on the ordinary course of their businesses. Any guarantees will be subject to the Aggregate Guarantee Limitation.

The Nonutility Applicants request authority to enter into guarantees (directly or indirectly through one or more Capital Corps), obtain letters of credit, support or expense agreements, or otherwise to provide credit support with respect to debt securities or other

contractual obligations of other Nonutility Applicants from time to time through the Authorization Period in an aggregate principal amount that, together with the Applicant/Utility Applicant Guarantees, will not exceed the Aggregate Guarantee Limitation at any one time, exclusive of any guarantees and other forms of credit support that are exempt under rule 45(b) and rule 52(b). The amount of Nonutility Applicant guarantees for obligations of any Rule 58 Companies shall remain subject to the limitations of rule 58(a)(i). The Nonutility Applicants also request authority to guarantee the performance obligations of other Nonutility Applicants as may be appropriate or necessary to enable the company whose obligations are being guaranteed to carry on the ordinary course of its business. Any guarantees will be subject to the Aggregate Guarantee Limitation.

Allegheny, AE Supply and the Utility Applicants anticipate that during the Authorization Period they may need to issue guarantees and obtain letters of credit for various purposes. One likely instance in which these types of issuances may occur is the posting of collateral in connection with participation in wholesale energy markets, whether for the purpose of meeting the company's own supply needs or selling energy to other market participants. Another likely instance would be the use of certain guarantees or letters of credit in connection with the expected divestiture of certain assets as part of the Applicants' overall plan for returning to financial health. Allegheny, AE Supply and the Utility Applicants are seeking guarantee authority that they expect will both be

sufficient for these purposes and enable them to respond to unanticipated circumstances or opportunities.<sup>24</sup>

Certain of the guarantees for which authority is being sought may be in support of the obligations of subsidiaries or associate companies that are not capable of exact quantification. In these cases, the company issuing the guarantee will determine the exposure of the instrument for purposes of measuring compliance with the Aggregate Guarantee Limitation by appropriate means, including estimation of exposure based on loss experience or projected potential payment amounts. With regard to financial guarantees, the terms of the securities of the subsidiaries or associate companies for which a guarantee is issued will comply with the financing parameters set forth above. If appropriate, these estimates will be made in accordance with GAAP, and these estimates will be re-evaluated periodically.

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<sup>24</sup> Non-financial guarantees in these situations can vary depending on the specific facts presented by a transaction. The Commission has previously acknowledged the multiplicity of possible financial and performance guarantees, including various indemnification obligations that may be necessary in connection with asset divestiture. *See* 2004 Guarantees Order. That order dealt with, among other things, guarantees of indemnification obligations of Allegheny Energy Supply Conemaugh, LLC ("Conemaugh") under certain agreements. Those obligations fell into four broad classes, *viz.*, obligations to indemnify for losses arising out of: (i) breaches by Conemaugh of its obligations under any of its covenants or agreements contained in certain contracts, *e.g.*, general obligations, such as the requirement to transfer the interest in question, and transaction specific obligations, such as to make certain adjustments related to emissions allowances; (ii) breaches by Conemaugh of its representations and warranties regarding corporate powers and authorizations, governmental approvals, and other similar matters; (iii) certain liabilities or obligations of Conemaugh related to its ownership of a divested interest in a generation facility, including tax, liability, personal injury claims, and general contract obligations; and (iv) the failure of Conemaugh to comply with the

A company issuing a guarantee authorized under this request may receive a fee for each guarantee from the company on whose behalf the guarantee was issued. This fee will not be greater than the costs, if any, of obtaining the liquidity necessary to perform the guarantee for the period of time the guarantee remains outstanding. Any guarantee that is outstanding at the end of the Authorization Period will remain in force until it expires or terminates in accordance with its terms.

The issuance of guarantees is subject to the general reservation of jurisdiction over transactions after June 30, 2006, pending completion of the record.

H. Intra-System Financing

Allegheny, AE Supply and the Existing Nonutility Applicants request authorization to engage in intra-system financings with each other and for the Existing Nonutility Companies to engage in intra-system financings among themselves, in an aggregate amount not to exceed \$1.0 billion outstanding at any time during the Authorization Period. Applicants request that the Commission reserve jurisdiction over these transactions by AE Supply pending completion of the record. Generally, Allegheny's, AE Supply's or a financing Nonutility Applicant's loans to, and purchase of capital stock from, a financed Nonutility Applicant will be exempt under rule 52, and capital contributions and open account advances without interest will be exempt under rule 45(b). Loans by Allegheny, AE Supply or a Nonutility Applicant to a Nonutility Applicant generally will have interest rates and maturity dates that are designed to parallel the lending company's effective cost of capital, in accordance with rule 52(b).

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provisions of any applicable bulk sales or transfer laws concerning claims of creditors in connection with transfers of a major part of Conemaugh's business.

To the extent that any intra-system loans or extensions of credit are not exempt under rule 45(b) or rule 52, as applicable, the company making the loan or extending the credit may charge interest at the same effective rate of interest as the daily weighted average effective rate of commercial paper, revolving credit and/or other short-term borrowings of that company, including an allocated share of commitment fees and related expenses. If no borrowings are outstanding, then the interest rate shall be predicated on the Federal Funds Effective Interest Rate (“Fed Funds Rate”), as quoted daily by the Federal Reserve Bank of New York. In the limited circumstance where the Nonutility Applicant effecting the borrowing is not a direct or indirect wholly-owned subsidiary of Allegheny, authority is requested under the Act for Allegheny, AE Supply or the Nonutility Applicants to make the loan to the Nonutility Applicant at an interest rate and maturity designed to provide a return to the lending company of not less than its effective cost of capital. If these types of loans are made to a Nonutility Applicant, that Nonutility Applicant will not provide any services to any associate Nonutility Applicant, except a company that meets one of the conditions for rendering of services on a basis other than at cost, as described below. Allegheny and AE Supply will comply with the requirements of rule 45(c) regarding tax allocations unless they receive approval from the Commission to alter this requirement.

I. Payment of Dividends Out of Capital Or Unearned Surplus

Applicants request authority for AE Supply, the Utility Applicants and the Nonutility Applicants to pay through the Authorization Period, to the extent permitted under applicable corporate law, up to \$2.0 billion in dividends out of capital or unearned surplus and to acquire, retire, or redeem any securities of these companies that are held

by an associate company, an affiliate, or an affiliate of an associate company. At this time, AE Supply, the Utility Applicants and the Nonutility Applicants seek authority to pay dividends out of capital and unearned surplus in an aggregate amount not to exceed \$1.75 billion through June 30, 2006, and request that the Commission reserve jurisdiction over the remaining balance of the \$2 billion Dividend Cap, pending completion of the record.

With regard to this request, the Applicants explain that there may be situations in which AE Supply, AGC, or a Nonutility Applicant will have unrestricted cash available for distribution in excess of current and retained earnings resulting, for example, from a disposition of assets or a restructuring. The Commission has authorized these types of dividends when an applicant (i) has received excess cash as a result of the sale of its assets; (ii) has engaged in a restructuring or reorganization; or (iii) is returning capital to an associate company.<sup>25</sup> With the exception of AGC as discussed below, the Applicants will not pay dividends out of capital or unearned surplus except in situations described in (i), (ii), and (iii), above. No Nonutility Applicant will declare or pay any dividend out of capital or unearned surplus if the Nonutility Applicant derives any material part of its revenues from the sale of goods, services or electricity to an Allegheny subsidiary that is a public-utility company under the Act.

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<sup>25</sup> See July 2004 Order. See also, for example, *AGL Resources Inc.*, Holding Co. Act Release No. 27917 (Nov. 24, 2004) and *Dominion Resources, Inc.*, Holding Co. Act Release No. 27927 (Dec. 11, 2004).

Applicants note that any payment of dividends by AE Supply, AGC, and the Nonutility Applicants may result in a decrease of the relevant company's common equity ratio. Applicants commit, however, that payment of the proposed dividends will not be made if such payment would impair the ability of the relevant company to meet its obligations, and that the relevant company's assets will be sufficient to meet anticipated expenses and liabilities.

AGC requests authority to pay dividends out of capital and unearned surplus from its normal operations. The Commission has previously granted AGC similar authority through December 31, 2005.<sup>26</sup> As noted in the AGC Dividend Order, AGC is a single asset company with declining capital needs. Because AGC has only one asset, a 40% interest in a 2100-megawatt hydroelectric station, and other Allegheny public-utility company subsidiaries take all of the capacity from that asset, the company, by design, has no growth opportunity. Cash received from revenues exceeds the cash requirements for operating expenses and return on investment primarily because of the recovery of depreciation expense. AGC's owners, AE Supply and Monongahela, expect a return on, as well as a return of, their investment. By design, the annual dividends must exceed the annual earnings to avoid a cash buildup approximately equal to the annual depreciation.

Similarly, the Commission previously authorized AE Supply to pay dividends out of capital and unearned surplus through July 31, 2005, in the 2003 Capitalization Order. As explained in that order, dividend payments were necessary to maintain debt repayment at the Allegheny level using funds generated from assets sales by AE Supply. The Commission has likewise authorized payment of dividends out of capital and unearned surplus for the Existing Nonutility Companies under certain circumstances.<sup>27</sup>

With respect to AE Supply and the Utility Applicants (except for AGC), the requested dividend authority is related to obligations under an intercreditor agreement ("ICA") between Allegheny, AE Supply and their respective lenders. Allegheny explains that it entered into the ICA to satisfy certain lenders at a time when it and AE Supply

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<sup>26</sup> Holding Co. Act Release No. 27571 (Sept. 27, 2002) ("AGC Dividend Order").

<sup>27</sup> See July 2004 Order.

“had severe financial problems and limited financing alternatives.”<sup>28</sup> The lenders that insisted on the agreement were concerned that given the company’s financial situation, management at the time might “take advantage of the corporate structure” to raise money at Allegheny or AE Supply, “use the proceeds to repay that entity’s obligations and avoid repaying the obligations of the other entity.”<sup>29</sup> Allegheny explains that the “ICA was the agreed upon mechanism” to ensure that this would not happen.<sup>30</sup>

The ICA provided in complex provisions that proceeds from certain securities issuances by company subsidiaries would be distributed within the holding company system to satisfy and protect these lenders.<sup>31</sup> Allegheny states that none of the parties to the agreement, except the holders of certain notes due in 2007, still hold debt covered by the agreement because of refinancings and repayments by the company. Since all of the lender parties to the agreement, except this one, have been eliminated, Allegheny explains that the provision of the agreement requiring the transfer of proceeds from securities issuances no longer carries the significance it originally did.<sup>32</sup> Nevertheless, the requirement is part of the agreement and the company must comply with it. Thus, Allegheny has requested dividend authority to allow it to make these intra-system transfers. However, as stated earlier, Allegheny has agreed in this Application and in prior applications to immediately return any proceeds dividend to comply with the ICA back to the subsidiary where it originated. Allegheny has committed in its amended

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<sup>28</sup> Response at 12. See the Application as well as the Response at 11-13 for a more detailed discussion of the ICA.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 12-13.

Application to pay the proceeds “regardless of circumstances” within the holding company system.

Applicants request up to \$1.6 billion through June 30, 2006,<sup>33</sup> for dividend payments in connection with this agreement. Of this amount, no more than \$200 million will be used by the Utility Applicants, and no dividend will be paid out of capital or unearned surplus by the Utility Applicants (with the exception of AGC) except to the extent necessary to comply with the terms of the ICA.

J. Money Pool and Utility Applicant Short-Term Debt Limits

In a series of orders,<sup>34</sup> Allegheny, AE Supply, AESC, and the Utility Applicants (“Money Pool Applicants”) were authorized, among other things, to establish and participate in the Money Pool. The Money Pool Applicants now request authority to continue the Money Pool through the Authorization Period, subject to the same terms and conditions set forth in the Prior Money Pool Orders. The Money Pool Applicants request that the Commission authorize (i) Monongahela, Mountaineer, Potomac Edison and West Penn to continue participation in the Money Pool as both lenders and borrowers, to the extent not exempt under rule 52; (ii) AGC to continue participation in the Money

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<sup>33</sup> Applicants note that \$800 million of this amount relates to the refinancing of Allegheny debt that is expected to occur in the near future.

<sup>34</sup> See orders dated January 29, 1992 (Holding Co. Act Release No. 25462), February 28, 1992 (Holding Co. Act Release No. 25481), July 14, 1992 (Holding Co. Act Release No. 22581), November 5, 1993 (Holding Co. Act Release No. 25919), November 28, 1995 (Holding Co. Act Release No. 26418), April 18, 1996 (Holding Co. Act Release No. 26506), December 23, 1997 (Holding Co. Act Release No. 26804), May 19, 1999 (Holding Co. Act Release No. 27030), October 8, 1999 (Holding Co. Act Release No. 27084), December 17, 2001 (Holding Co. Act Release No. 27475), October 24, 2002 (Holding Co. Act Release No. 27585), July 14, 2000 (Holding Co. Act Release Nos. 27199) (“Prior Money Pool Orders”).

Pool as a borrower only, to the extent not exempt under rule 52; and (iii) Allegheny and AE Supply to continue participation in the Money Pool as lenders only.

The Money Pool will continue to be administered on behalf of the Money Pool Applicants by AESC and under the direction of an officer of AESC. AESC will not be a participant in the Money Pool. The Money Pool will consist principally of surplus funds received from the Money Pool Applicants. In addition to surplus funds, funds borrowed by Allegheny, AE Supply, Monongahela, Potomac Edison and West Penn through the issuance of short-term notes or other debt, or by the selling of commercial paper (“External Funds”), as described above, may be a source of funds for making loans or advances to companies borrowing from the Money Pool.

The Money Pool Applicants do not propose any material changes to the operation of the Money Pool as currently authorized. Transactions under the Money Pool will be designed to match, on a daily basis, the surplus funds of the pool participants with the short-term borrowing requirements of the pool participants (other than the pool participants who are lenders only), thus minimizing the need for short-term debt to be incurred by the pool participants from external sources. The Money Pool Applicants believe that the cost of the proposed borrowings through the Money Pool generally will be more favorable to the borrowing participants than the comparable cost of external short-term borrowings, and the yield to the participants contributing available funds to the Money Pool generally will be higher than the typical yield on short-term investments.

The funds available through the Money Pool will be loaned on a short-term basis to those eligible pool participants that have short-term debt requirements. If no short-term requirements match the amount of funds that are available, AESC will invest the

funds, directly or indirectly, in: (1) direct or indirect obligations of the United States Government, (2) certificates of deposit of commercial banks with assets exceeding \$2.5 billion; (3) bankers' acceptances of commercial banks with assets exceeding \$2.5 billion; (4) commercial paper of companies having a minimum net worth of \$150 million having a "1" commercial paper rating by at least two of the three recognized rating services (Moody's, S&P and Fitch); (5) taxable or tax exempt institutional money market funds with assets of at least \$500 million, which restrict investments to high quality money market instruments; and (6) other investments as permitted by section 9(c) of the Act and rule 40 under the Act. AESC will allocate the interest earned on investments among the pool participants, providing the funds on a *pro rata* basis according to the amount of the funds provided.

All borrowings from, and contributions to, the Money Pool will be documented and will be evidenced on the books of each pool participant that is borrowing from or contributing surplus funds to the Money Pool. Any pool participant contributing funds to the Money Pool may withdraw those funds at any time without notice to satisfy its daily need for funds. All short-term debt through the Money Pool (other than from External Funds) will be payable on demand, may be prepaid by any borrowing pool participant at any time without penalty, and will bear interest for both the borrower and lender. Interest income and expense will be calculated using the previous day's Fed Funds Rate, as quoted by the Federal Reserve Bank of New York, as long as this rate is at least four basis points lower than the previous day's seven-day commercial paper rate as quoted by the same source. Whenever the Fed Funds Rate is not at least four basis points lower than the seven-day commercial paper rate, then the seven-day commercial paper rate,

minus four basis points, will be used. Interest income and expense will be calculated daily and settled on a cash basis on the first business day of the following month.

Each of the Utility Applicants may use the proceeds it borrows from the Money Pool (i) for the interim financing of its construction and capital expenditure programs; (ii) for its working capital needs; (iii) for the repayment, redemption or refinancing of its debt and preferred stock; (iv) to meet unexpected contingencies, payment and timing differences, and cash requirements; and (v) to otherwise finance its own business and for other lawful general corporate purposes. The following companies request authority to borrow from the Money Pool up to stated amounts at any one time outstanding: AGC, \$100 million; Monongahela, \$125 million; Mountaineer, \$100 million; Potomac Edison, \$150 million; West Penn, \$200 million.

Allegheny, AE Supply and each of the Utility Applicants also request authority to raise External Funds through short-term borrowing, as discussed above. External Funds raised by the Utility Applicants shall be in an amount equal to the relevant Utility Applicant's authority to borrow from the Money Pool. Allegheny, AE Supply and the Utility Applicants, other than AGC, would use the External Funds that they receive in this way either to make loans or advances to companies borrowing from the Money Pool or for general corporate purposes. AGC would use External Funds for general corporate purposes only.

#### IV. Other Requests

##### A. Changes in Capitalization and Internal Reorganizations of Nonutility Applicants

Allegheny and AE Supply cannot ascertain at this time the portion of an individual Nonutility Applicant's aggregate financing to be effected through the sale of

capital stock or equivalent interests in the form of limited liability company or general partnership interests during the Authorization Period either under Commission authorization or under rule 52. However, a proposed sale of capital stock or equivalent interests may in some cases exceed the capital stock or equivalent interests of a Nonutility Applicant authorized at that time. In addition, a Nonutility Applicant may elect to use capital stock with no par value or to convert from one form of business organization (*e.g.*, a corporation) to another (*e.g.*, a limited liability company). A Nonutility Applicant also may wish to undertake a reverse stock split in order to reduce franchise taxes or for other corporate purposes. Allegheny and AE Supply, therefore, request authority to change the terms of any Nonutility Applicant's authorized capitalization as needed to accommodate these types of transactions and to provide for future issuances of securities as Allegheny and AE Supply or another parent company deem appropriate, provided that the consent of all other shareholders or owners of equivalent interests to a change has been obtained if the Nonutility Applicant in question is not a direct or indirect wholly-owned subsidiary company of Allegheny or AE Supply. The requested authority would permit a Nonutility Applicant to increase the number of its authorized shares of capital stock or equivalent interests, change the par value of its capital stock, change between par value and no-par value stock, or convert from one form of business organization to another without additional Commission approval.<sup>35</sup>

In addition, to the extent not otherwise exempt under the Act or the rules under the Act, Allegheny and AE Supply request approval to consolidate, sell, transfer, or

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<sup>35</sup> The Commission has previously authorized substantially similar proposals. See *Conectiv, Inc.*, Holding Co. Act Release No. 26833 (Feb. 26, 1998); *NiSource Inc.*,

otherwise reorganize all or any part of their direct and indirect ownership interests in Nonutility Applicants, as well as investment interests in entities that are not subsidiary companies. To effect any consolidation or other reorganization, Allegheny and AE Supply may wish either to contribute the equity securities of one Nonutility Applicant to another, including a newly formed intermediate company ("Intermediate Company"),<sup>36</sup> or to sell (or cause a Nonutility Applicant to sell) the equity securities or all or part of the assets of one Nonutility Applicant to another. These transactions also may occur through a Nonutility Applicant selling or transferring the equity securities of a subsidiary or all or part of the subsidiary's assets as a dividend to an Intermediate Company or to another Nonutility Applicant, and the acquisition, directly or indirectly, of the equity securities or assets of the subsidiary, either by purchase or by receipt of a dividend. The purchasing Nonutility Applicant in any transaction structured as an intrasystem sale of equity securities or assets may execute and deliver its promissory note evidencing all or a portion of the consideration given. Allegheny and AE Supply also may liquidate or merge Nonutility Applicants.<sup>37</sup>

**B. Exemption of Certain Transactions from At-Cost Requirements**

The Nonutility Applicants request authority to provide certain services in the ordinary course of their business to each other, in certain circumstances described below,

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Holding Co. Act Release No. 27265 (Nov. 1, 2000); and *Ameren Corp.*, Holding Co. Act Release No. 27777 (Dec. 18, 2003).

<sup>36</sup> The Commission authorized AE Supply to organize Intermediate Companies to facilitate investments in exempt activities. Holding Co. Act Release No. 27383 (April 20, 2001).

<sup>37</sup> The Commission has previously authorized substantially similar proposals. See *Entergy Corp.*, Holding Co. Act Release No. 27039 (June 22, 1999); *NiSource Inc.*, Holding Co. Act Release No. 27265 (Nov. 1, 2000); and *Ameren Corp.*, Holding Co. Act Release No. 27777 (Dec. 18, 2003).

at any price they deem appropriate, including, but not limited to, cost or fair market prices; and they request an exemption under section 13(b) from the "at cost requirement" of rules 90 and 91 to the extent that a price other than "cost" is charged.<sup>38</sup> Any services provided by the Nonutility Applicants to the Operating Utilities and Mountaineer will continue to be provided at "cost" consistent with rules 90 and 91. A Nonutility Applicant will not provide services at other than "cost" to any other Nonutility Applicant that, in turn, provides the services, directly or indirectly, to any other associate company that is not a Nonutility Applicant, except under the requirements of the Commission's rules and regulations under section 13(b) or an exemption from those rules and regulations from the Commission.

Section 13(b) permits the Commission to exempt certain categories of transactions otherwise falling within the scope of section 13(b) from the at-cost requirement if the transactions "involve special or unusual circumstances." In the past, the Commission has recognized that the at-cost provisions of the Act and the rules under the Act were "designed to protect public-utility companies against the tribute heretofore exacted from them in the performance of service . . . contracts by their holding companies and by servicing . . . companies controlled by their holding companies." In light of this fact, the Commission has granted exemptions from the at-cost requirement "where

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<sup>38</sup> Allegheny Ventures Inc. is currently authorized to provide, directly or through a special purpose subsidiary, energy management services and demand side management services to non-associate companies at market prices. Holding Co. Act Release No. 26401 (Oct. 27, 1995).

structural protections to protect customers against any adverse effect of pricing at market rates were in place."<sup>39</sup>

The authority requested in this connection would be limited to situations where a Nonutility Applicant provides services at other than cost to a Nonutility Applicant that is:

- (a) an EWG that derives no part of its income, directly or indirectly, from the generation, transmission, or distribution of electric energy for sale within the United States;
- (b) an EWG that sells electricity at market-based rates that have been approved by FERC, provided that the purchaser of the electricity is not an associate public-utility company;
- (c) a "qualifying facility" ("QF") within the meaning of the Public Utility Regulatory Policies Act of 1978, as amended ("PURPA"), that sells electricity exclusively (a) at rates negotiated at arm's-length to one or more industrial or commercial customers purchasing electricity for their own use and not for resale, and/or (b) to an electric utility company (other than an associate utility company) at the purchaser's avoided cost as determined in accordance with FERC's regulations under PURPA;
- (d) a domestic EWG or QF that sells electricity at rates based upon its cost of service, as approved by FERC or any state public utility commission having jurisdiction, provided that the purchaser of the electricity is not an associate public-utility company; or
- (e) a direct or indirect subsidiary of Allegheny formed under rule 58 or any other nonutility company that (i) is partially owned by Allegheny, provided that the ultimate recipient of the services is not an associate public-utility company, or (ii) is engaged solely in the business of developing, owning, operating, and/or providing services to Nonutility Applicants described in clauses (a) through (d) immediately above, or (iii) does not derive, directly or indirectly, any material part of its income from sources within the United States and is not a public-utility company operating within the United States.

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<sup>39</sup> *Entergy Corp., Holding Co. Act Release No. 27039 (June 22, 1999)*, and decisions cited. *See also Interstate Energy Corp., Holding Co. Act Release No. 27069 (Aug. 26, 1999)*, and decisions cited; and *New England Electric System, Holding Co. Act Release No. 22309 (Dec. 9, 1981)*.

V. Discussion

A. 30% Common Equity Capitalization Ratio

The Applicants' requested authority would be a routine financing request but for the equity capitalization ratios of Allegheny and AE Supply, which, as noted earlier, are below 30%. The Commission has used 30% as a guideline for registered holding companies and their subsidiaries. Neither the Act nor the rules under the Act require companies to maintain a common equity ratio of at least 30%. The guideline is a policy that has developed during the administration of the Act and after analyses of securities issuances under section 7 of the Act.

The Commission has interpreted its common equity policy flexibly. In a 1956 announcement of a study concerning a policy on capitalization ratios for registered holding company systems, the Commission stated that it attempts to ensure a "balanced capital structure [that] provides a considerable measure of insurance against bankruptcy, enables the utility to raise new money most economically, and avoids the possibility of deterioration in service to consumers if there is a decline in earnings."<sup>40</sup> The Commission noted that "[a]n adequate equity cushion to absorb the vagaries of business conditions is an important attribute of a good security."<sup>41</sup> The Commission has settled on a 30%

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<sup>40</sup> Announcement of Study by Division of Corporate Regulation of the Securities and Exchange Commission Regarding a Proposed Statement of Policy Relative to Capitalization Ratios for Registered Holding Company Systems Subject to the Public Utility Holding Company Act of 1935, Holding Co. Act Release No. 13255 (Sept. 5, 1956) (quoting Tenth Annual Report to Congress for the fiscal year ended June 30, 1944, at 99). The study was not completed.

<sup>41</sup> *Id.* (quoting *Report for the SEC Subcommittee of the House Committee on Interstate and Foreign Commerce on PUHCA* at 27) (Oct. 15, 1951). Early cases that discuss and develop the standard include *Eastern Utilities Associates*, Holding Co. Act Release No. 11625, 34 S.E.C. 390, 444-445 (Dec. 18, 1952) and *Kentucky Power Company*, 41 S.E.C. 29, 39 (1961).

common equity ratio as a reasonable standard for achieving these purposes and has characterized this standard as serving "to maintain conservative capital structures that would tend to produce economies in the cost of new capital."<sup>42</sup>

On the other hand, the Commission has never sought to implement the standard in a way that would cause further harm to an ailing company. Rather, the Commission has consistently sought to assist registered holding companies in restoring their capital structures when their common equity drops below 30%. For example, in *Alabama Power Co., Holding Co.* Act Release No. 21711 (Sept. 10, 1980), the Commission authorized the extension of short-term borrowing for Alabama Power Company when its common equity ratio was 28.1%. In that order the Commission noted that "the proposed financing is directed to curing critical financial problems of Alabama. The suggestion that the financing program be deferred makes no financial or statutory sense."<sup>43</sup>

In *Eastern Utilities Associates*,<sup>44</sup> the Commission issued a supplemental order releasing jurisdiction over various financing transactions requested by Eastern Utilities Associates ("EUA") and an electric utility subsidiary in connection with the subsidiary's investment in a nuclear-fueled generating plant in Seabrook, New Hampshire, despite EUA's failure to meet the 30% common equity ratio standard.<sup>45</sup> The Commission approved the requests even though the common equity ratio of EUA would drop to

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<sup>42</sup> U.S. Sec. & Exch. Comm'n, Div. of Investment Mgmt., *The Regulation of Public-Utility Holding Companies* at 42 and n. 8 and accompanying text (June 1995) (citation omitted).

<sup>43</sup> Alabama Power Company was experiencing financial problems because of difficulties securing rate relief.

<sup>44</sup> Holding Co. Act Release No. 24879 (May 5, 1989).

<sup>45</sup> *Eastern Utilities Associates*, Holding Co. Act Releases No. 24245 (Nov. 21, 1986) and No. 24641 (May 12, 1988).

approximately 28.9% and that of the subsidiary to approximately 24%. The Commission stated that “under appropriate circumstances [it] has applied capitalization ratio standard flexibly where, for example, there was assurance that capitalization ratios would improve over the foreseeable future, and where it was in the public interest and the interest of investors and consumers that a proposed financing should be permitted to go forward.”<sup>46</sup>

In *Conectiv, et al.*,<sup>47</sup> the Commission lowered the required consolidated common equity ratio from 30 to 20%.<sup>48</sup> Conectiv needed the modification because of circumstances resulting from restructuring legislation in the states in which its public

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<sup>46</sup> In *Eastern Utilities*, the Commission took into consideration that absent an order permitting the requested financings, the subsidiary would forfeit its investment in Seabrook and EUA's equity investment in the subsidiary would become worthless. The Commission found that the loss of the subsidiary's financial support of its share in Seabrook would carry serious adverse consequences for the project as a whole. The Commission focused on actions to restore the financial well being of the companies in question and concluded that, on balance, the subsidiary's issuance of additional notes, and a further investment by EUA in the subsidiary's preferred stock, was a prudent course for the companies in light of the continuing progress of the license procedures of the Seabrook project. The Commission also took into consideration that EUA's common equity ratio was expected to be above 30% in the foreseeable future.

*See also*, Holding Co. Act Release No. 25363 (Aug. 20, 1991), in which the Columbia Gas System, Inc. ("Columbia"), a debtor-in-possession under Chapter 11 of the Bankruptcy Code, was authorized to issue and sell short-term secured promissory notes at a time when Columbia's common equity ratio was below 30% because of a write-off of approximately \$1.2 billion of high-cost supply contracts of one of Columbia's subsidiaries. The issuance of the notes was expected to reduce Columbia's common equity ratio to 28.3%. The Commission stated that compelling circumstances as those in the Columbia situation may warrant approval of a consolidated equity capitalization below the customary 30% level.

*See also*, Central Power & Light Co., 27 S.E.C. 185 (1947); Indiana Service Corp., 24 S.E.C. 463 (1946); Republic Service Corp., 23 S.E.C. 436 (1946); Alabama Power Co., 22 S.E.C. 267 (1946); Consumer's Power Co., 20 S.E.C. 413 (1945); and Ohio Edison Co., 18 S.E.C. 529 (1945).

<sup>47</sup> Holding Co. Act Release No. 27111 (Dec. 14, 1999).

<sup>48</sup> In two subsequent orders, the Division of Investment Management granted further financing authority to Conectiv, although Conectiv's common equity ratio remained under 30% throughout the year 2002. *See Conectiv, Inc.*, Holding Co. Act Release Nos. 27192 (June 29, 2000) and 27507 (March 22, 2002).

utility company subsidiaries operated. The Commission noted in its order that it “has in the past . . . granted exceptions to the 30% requirement where there was some special circumstance leading to the inability to maintain this standard, including difficulties expected in connection with industry restructuring, and it was likely that the standard could be met in the near future.”<sup>49</sup>

Finally, the Commission has applied this precedent to the Allegheny and AE Supply themselves in a number of recent orders.<sup>50</sup> Applicants submit that a flexible approach to the Commission's capitalization standards for registered holding company systems should apply equally to their current request.

**B. Applicable Statutory Standards**

The proposed financing transactions are subject, variously, to sections 6, 7, 12(b) and 12(c) of the Act.<sup>51</sup> Section 6(a) of the Act requires the filing of a declaration under section 7 in connection with the issue and sale of a security by a registered holding

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<sup>49</sup> More recently in *Xcel Energy Inc. (Holding Co. Act Release No. 27597 (Nov. 7, 2002)*, the Commission authorized a consolidated common equity ratio of 24%. Xcel's request was related to the affects on its capitalization ratio of the financial difficulties experienced by its energy trading and merchant generation subsidiary, NRG Energy, Inc. In approving Xcel's request, the Commission stated that “[t]he Act itself neither specifically addresses nor mandates particular capitalization structures” and repeated the conclusions set forth in Proposed Capitalization Policy of 1956. The Commission also pointed out that the 30% common equity standard is a “benchmark rather than an absolute requirement” and that it has “permitted capital structures with less than 30 percent common equity when mitigating circumstances are present, particularly when market conditions are concerned.”

<sup>50</sup> See Holding Co. Act Release No. 27701 (July 23, 2003); Holding Co. Act Release No. 27780 (Dec. 22, 2003); Holding Co. Act Release No. 27796 (Feb. 3, 2004); Holding Co. Act Release No. 27797 (Feb. 3, 2004); Holding Co. Act Release No. 27840 (April 29, 2004); Holding Co. Act Release No. 27878 (July 27, 2004).

<sup>51</sup> Related acquisitions of securities by Allegheny system companies are subject to sections 9(a)(1) and 10 of the Act. Section 13(b) and rule 90(d) are applicable to certain routine deviations from the “at cost” standard of section 13(b).

company or subsidiary. Section 7(b) provides in relevant part that “[a] declaration filed under this section shall become effective within such reasonable time after the filing thereof as the Commission shall fix by rules and regulations or order.”<sup>52</sup> Section 7(d) provides that if the requirements of subsections (c) (concerning the type of security to be issued) and (g) (concerning any necessary state approval) are satisfied, the Commission shall permit a declaration regarding the issue or sale of security to become effective unless the Commission makes certain specified adverse findings. The declaration may not become effective if the Commission finds that:

- the security is not reasonably adapted to the security structure of the declarant and other companies in the same holding-company system [section 7(d)(1)];
- the security is not reasonably adapted to the earning power of the declarant [section 7(d)(2)];
- financing by the issue and sale of the particular security is not necessary or appropriate to the economical and efficient operation of a business in which the applicant lawfully is engaged or has an interest [section 7(d)(3)]; or
- the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers [section 7(d)(6)]. The declaration also may not become effective if the Commission finds that: the fees, commissions or other remuneration paid directly or indirectly in connection with the financing are not reasonable [section 7(d)(4)]; or, in the case of a security that is a guarantee, the circumstances are such as to constitute the making of the guarantee an improper risk for the declarant [section 7(d)(5)];

Thus, absent any adverse finding, the Commission approves a requested authorization. In this event, section 7(f) of the Act permits the Commission’s order “to contain such terms and conditions as the Commission finds necessary to assure compliance with the conditions specified in this section.”

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<sup>52</sup> Section 7(b) adds the proviso, “unless the Commission, prior to the expiration of such period, shall have issued an order to the declarant to show cause why such

Section 12(b) of the Act applies to intercompany loans, and makes it unlawful for a registered holding company or subsidiary “to lend or in any manner extend its credit to or indemnify any company in the same holding-company system in contravention of such rules and regulations or orders as the Commission deems necessary or appropriate in the public interest or for the protection of investors or consumers [the ‘protected interests’ under the Act] or to prevent the circumvention of the provisions of this title or the rules, regulations, or orders thereunder.” Rule 45(a) in pertinent part requires the filing of a declaration in connection with a proposed transaction under section 12(b).

The requests for authorization to pay dividends out of capital surplus are subject to section 12(c) of the Act, which makes it unlawful for any registered holding company or subsidiary “to declare or pay any dividend on any security . . . in contravention of such rules and regulations or orders as the Commission deems necessary or appropriate to protect the financial integrity of companies in holding-company systems, to safeguard the working capital of public-utility companies, to prevent the payment of dividends out of capital or unearned surplus, or to prevent the circumvention of the provisions of this title or the rules, regulations, or orders thereunder.” Section 12(c) was intended to prevent the improper “milking of operating companies in the interest of controlling holding company groups” and “to safeguard the working capital of the public-utility companies.”<sup>53</sup>

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declaration should become effective.”

<sup>53</sup> S.Rep. No. 621, 74<sup>th</sup> Cong., 1<sup>st</sup> Sess. 35 (1935).

The request for authority to change the terms of the authorized capitalization of a Nonutility Applicant's capital stock, or equivalent ownership interests, is subject to sections 6, 7, 9(a)(1) and 10 of the Act. Related acquisitions of securities or assets of existing and new Nonutility Applicants are subject to sections 9(a)(1) and 10 of the Act.

C. Request For Hearing

On February 18, 2005, Harbert filed comments and a request for a hearing ("Request"). As noted earlier, Allegheny replied to those comments in its Response on March 18, 2005. Harbert filed Additional Comments on April 1, 2005.

Harbert describes itself as an investor "in securities of various companies in the electric power industry, including [Allegheny, AE Supply, Monongahela, Mountaineer, Potomac Edison and West Penn (the last four companies are referred to collectively in this section as the "Utilities")],” and states that it seeks the protection of Allegheny's and the four Utilities' credit quality and access to capital.”<sup>54</sup>

Harbert views AE Supply as a continuing liquidity drain upon Allegheny and the Utilities.<sup>55</sup> Harbert suggests that AE Supply is headed for bankruptcy,<sup>56</sup> and that management has failed to reverse this trend. Harbert rejects the assertion that Allegheny has "reversed this situation fundamentally,” placing operations “on a steady course to

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<sup>54</sup> Request at 8. Harbert does not identify its specific investments in Allegheny system companies and thus does not clearly identify the class of investors whose interests it is seeking to protect. Its website states that Harbert's "objective is to generate superior, risk-adjusted returns by investing in distressed and high yield debt securities.” See <http://www.harbert.net/distressed-securities/default.php>.

<sup>55</sup> “Cash flow and equity value [of these companies] are being diverted to support staggering losses and deteriorating equity levels at the unregulated business.” Request at 4.

<sup>56</sup> “[Allegheny and AE Supply] fail to acknowledge the continued financial, operating and regulatory risks facing [them] and overstate the impact of possible improvements.” Request at 4.

return to full financial health and compliance with the Commission’s benchmark 30 percent common equity requirement.”<sup>57</sup> Harbert states that “banking on [Allegheny’s and AE Supply’s] ability to achieve a 30% equity level is not prudent” because they have “failed to improve consolidated equity levels to date, relied on consummating speculative near term transactions for equity enhancement, since August 2002 have lacked adequate financial controls required to prepare reliable projections, and face serious near term business risks.”<sup>58</sup>

In Harbert’s view, the requested authorizations would make matters worse, because they “would permit [Allegheny and AE Supply] to substantially compromise the [Utilities] in the face of an escalating financial crisis to the point where it would be too late to prevent the [Utilities] from being *bankrupted* by Supply.”<sup>59</sup> Harbert contends the Application should be denied because the Applicants seek greater opportunities to subsidize and sustain “the losses at Supply based upon the financial strength of [Allegheny’s] Operating Utilities, ultimately backstopped by the Operating Utilities’ investors and retail ratepayers.”<sup>60</sup>

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<sup>57</sup> *Id.* at 4.

<sup>58</sup> *Id.* at 7 (emphasis in original).

<sup>59</sup> *Id.* at 10. “Supply may represent a slow motion financial train wreck.” *Id.* at 45. Granting the requested authority “invites even greater compromising of the [Utilities’] financial viability.” *Id.* at 3.

<sup>60</sup> Request at 10-11.

Harbert recommends that the Commission “direct that Supply stand on its own financial feet.”<sup>61</sup> Any authorizations should “be made contingent on Allegheny and the [Utilities] implementing and observing a comprehensive ring-fencing plan to protect the finances of the [Utilities] and the holding company from additional conscription to bail out [AE] Supply.”<sup>62</sup> Harbert explains that “[r]ing-fencing has been described in shorthand as ‘shielding the beneficiary companies’ assets from creditors in any future bankruptcy proceeding.”<sup>63</sup> To this end, Harbert proposed various specific measures, discussed below.

The Commission does not believe that Harbert has raised any issue of fact or law requiring a hearing. Mere allegations that company activities are not, or will not be, profitable, do not suffice to establish a showing that the statutory standards are not satisfied. It is well settled that evidentiary hearings are required only where there exists a genuine issue of material fact.<sup>64</sup> The Commission’s reasons for its conclusion are discussed below.

The main thrust of Harbert’s arguments is that Allegheny’s projections are not credible -- that is, that the facts do not support Allegheny’s claims that its and AE

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<sup>61</sup> *Id.* at 45.

<sup>62</sup> *Id.* at 12, 45. “The [Utilities], their subsidiaries and [Allegheny] should be made bankruptcy remote from the rest of the enterprise . . . .” *Id.* at 9.

<sup>63</sup> *Id.* at 9, citing *California ex. rel. Lockyer v. FERC*, 329 F.3d 700, 704-05 (9<sup>th</sup> Cir. 2004).

<sup>64</sup> *See City of New Orleans v. S.E.C.*, 969 F.2d 1163, at 1167 n. 6 (D.C. Cir. 1992), quoting *Wisconsin’s Environmental Decade, Inc. v. S.E.C.*, 882 F.2d 523, 526 (D.C. Cir. 1989). As the court went on to note, “[T]he proponent of such a hearing ‘must make a minimal showing that material facts are in dispute’ and may not rely on mere, bald or conclusory allegation[s] that such a dispute exists.” *id.* (quoting, *Connecticut Bankers’ Ass’n v. Board of Governors of the Federal Reserve System*, 627 F.2d 245, 251 (D.C. Cir. 1980)).

Supply's financial condition will continue to improve -- and that Allegheny's application, thus, should not be approved. However, although Allegheny has submitted significant material that underpins the credibility of its projections, ultimately, our conclusion not to make any adverse findings under section 7(d) is not dependent on Allegheny and AE Supply reaching a 30% capitalization level. Rather, it is based on our conclusion that Allegheny's financing requests are appropriate given its current capitalization and overall financial condition. Moreover, the limited duration of the authorization, combined with the fact that the authorization would terminate if Allegheny's situation deteriorated any further, provide assurances that even if Harbert's worst-case scenario were correct, the Commission would be able to revisit Allegheny's financing authority in light of the changed circumstances.

Harbert's other significant claim is that Allegheny is using the value of, and dividends from, the Utilities to prop up AE Supply and to prevent it from falling into bankruptcy.<sup>65</sup> However, Harbert has not presented any evidence that this is, in fact, the

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<sup>65</sup> Harbert warns that the "Commission must guard against a situation in which the [Utilities] continue to be milked to support Supply until Supply goes bankrupt . . ." Request at 24.

By characterizing AE Supply as an "unregulated business," *see, e.g.*, Request at 4, Harbert suggests that the company is a nonutility subsidiary of Allegheny. Harbert asserts that the Act "was not designed to protect investors in a holding company's non-utility subsidiaries." *Id.* at 11. But AE Supply is now and has always been a public-utility company within the meaning of the Act and an integral part of the Allegheny electric integrated system. The Commission authorized the formation of AE Supply in 1999 (*see Allegheny Energy, Inc., Holding Co. Act Release No. 27101 (Nov. 12, 1999)*), in connection with the transfer of generating assets to the subsidiary by the electric utilities, as required by deregulation legislation in Maryland, Virginia and Pennsylvania. *Compare Exelon Corp., Holding Co. Act Release No. 27256 (Oct. 19, 2000)* (authorizing formation of a subsidiary of the registered holding company to which the generating assets of the system utilities would be transferred; the subsidiary would register as a holding company and would be a utility for purposes of the Act and the Federal Power Act, but would not be a state-regulated utility).

case. Harbert has not provided and we have not seen any evidence that the Utilities are being milked to bail AE Supply out of its financial problems. The Utilities have maintained common equity capitalization ratios at or above the ratios they had three years ago when new management was put in place. All of the utility companies have equity ratios significantly above 30%.<sup>66</sup> With respect to this issue, Harbert has failed to establish that there is a material issue of fact warranting a hearing.

In addition to these details, we discuss certain of Harbert's specific arguments and assertions below:

(a) Payment of Dividends

Harbert views dividends paid to Allegheny by the Utilities out of retained earnings as a problem and further evidence that the Utilities are being called on to support AE Supply, but these dividends have been from retained earnings and in compliance with the Act.<sup>67</sup> These payments of dividends involve a business judgment on the part of Allegheny management. Moreover, apart from the 12(c) relief discussed below, no subsidiary within the Allegheny system – and particularly, none of the Operating Utilities – is permitted to pay a dividend not otherwise permitted by the Act. There is no evidence that these payments adversely affected any company and the interested state utility commissions have raised no objection to them.<sup>68</sup> Harbert's

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<sup>66</sup> As stated above, the common equity ratios of the Utilities as of December 31, 2004, were: West Penn, 62.3%; Potomac Edison, 49%; and Monongahela Power, 36.2%. In comparison, the common equity ratios for the same companies as of December 31, 2002, were 45.1%; 48.3% and 35.7%, respectively.

<sup>67</sup> West Penn, Potomac Edison and Monongahela produced approximately \$397 million of net income and paid to Allegheny out of these earnings common stock dividends of \$369 million for the three-year period ended December 31, 2004. The companies sustained retained earnings over this period.

<sup>68</sup> See Response at 11.

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allegation that the payment of these dividends constituted an unlawful extension of credit to the holding company, in contravention of section 12(a) of the Act, is baseless.<sup>69</sup> A dividend issued out of retained earnings is nothing more than a dividend; it is certainly not a loan. It does not appear that there has been any violation of section 12(a) by the companies.

The current Application requests authority for a different type of dividend to be paid. The Application requests authority under section 12(c) of the Act for AE Supply, the Utility Applicants and the Nonutility Applicants to pay dividends out of capital and unearned surplus in an amount up to \$1.75 billion through June 30, 2006, with a reservation of jurisdiction over the remainder of the \$2 billion requested authority.

The Commission has on numerous occasions approved certain payments of dividends out of capital or unearned surplus, for example, when a company has cash available in excess of retained earnings as a result of a disposition of assets.<sup>70</sup> Applicants explain that a portion of the \$2 billion requested dividend authority is for payments of dividends out of capital or unearned surplus with proceeds from the disposition of assets, a restructuring or reorganization or in cases where capital is being returned to an associate company. AGC requests authority to pay dividends out of capital or unearned surplus from normal operations (excluding debt financing) as discussed in more detail

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<sup>69</sup> See also Request at 31 (referring to “further extensions of credit to Supply . . . indirectly, from the [four Utilities]”). Section 12(a) of the Act in pertinent part makes it unlawful for a registered holding company, directly or indirectly, “to borrow, or to receive any extension of credit or indemnity,” from any utility in the same holding-company system.

<sup>70</sup> See footnote 25.

above and as previously authorized by the Commission. The requested authority is consistent with Commission precedent under 12(c).

In addition, a major portion of the authority requested -- \$1.6 billion -- is earmarked to pay dividends out of capital or unearned surplus in connection with the provisions of the complicated ICA discussed earlier, which Harbert claims is “[a]nother example of making the [Utilities] hostage of Supply’s misfortunes”<sup>71</sup> and sleight-of-hand deception of creditors.<sup>72</sup> The Commission disagrees. The Commission has analyzed the ICA and its effects on the Utilities and is of the opinion that the agreement does not have the detrimental effects on the Utilities or the creditors that Harbert envisions. Most important to the Commission, Allegheny has committed in the Application that it will immediately return any amounts dividended to it under the ICA provisions to the subsidiary making the dividends. Unless Allegheny is able to do this in each situation where the ICA applies, this Order does not allow payment of the dividends in the first instance.

The Commission has in past Allegheny orders authorized similar payments of dividends because the payments did not, in effect, constitute a shifting of proceeds but merely a process to comply with the ICA. In essence, because these dividends cannot be paid unless the money ultimately ends up in the entity originally paying the dividend, the grant of this authority has minimal or no effect on the financial condition of the holding company and its subsidiaries. We are, therefore, satisfied that the authority requested will not cause any of the harms section 12(c) of the Act is intended to prevent.

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<sup>71</sup> Request at 37.

<sup>72</sup> Request at 37-39.

(b) Credit Ratings

Harbert states that the Utilities' credit ratings have been "lowered because of the fallout from Supply, while revenue is being diverted to Supply."<sup>73</sup> It is true that the corporate credit ratings of companies in the Allegheny system were lowered in 2003. However, as a result of actions by the new management to initiate a return to financial health, the ratings have continually improved, as noted above and at Appendix A.

(c) Misuse of the Equity Value Of Utilities

Harbert alleges that Allegheny has misused the equity value of the Utilities, through "[d]ebt reduction based on compromising utility investors and retail ratepayers."<sup>74</sup> Harbert notes in this regard that, in the summer of 2003, Allegheny sold \$300 million of subordinated convertible debentures in a private placement and used the proceeds to satisfy 2003 maturities of both Allegheny and AE Supply.<sup>75</sup> Harbert complains that, because the financing was done at Allegheny rather than AE Supply, the lenders looked to the equity value of the Utilities to support the financing, "thereby adversely affecting the [Utilities] given the loan's relatively high interest rate, short maturity and impact on leverage." As Harbert sees it, "the [Utilities'] cash flows now must support \$300 million of high interest rate debt which is subject to mandatory conversion to equity only if the common stock trades above \$15 for a specified period of

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<sup>73</sup> Request at 32. Harbert asserts, for example, that "since July 2003 (after implementation of rescue financing), Moody's rated, and continues to rate, the four Utilities below investment grade."

<sup>74</sup> Request at 19.

<sup>75</sup> The Commission authorized the issuance in the 2003 Trust Preferred Securities Order.

time after June 2006, a circumstance ... which represents a roll of the financial dice, not a steady course of debt reduction.”<sup>76</sup>

These claims, however, do not raise a material issue of law or fact. Holding companies, which operate solely through their subsidiaries, clearly must rely upon the earnings and value of those companies to support issuances of securities. This claim by itself does not demonstrate that an adverse finding is warranted under section 7(d). Ultimately, the underlying utilities are protected through the maintenance of acceptable capitalization ratios, their inability to guarantee the debt of the holding company, and other similar statutory protections. The authority granted by this order does not, as outlined above, fundamentally impair any of these protections. Harbert’s assertions that the holding company has relied on the “value” of its subsidiaries, thus, do not warrant a hearing in this matter.

(d) Ratemaking

Harbert appears to object to various aspects of AE Supply’s rates (specifically, the power sales contracts under which AE Supply provides power to system electric utilities,<sup>77</sup> the rate plan that West Penn has filed in Pennsylvania concerning provider of last resort (“POLR”) service,<sup>78</sup> and a 10% rate increase request for the benefit of the purchaser of Mountaineer that conditions the close of the sale<sup>79</sup>). Rates for POLR service

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<sup>76</sup> *Id.* at 16.

<sup>77</sup> Response at 10.

<sup>78</sup> Request at 23. *See also* Response at n.30.

<sup>79</sup> Harbert also objects to the sale of Mountaineer because Allegheny purchased the utility in 2000 for \$323 million, 50% more than the sale price that would be received under the current proposal. Allegheny’s decision to sell at that price resulted in a write-down of its consolidated capitalization of \$36.7 million before taxes in the third quarter

by West Penn are subject to the jurisdiction of the Pennsylvania commission, and retail rates of Mountaineer are subject to the jurisdiction of the West Virginia commission. Contracts for the sale of electric energy by one registered system utility to another are subject to the jurisdiction of the Federal Energy Regulatory Commission (“FERC”). In contrast, under the definition of a sales contract under section 2(a)(20), we lack jurisdiction over rates for the sale of power.<sup>80</sup> These objections regarding rates are, thus, not relevant to the authority Allegheny is seeking and do not warrant a hearing.

(e) Ring-fencing

Harbert states that Allegheny “seems intent on making its [Utilities] and their ratepayers long-term hostages to the vagaries of Supply’s operations,” indeed, to bankruptcy.<sup>81</sup> Harbert believes that a bankruptcy would not disrupt the physical supply of electricity to the system electric utilities.<sup>82</sup> However, Harbert suggests that “tighter controls and more explicit protections” are needed to protect ratepayers and investors in

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of 2004. (Request at 8). Elsewhere, Harbert also criticizes the sale of assets “that would, if consummated, permit debt reduction but at valuations that have materially impaired Allegheny’s nominal dollar equity and the share of equity as a percentage of its capitalization.” *Id.* at 4. Applicants acknowledge that Allegheny’s continuing divestment of assets has forced it to take one-time losses in connection with these sales. Applicants counter, however, that “while these sales of non-core assets have a temporary negative impact on Allegheny’s balance sheet, they have greatly improved [the holding company’s] longer term prospects.” (Response at 16) The Commission generally agrees with this assessment. As noted previously, the sale of Mountaineer requires Commission approval.

<sup>80</sup> See *Southern Co., Holding Co.* Act Release No. 21665 (July 24, 1980), citing *City of Lafayette v. SEC*, 454 F.2d 941, 954-56 (D.C. Cir. 1971), *aff’d sub nom. Gulf States Utilities Co. v. FPC*, 411 U.S. 747, 754-55 (1973). See also *Alabama Electric Cooperative v. SEC*, 353 F.2d 905, 907 (D.C. Cir. 1965).

<sup>81</sup> Request at 10.

<sup>82</sup> *Id.* at 36.

the Utilities.<sup>83</sup> Harbert recommends that any authorizations be made contingent on ring-fencing measures “to protect the finances of the [Utilities] and the holding company from additional conscription to bail out Supply.”<sup>84</sup> Harbert has not, however, submitted material evidence suggesting that a bankruptcy of AE Supply is inevitable. And, Allegheny is lawfully engaged in the businesses of AE Supply.<sup>85</sup>

Matters of business judgment are generally entrusted to the management of registered holding company systems under the Act. Most importantly, as we have described above, other requirements of this order, including its limited duration and the requirement that the utilities maintain an adequate capitalization structure, are designed to accomplish the same goals as ring-fencing and are more consistent with the prior Allegheny orders and the Commission’s traditional approach to protecting utilities from the other businesses of utility holding companies. In the end, because the authority granted by this order would terminate if the capitalization levels of the Operating Utilities dropped below 30% or if the capitalization ratio of Allegheny or AE Supply deteriorates further, we would then be in a position to take any additional steps necessary to protect the Operating Utilities. We, therefore, do not believe that Harbert’s assertion that ring-fencing is required raises a material issue of law or fact that warrants a hearing.

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<sup>83</sup> *Id.* at 29.

<sup>84</sup> *Id.* at 29.

<sup>85</sup> As explained above, AE Supply is a public-utility company and a registered holding company under the Act. With respect to nonutility activities, Allegheny has undertaken that it will not make new non-core investments as long as its consolidated common equity remains below 30%. Specifically, neither it nor any of its subsidiaries will invest, or commit to invest, any funds in any new projects that qualify as EWGs or FUCOs under the Act or in any Rule 58 companies, other than to preserve or enhance the economic value of existing investments.

(f) 30% Equity Capitalization Ratio

Harbert asserts that it is unrealistic to think that Allegheny and AE Supply are “on course to satisfy ‘the Commission’s benchmark 30 percent common equity requirement.’”<sup>86</sup> Applicants’ projections are, however, supported by substantial evidence in the record. More importantly, as discussed elsewhere, our lack of adverse findings under section 7(d) is not based on Allegheny’s projections regarding its future capitalization levels, but rather on its current financial conditions and our ability to revisit its requests for authority should its financial condition deteriorate. Again, therefore, Harberts’ claims do not warrant a hearing.

(g) Length of Authorization Period

Harbert expresses concern generally that an Authorization Period through November 30, 2007, is too long; and that the requested order would provide too much

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<sup>86</sup> Request at 5.

Harbert further asserts that the holding company’s “improvident prepayment of AE Supply’s debt with a holding company equity issuance creates a near term liquidity crisis at the holding company level.” Allegheny has publicly committed to repay at least \$1.5 billion of debt between December 1, 2003, and December 31, 2005. As noted earlier, approximately \$1.2 billion of this amount has already been repaid. The sources of the remaining repayment will be internally generated cash from operations and proceeds from anticipated asset sales.

According to Harbert, it is unclear “where Allegheny will obtain all of the \$300 million required to retire debt due in August 2005, other than from some still conditional asset sale transactions or new borrowings.” *Id.* at 36. Examining cash flow of the Utilities, Harbert states that it “will not be close to providing for the \$300 million summer 2005 maturity.” *Id.* at 22.

The company’s attempts to repay and refinance debt that was incurred when its financial situation was far more critical than it is now refutes Harbert claims that the debt of Allegheny and AE Supply is risky, with a large floating exposure. Harbert criticizes, among other things, Applicants’ “reliance on unusually aggressive debt markets and low interest rates to provide continued access to debt on attractive terms, much at floating rates.” Request at 5. The Response at 8 notes that, at December 31, 2004, the net

flexibility to the Applicants.<sup>87</sup> While Allegheny's capitalization levels remain below acceptable conditions, we agree that careful review and monitoring of its situation is warranted. Our order, therefore, approves the proposed transactions for a fourteen-month period. Specifically, the order approves certain specific transactions in certain aggregate dollar amounts through June 30, 2006, and reserves jurisdiction over proposed transactions after that date and through the end of the Authorization Period.

(h) Management Decisions

Harbert voices criticism of several decisions taken by the new Allegheny management. Among other things, Harbert complains that dividends from the four Utilities have not gone to increase equity value at the operating company or holding company level nor have they been used to pay shareholders.<sup>88</sup> Harbert also contends that the decision by Allegheny to prepay debt of AE Supply was an erroneous decision and this money should have been used to fund capital expenditures at AE Supply that could reduce potential financial liabilities under the Clean Air Act.<sup>89</sup> Harbert suggests that Allegheny wants to "shift the burden for these costs to retail ratepayers."<sup>90</sup> And, Harbert

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floating rate debt (floating rate debt net of cash and interest rate swaps) was approximately 10%. The Commission rejects Harbert's characterization of the debt.

<sup>87</sup> Request at 2.

<sup>88</sup> "Indeed, Allegheny dividends have been terminated because of Supply's problems, with serious consequences for Allegheny stock values." Request at 32.

<sup>89</sup> Harbert states that on May 20, 2004, the Attorneys General of New York, New Jersey and Connecticut, and the Pennsylvania Department of Environmental Protection Agency notified Allegheny of their intention to bring an action claiming violations of the Clean Air Act. The notice indicated that the Attorneys General would be willing to discuss a settlement. *Id.* at 24. In communications with the investment community, Allegheny management estimated the cost of compliance expenditures to be about \$1.3 billion. *Id.* at 25.

<sup>90</sup> *Id.* at 26. In Harbert's view, "The result is that the *Operating Utilities* will hold *increased downside risk* associated with fixed cost funding of Supply's environmental

states that equity investors in the holding company have benefited from the support of the Utilities' equity value to fund an equity investment in Supply.<sup>91</sup> Harbert refers to a private placement by Allegheny on October 4, 2004, of 10 million of its common shares at \$15.15 per share. On November 4, 2004, Allegheny used the \$150 million of stock proceeds and \$50 million of cash on hand to repay \$200 million of AE Supply's term loans. Harbert suggests that instead of this private placement, Allegheny should have elected to sell equity in AE Supply to de-leverage the subsidiary.<sup>92</sup> These various criticisms all go to matters of business judgment. As a general matter, the Act "does not require the Commission generally to review planning and management decisions."<sup>93</sup> Rather, the Act requires the Commission to approve proposed transactions that satisfy the applicable statutory standards.<sup>94</sup> Hence, unless these actions somehow affect whether adverse findings are required under section 7(d), we do not believe that they need to be reviewed here. Harbert has not shown why they should affect our 7(d) analysis. We, thus, do not believe these issues raise a material issue of law or fact.

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equipment and *Supply* will have the *upside benefits* of improved asset values on its generating plants, and the greater potential to sell emission credits." (emphasis in original) *Id.*

<sup>91</sup> *Id.* at 8.

<sup>92</sup> *Id.* at 7.

<sup>93</sup> *Xcel Energy, Inc., Holding Co. Act Release No. 27533 (May 30, 2002)* (citations omitted).

<sup>94</sup> *Id.*

VI. Fees and Expenses; Jurisdiction

Fees, commissions and expenses incurred or to be incurred in connection with this Application will be approximately \$100,000.

No state or federal commission other than the Commission has jurisdiction with respect to any of the proposed transactions for which authority is sought in this Application.

VII. Rule 54 Analysis

Rule 54 under the Act states that in determining whether to approve the issuance or sale of a security by a registered holding company for purposes other than the acquisition of an EWG or a FUCO or approve other transactions by the registered holding company or its subsidiaries, other than with respect to EWGs or FUCOs, the Commission shall not consider the effect of the capitalization or earnings of any subsidiary which is an EWG or a FUCO upon the registered holding company system if rules 53(a), (b), or (c) are satisfied.

Allegheny does not satisfy the requirements of rule 53(a)(1). In the Original 2001 Financing Order, the Commission authorized Allegheny to invest up to \$2 billion in EWGs and FUCOs. As of December 31, 2004, Allegheny's "aggregate investment," as defined in rule 53(a)(1), was approximately \$130 million. Allegheny is no longer in compliance with the financing conditions set forth in the Original 2001 Financing Order since its common equity ratio is below 30%. As a result, Allegheny is no longer able to make any investments in EWGs and FUCOs without further authorization from the Commission.

Allegheny currently complies with, and will comply with, the requirements of rule 53(a)(2), 53(a)(3) and 53(a)(4). None of the circumstances described in 53(b)(1) has

occurred. The circumstances described in rule 53(b)(2) and 53(b)(3) have occurred. Allegheny submits that the requirements of rule 53(c) are met. Allegheny maintains that the requested authorization will not have a substantial adverse impact upon the financial integrity of Allegheny, the Operating Utilities, or Mountaineer. Moreover, the Operating Utilities, Mountaineer, and their customers will not be adversely impacted by the requested relief. The ratio of common equity to total capitalization of each of the Operating Utilities and Mountaineer will continue to be maintained at not less than 30%. In addition, each of the Operating Utilities and Mountaineer is subject to regulation by state commissions that are able to protect utility customers within their respective states.

#### VIII. Reporting Requirements

Allegheny proposes to file rule 24 certificates of notification quarterly, within 60 days after the end of each of the first three calendar quarters and 90 days after the end of the last calendar quarter in which transactions occur. The certificates will contain all information specified below and will include a representation that each transaction described in the certificate was carried out in accordance with the terms and conditions described, and for the purposes represented, in this Application. That portion of any reports filed under the Securities Act of 1933 and the Securities Exchange Act of 1934, containing or reflecting disclosures of transactions occurring under the authorization granted in this order, may be incorporated by reference into the proposed rule 24 certificates. Allegheny also proposes that the rule 24 certificates will include information with respect to all securities issuances that are exempt under rule 52, and that the rule 24 certificates containing this information will be in lieu of any separate certificates required on Form U-6B-2 under rule 52. The rule 24 certificates of notification will contain the following information:

- (a) If sales of common stock by Allegheny are reported, the purchase price per share and the market price per share at the date of the agreement of sale;
- (b) The total number of shares of common stock issued during the quarter, contributed to Allegheny's pension plan and any employee benefit or executive compensation plans adopted after the issuance of the Commission's order in this proceeding;
- (c) If a guarantee or other form of credit support is issued during the quarter, the name of the issuing company, the name of the subsidiary to which the issuance pertains, and the amount, terms and purpose of the guarantee or other form of credit support;
- (d) The amount and terms of any short-term debt issued by Allegheny during the quarter;
- (e) The amount and terms of any financings not exempt under rule 52 by any Operating Utility during the quarter;
- (f) The amount and terms of any financings not exempt under Rule 52 consummated by AE Supply or any Nonutility Applicant during the quarter;
- (g) The amount and terms of any financings by any Operating Utility during the quarter that are exempt under rule 52;
- (h) The amount and terms of any financings by AE Supply or any Nonutility Applicant during the quarter that are exempt under rule 52;
- (i) The notional amount and principal terms of any instruments to hedge interest rate or currency risk entered into during the quarter and the identity of the parties to these instruments;
- (j) The name, parent company and amount invested in any new intermediate company or Capital Corp during the quarter;
- (k) Future registration statements filed under the Securities Act of 1933 with respect to securities that are the subject of this Application will be filed (or incorporated by reference) as exhibits to the next certificate filed under rule 24.

IX. Conclusion

Due notice of the filing of this Application has been given in the manner prescribed in rule 23 under the Act, and no hearing has been ordered by the Commission. Based on the facts in the record, the Commission finds that, except as to those matters over which jurisdiction has been reserved, the applicable standards of the Act and rules are satisfied and that no adverse findings are necessary.

IT IS ORDERED, under the applicable provisions of the Act and the rules under the Act, that, except as to those matters over which jurisdiction has been reserved, the Application, as amended, be granted and permitted to become effective immediately, subject to the terms and conditions prescribed in rule 24 under the Act and the reporting requirements under rule 24 listed above.

IT IS FURTHER ORDERED that jurisdiction is reserved, pending completion of the record, over:

- (i) all authority granted in this order after June 30, 2006;
- (ii) all authority granted in this order when the common stock equity ratios of the following companies, as described above, fall below the stated levels: Allegheny, on a consolidated basis, 21%; AE Supply, on a consolidated basis, 16%; the Operating Utilities, 30%.
- (iii) all authority granted in this order at any time that Allegheny, AE Supply, the Utility Applicants, Allegheny Energy Solutions, Inc., or Allegheny Ventures, Inc., are in bankruptcy.

(iv) the remaining balances of the External Equity Cap, the External Debt Cap, and the Dividend Cap, as described above, after June 30, 2006, and during the remainder of the Authorization Period;

(v) the issuances of secured long-term debt securities by Allegheny and the Nonutility Applicants, as described above;

(vi) authority for AE Supply to engage in intra-system financings with Allegheny and the Nonutility Applicants; and

(vii) additional investment by Applicants in EWGs, FUCOs, and Rule 58 Companies, as described above, when Allegheny's common equity ratio is below 30%.

IT IS FURTHER ORDERED that the request for a hearing be, and hereby is, denied.

By the Commission.

J. Lynn Taylor  
Assistant Secretary

## Appendix A

The following chronology of ratings agency activity with regard to the Applicants shows improvement since 2003:

- May 8, 2003: S&P lowered its corporate credit rating for Allegheny, AE Supply and other subsidiaries from BB- to B; and all ratings were removed from Credit Watch and placed on negative outlook. S&P quoted a reliance on asset sales to bolster liquidity under challenging industry conditions as the basis for its negative outlook. AE Supply's senior unsecured rating was downgraded to CCC+.
- July 1, 2003: Moody's downgraded Allegheny's and AE Supply's senior unsecured ratings to B2 from B1 and B3 from B1. The ratings of the system Operating Utilities were also downgraded, with all ratings under review for possible further downgrade. Moody's ratings reflected its concerns about (1) Allegheny's liquidity and limited financial flexibility in the near and intermediate term, (2) weak operating cash flow relative to consolidated debt levels, (3) pressures on cash flow and earnings due to renegotiated power sales contracts (*i.e.*, a certain power supply contract with the electricity buyer for the State of California that was sold to J. Aron & Company on September 15, 2003), and (4) execution risk with Allegheny's plan to meet the debt repayment schedule and strengthen its balance sheet.
- January 28, 2004: Moody's affirmed the ratings of Allegheny, AE Supply and other subsidiaries and moved the outlook to stable. On February 12, 2004, Moody's assigned ratings to the company's new loan facilities (*i.e.*, the agreements that Allegheny and AE Supply entered into on March 8, 2004 with various credit providers to refinance and restructure the bulk of their bank debt), and upgraded AE Supply's Statutory Trust Secured Debt to B1 from B2.
- February 12, 2004: Moody's assigned credit ratings to the New Loan Facilities and upgraded AE Supply's Statutory Trust Secured Debt to B1 from B2.
- February 12, 2004: Fitch affirmed the ratings of Allegheny, AE Supply and other subsidiaries, while moving the outlook to stable. In addition, Fitch assigned ratings to the New Loan Facilities and upgraded AE Supply's Statutory Trust Secured Debt to BB- from B+.

- February 17, 2004: S&P reaffirmed its ratings, revised the outlook from negative to stable and provided ratings for the New Loan Facilities of Allegheny and AE Supply.
- May 26, 2004: Fitch revised Monongahela's outlook to negative from stable.
- August 13, 2004: S&P upgraded its credit rating of Allegheny to B+ from B. In addition, S&P upgraded its credit ratings of the majority of Allegheny's subsidiaries one notch and revised the outlook of Allegheny and its subsidiaries from stable to positive.
- September 10, 2004: Fitch revised Monongahela's outlook to stable from negative.
- February 17, 2005: S&P upgraded its credit rating of AE Supply's Term B Loan (referred to as the Refinanced AE Supply Loan) and the secured portion of the Amended A-Notes to BB from B+. S&P's outlook for Allegheny and its subsidiaries remains positive.
- February 24, 2005: S&P upgraded its credit rating for Allegheny's senior unsecured debt from B2 to B1. Moody's also upgraded its credit rating for AE Supply's senior secured debt from B1 to Ba3 and upgraded its credit rating for AE Supply's unsecured debt from B3 to B2. Moody's also upgraded its credit rating for AGC's unsecured debt from B3 to B2. Moody's also upgraded its outlook for Monongahela, Potomac Edison and West Penn to positive from stable, making the rating outlook for all of Allegheny's rated system companies positive.
- February 25, 2005: Fitch revised its outlook of Allegheny, AE Supply and AGC from stable to positive.