

BEFORE THE CORPORATION COMMISSION OF OKLAHOMA

APPLICATION OF PUBLIC SERVICE OF §  
OKLAHOMA FOR COMMISSION §  
AUTHORIZATION OF A PLAN AND §  
COST RECOVERY OF ACTIONS OF PSO §  
TO BE IN COMPLIANCE WITH CERTAIN §  
ENVIRONMENTAL RULES §  
PROMULGATED BY THE UNITED §  
STATES ENVIRONMENTAL §  
PROTECTION AGENCY; SUCH §  
ACTIVITIES INCLUDE, BUT NOT §  
LIMITED TO, CAPITAL EXPENDITURES §  
FOR EQUIPMENT AND FACILITES; §  
CONSTRUCTION OR PURCHASE OF AN §  
ELECTRIC GENERATING FACILITY OR §  
ENTER INTO A LONG-TERM PURCHASE §  
POWER CONTRACT (AND POSSIBLE §  
EARNING ON THE CONTRACT); §  
CHANGE IN DEPRECIATION RATES §  
AND/OR ESTABLISHMENT AND §  
RECOVERY OR A REGULATORY §  
ASSET; AND FOR SUCH OTHER RELIEF §  
AS THE COMMISSION DEEMS PSO IS §  
ENTITLED. §

CAUSE No. PUD 201200054

**FILED**  
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CORPORATION COMMISSION  
OF OKLAHOMA

RESPONSIVE TESTIMONY OF  
DANIEL J. LAWTON  
ON BEHALF OF  
OKLAHOMA INDUSTRIAL ENERGY CONSUMERS  
JANUARY 8, 2013

Responsive Testimony of Daniel J. Lawton

Cause No. 201200054

RESPONSIVE TESTIMONY OF DANIEL J. LAWTON  
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26 above the actual cost associated with PSO entering into and employing the capacity and  
27 energy of the Calpine Oneta, LLC purchase power contract (“Calpine Contract” or  
28 “Contract”). More specifically, my testimony addresses the claims made in the direct  
29 testimony of Company witness Allen W. Decker that suggest that the Oklahoma  
30 Corporation Commission (“Commission”) denial of the Company’s request would:

- 31 • Represent another significant long-term earnings loss for PSO;
- 32 • Cause PSO’s annual earnings to be on average some \$11 million less;
- 33 • Cause PSO’s financial ratios to be less favorable than they might  
34 otherwise be; and
- 35 • Without earnings on this Contract, result in reduced cash flow and funds  
36 from operations, which means, all other things being equal, that the  
37 financial rating agencies will view PSO as a riskier investment.

38  
39 As is fully explained in detail in the following pages, Mr. Decker’s claims of lost  
40 earnings, reduced cash flows, increased risks and the need for additional earnings are not  
41 only unsupported by evidence, but are based on the false narrative of lost opportunity  
42 and should be rejected. I should note that another OIEC witness, Mr. Mark Garrett will  
43 address the general policy concerns raised by the Company’s proposal to collect  
44 earnings on the Contract. To avoid duplication of effort, my testimony is generally  
45 focused on the financial and risk claims raised by Mr. Decker’s testimony

46 **Q. WHAT MATERIALS DID YOU REVIEW AND RELY ON FOR THIS TESTIMONY?**

47 **A.** I have reviewed Mr. Decker’s direct testimony in this Cause and his previous testimony  
48 on this topic in PUD 201200079, Company responses to data requests, Value Line  
49 Investment Survey (“Value Line”), financial reports of the Company along with other  
50 utility companies, and various other financial information available in the public  
51 domain. When relying on various sources, I have referenced such sources in my  
52 testimony and/or attached Schedules and included copies or summaries in my Schedules  
53 or workpapers.

54 SECTION II: Overview of Company Request

55 Q. PLEASE SUMMARIZE YOUR UNDERSTANDING OF THE COMPANY'S  
56 REQUEST IN THIS CASE?

57 A. As I understand the Company's request, PSO is requesting that it be allowed additional  
58 annual earnings of \$3 million and to increase rates \$5 million annually (to recover \$3  
59 million in added earnings and \$2 million in added taxes on those earnings).<sup>1</sup> The  
60 Company's request does not result from increased costs in connection with providing  
61 service to its customers. Instead, the Company's request is to add phantom costs to the  
62 Calpine Contract so that such earnings on the Contract will flow to the bottom line  
63 equity component of PSO's books.

64 PSO claims that if they had built a power plant rather than entering into a firm purchase  
65 power agreement, PSO's earnings would be on average \$11 million higher annually.<sup>2</sup>  
66 PSO maintains that the decision to enter the lower cost purchase power agreement rather  
67 than the higher cost build a plant option results in:

- 68
- 69 • A loss of \$11 million in earnings annually;
  - 70 • Less favorable financial ratios;
  - 71 • Reduced cash flow;
  - 72 • Reduced funds from operation (FFO); and
  - 73 • Increased risks to PSO.<sup>3</sup>

74 Mr. Decker points out that this request is similar to PSO's request in Cause No. PUD  
75 201200079,<sup>4</sup> wherein PSO requested \$11 million in additional annual earnings and a  
76 total rate adjustment of \$17.9 million to recoup taxes on those earnings.<sup>5</sup>

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<sup>1</sup> Direct Testimony Alan Decker at 8:20-22

<sup>2</sup> ID at 3:12.

<sup>3</sup> ID at 3:15-22.

<sup>4</sup> ID at 4:1-4.

<sup>5</sup> Cause No. PUD 201200079, Decker direct testimony at 18:6-10

78 Q. HOW DID PSO ARRIVE AT THE \$ 3 MILLION ANNUAL EARNINGS INCREASE  
79 IN THIS CASE?  
80

81 A. Mr. Decker's direct testimony states; "...PSO's request is based on a comparison of the  
82 foregone earnings PSO will experience and the cost savings associated with the Calpine  
83 Contract in comparison to the costs of a build alternative."<sup>6</sup> PSO claims that the contract  
84 will average about \$5 million in lower costs per year (in annual fixed costs) over the 15-  
85 year contract period.<sup>7</sup> PSO is requesting that earnings on the Contract be increased to  
86 \$5 million to collect the \$3 million in earnings and associated taxes.<sup>8</sup> Thus, the Company  
87 proposes to increase its earnings and resulting customer rates just enough to capture the  
88 entirety of projected customer fixed cost savings under the Calpine Contract. The  
89 Company proposes to retain these purchase power savings for shareholders rather than  
90 lowering customer bills.  
91

92 Q. DOES THE COMPANY CLAIM THAT THERE WILL BE FINANCIAL HARM IF  
93 THE REQUESTED INCREASE IN EARNINGS (SHAREHOLDER PROFIT) IS  
94 DENIED?  
95

96 A. Yes. First, Mr. Decker asserts that without earnings on purchase power contracts, PSO  
97 earnings will be less than earnings of similar type and risk investments in the same  
98 general locality.<sup>9</sup> Unfortunately Mr. Decker fails to explain that investor returns may in  
99 fact be the same for PSO and other similarly situated entities, and, instead, focuses on  
100 the meaningless metric of absolute scale of earnings. I address this issue in the next  
101 section of my testimony.  
102

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<sup>6</sup> Direct Testimony Alan Decker at 9:1-3

<sup>7</sup> Id at 9:10-11

<sup>8</sup> \$3 Million in earnings times (1.6308 state and federal tax conversion factor) = \$4.89 Million or approximately \$5 Million annual rate increase to customers.

<sup>9</sup> Direct Testimony Alan Decker at 8:11-18

103           Second, Mr. Decker asserts that allowing an additional \$3 Million of annual  
104 earnings for PSO will increase equity return by a “relatively modest” 34 basis points.<sup>10</sup>  
105 What Mr. Decker fails to mention is that a regulated utility’s equity return is set in a  
106 base rate proceeding where all current market data on capital costs is considered along  
107 with all revenue and cost increases and decreases. Taking one element of the rate model  
108 and employing a piecemeal adjustment in isolation is not appropriate ratemaking,  
109 irrespective of the size of the adjustment.

110           Third, without evidence or analysis presented, Mr. Decker claims that without  
111 earnings on this purchase power agreement PSO will have reduced cash flow and be  
112 viewed by financial rating agencies as a riskier investment. <sup>11</sup> As I discuss below, rating  
113 agency evaluations of credit risk associated with purchase power contracts consider cost  
114 recovery mechanisms in place to recover the actual costs of these contracts. Given the  
115 absence of allowed returns or earnings adder on such contracts, I have found no rating  
116 agency report ever addressing this issue. No evidence has been presented which supports  
117 Mr. Decker’s claim of potential financial harm resulting from financial rating agencies  
118 analyses.

119  
120 **SECTION III:           General Comments on PSO Request**  
121

122  
123 **Q.     DO YOU HAVE ANY GENERAL COMMENTS AND RESPONSES TO THE**  
124 **CLAIMS CONTAINED IN MR. DECKER’S DIRECT TESTIMONY?**

125  
126 **A.**    Yes, I have a number of comments. At page 6 lines 3-7 of Mr. Decker’s direct  
127 testimony, he argues in support of a regulatory allowance of earnings on long-term  
128 purchase power contracts and makes the following two general conclusions:

- 129                           1. “By law, PSO should be allowed to earn on its entire power  
130                           portfolio- not just the physical asset portion of its portfolio,” and  
131                           2. “Without earnings on its long-term, firm purchased power  
132                           contracts, PSO would only be earning on two-thirds of its power

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<sup>10</sup> Id at 10:5-9

<sup>11</sup> Id at 3:19-22

133 portfolio and its overall earnings would accordingly be  
134 unreasonable.”

135

136 Mr. Decker’s theory is that utility regulators should base rates not on costs and return on  
137 used and useful investment, but instead on the size and attributes of a utility’s power  
138 portfolio. However, an electric utility’s power portfolio is not indicative of cost and/or  
139 earnings requirements. No public utility commission, to my knowledge, sets rates based  
140 on the size of a utility’s power portfolio. Instead, regulators look to utility costs as the  
141 basis of the rate setting model.

142 Typically, regulators are authorized to establish rates that are fair, just and  
143 reasonable. Such rates allow the utility to recover reasonable and necessary operating  
144 expenses plus an opportunity to earn a reasonable return on the utility’s used and useful  
145 invested capital in providing service to customers. The size or capability of the power  
146 portfolio in and of itself has no relationship to cost and/or setting rates and charges. It is  
147 the utility’s funding of used and useful capital investment such as debt, preferred stocks  
148 and common equity that creates costs such as interest, preferred dividends and a  
149 percentage equity return that needs to be recovered in the rate making process. The size  
150 of the utility’s power portfolio relative to owned-generation, purchased power or another  
151 utility’s generation portfolio is an irrelevant measure when establishing fair, just and  
152 reasonable rates.

153

154 **Q.** DO RATING AGENCIES SUCH AS STANDARD & POOR’S OR MOODY’S  
155 EVALUATE FINANCIAL RISK OF A UTILITY BASED ON THE SIZE OF THE  
156 UTILITY’S POWER PORTFOLIO?

157

158 **A.** No. Rating agencies such as Standard & Poor’s and Moody’s do not employ the size of  
159 the utility’s power portfolio as a financial metric. Instead, rating agencies look to cost  
160 recovery and its timing and various earnings, interest and debt metrics when evaluating  
161 risks and ratings. I discuss rating agency evaluation methods in detail in Section IV

162 of this testimony. Thus, it is return on investment- not return on generation portfolio size  
163 or capacity that forms the basis of rate setting by regulators and financial risk evaluation  
164 by financial analysts, investors and rating agencies.

165

166 **Q.** EARLIER YOU STATED MR. DECKER'S CLAIMS OF LOST EARNINGS,  
167 REDUCED CASH FLOWS AND RESULTING INCREASED RISKS TO PSO ARE  
168 BASED ON A "FALSE NARRATIVE" PLEASE EXPLAIN?

169

170 **A.** Mr. Decker asserts that because of the availability of lower cost purchase power, PSO is  
171 unable to invest capital into self-build generation and earn returns on this capital  
172 investment opportunity. The PSO self-build generation is simply not competitive with  
173 the purchase power alternatives. Mr. Decker's analysis shows purchase power to be \$5  
174 million per year less expensive for customers. Based on the above background, Mr.  
175 Decker asserts lost earnings or a lost opportunity for PSO to earn more. Because PSO  
176 will pursue the lower cost option of purchase power, PSO will not earn approximately  
177 \$11 million per year on the non-competitive self-build generation. He then claims that  
178 PSO should be able to retain the \$5 million of customer savings as added earnings and  
179 taxes on those earnings because of PSO's lost opportunity.

180 However, once the analysis showed the Calpine Contract was a lower cost  
181 alternative, the self build scenario ceased to be an option or opportunity available to  
182 PSO. There is no lost opportunity, or lost earnings or increased risk. Building more  
183 costly plants to increase shareholder earnings is not the behavior of prudent  
184 management.

185

186 **Q.** WHAT WOULD THE ECONOMIC CONSEQUENCES BE OF IGNORING  
187 ECONOMIC REALITY AND SELECTING A MORE COSTLY OPTION SUCH AS  
188 THE SELF-BUILD APPROACH?

189

190 **A.** In competitive (non-regulated) markets, the selection of the more costly production  
191 process allows your competitors to under price your product and take your market share.

192 In regulated markets which are a substitute for competition, regulatory authorities  
193 disallow imprudent investment from rates. The consequences of ignoring the economic  
194 reality associated with the more costly self build approach is that costs would ultimately  
195 be disallowed and these projected \$11 million of earnings opportunity would never have  
196 been allowed in customer rates. The bottom line is that there is no lost opportunity, or  
197 lost earnings or increased risks.

198

199 **Q.** AT PAGE 8, LINES 8-18 OF MR. DECKER’S TESTIMONY, HE ARGUES THAT  
200 PSO’S RELIANCE ON LOW COST PURCHASE POWER CONTRACTS CAUSES  
201 PSO’S EARNINGS TO NOT “BE EQUAL TO OTHERS IN THE SAME GENERAL  
202 LOCALITY IN BUSINESS UNDERTAKINGS ATTENDED BY SIMILAR RISKS”,  
203 DO YOU AGREE?

204

205 **A.** Absolutely not. Mr. Decker’s argument and conclusions are just plain wrong. Here, Mr.  
206 Decker changes the basis of his argument from the size of the generation portfolio to  
207 actual generation investment. He correctly concludes a firm such as the Oklahoma Gas  
208 and Electric Company (“OGE”) with double the generation investment as PSO will  
209 likely have twice the earnings as PSO- all else equal. But, he fails to mention that OGE  
210 will likely have twice the interest obligation and return requirements for investors- all  
211 else equal. It is not the absolute amount of earnings that needs to be comparable in  
212 “...business undertakings attended by similar risks”<sup>12</sup>. Instead, it is the percentage return  
213 on investment an investor can expect in “...business undertakings attended by similar  
214 risks” that is important.

215 Thus, an investor who looks at putting an investment in OGE or PSO will be  
216 indifferent if the investor expects a 10% return from either investment (all else equal)  
217 even though OGE may have twice the generating asset level (and twice the earnings) as  
218 PSO. Mr. Decker’s analysis and conclusions are misguided and do not reflect the  
219 analysis of a rational investor.

220

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<sup>12</sup> Direct Testimony of Alan Decker at 8:16-18.  
Responsive Testimony of Daniel J. Lawton

221 SECTION IV: Business and Financial Risk Assessments by Credit Rating Agencies

222 Q. WHAT ISSUE DO YOU ADDRESS IN THIS SECTION OF YOUR TESTIMONY?

223 A. In this section, I address business and financial risk assessments of utility operations  
224 from the perspective of credit rating agencies such as S&P and Moody's. Credit rating  
225 agencies evaluate utility creditworthiness and risks by assessing the regulatory  
226 environment, business risk, financial risk, along with expectations of the future. It is  
227 important to consider all risk attributes and evaluations in determining risk and cost of  
228 capital. What is important to note is that Mr. Decker's overall theory of lost opportunity  
229 to earnings or opportunity costs is not part of the overall risk assessment by credit rating  
230 agencies.

231 Q. HOW DO CREDIT RATING AGENCIES SUCH AS S&P, MOODY'S AND FITCH  
232 EVALUATE UTILITY RISK AND ASSESS CREDITWORTHINESS FOR  
233 PURPOSES OF BOND RATINGS?

234 A. Generally, ratings agencies review utilities risk and creditworthiness employing a range  
235 of both qualitative and quantitative factors. One of the better explanations and outlines  
236 of the rating evaluation process for utility companies was published by Moody's  
237 Investor Services in August 2009 entitled "Infrastructure Finance: Ratings Methodology:  
238 Regulated Electric and Gas Utilities."

239 In this Moody's publication, Moody's identifies four factors and nine sub-factors that  
240 are key to identifying and differentiating credit risk in the electric and gas regulated  
241 utility sector.<sup>13</sup> The four factors and the general weights applied to each of the ratings  
242 evaluation factors are as follows:

243

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<sup>13</sup> Moody's Investor Services; Ratings Methodology: Regulated Electric and Gas Utilities (August 2009) at 1.  
Responsive Testimony of Daniel J. Lawton

244

|     |                                   |      |
|-----|-----------------------------------|------|
| 245 | 1) Regulatory Framework           | 25%  |
| 246 | 2) Ability to Recover Costs       | 25%  |
| 247 | 3) Diversification                | 10%  |
| 248 | 4) Financial Strength & Liquidity | 40%  |
| 249 | Total                             | 100% |

250 Each of these main factors and sub factors (discussed below) is evaluated and assigned a  
 251 numeric score related to a particular bond rating of 1=Aaa to 15=B.<sup>14</sup> These numeric  
 252 factors are combined with the weighting for each category and combined with other  
 253 factor categories to arrive at a composite score.<sup>15</sup> The composite score is then mapped  
 254 with a bond rating to arrive at an indicated bond rating as shown in the following table:

| Table 1 <sup>16</sup>          |                               |
|--------------------------------|-------------------------------|
| Moody's Composite Rating Index |                               |
| Indicated Rating               | Average Weighted Factor Score |
| Aaa                            | <1.5                          |
| Aa1                            | 1.5<2.5                       |
| Aa2                            | 2.5<3.5                       |
| Aa3                            | 3.5<4.5                       |
| A1                             | 4.5<5.5                       |
| A2                             | 5.5<6.5                       |
| A3                             | 6.5<7.5                       |
| Baa1                           | 7.5<8.5                       |
| Baa2                           | 8.5<9.5                       |
| Baa3                           | 9.5<10.5                      |

255 **Q.** PLEASE EXPLAIN THE FACTORS “REGULATORY FRAMEWORK” AND HOW  
 256 IT IS EVALUATED AND QUANTIFIED.

257 **A.** This “Regulatory Framework” factor is one evaluated based on predictability and  
 258 supportiveness.<sup>17</sup> Considerations involve such factors as; (i) track record of  
 259 predictability, (ii) stability in regulatory decision making and (iii) development of the

<sup>14</sup> *Id* at 5

<sup>15</sup> *Id*

<sup>16</sup> *Id* Only investment grade bonds above baa3 are presented herein.

<sup>17</sup> *Id* at 6

260 regulatory framework and regulator's authority over utility regulatory issues.<sup>18</sup> This  
261 factor is a qualitative judgment made by the rating analyst utilizing a defined set of  
262 guidelines for the evaluation and rating of the "Regulatory Framework." I have included  
263 in Appendix A the summary guidelines for this factor as provided by Moody's.

264 **Q.** HOW DOES MOODY'S RATE PSO'S "REGULATORY FRAMEWORK"?

265 A. Based on the early 2012 Moody's Credit Opinion for PSO, the Oklahoma "Regulatory  
266 Framework" is viewed as a generally credit – supportive framework, and this ratings  
267 factor received a score of Baa from Moody's analysis.<sup>19</sup> The solid Baa rating is  
268 consistent with PSO's current rating and continued financial integrity.

269 **Q.** PLEASE DESCRIBE HOW RATINGS FACTOR 2 "ABILITY TO RECOVER COSTS  
270 AND EARN RETURNS" IS EVALUATED FOR CREDITWORTHINESS.

271 A. This ratings consideration is more utility specific than Regulatory Framework discussed  
272 above in that the utility's ability to recover costs and earn a return are the variables  
273 subject to consideration.<sup>20</sup> Based on Moody's guidelines, the evaluation considers "...the  
274 statutory protections that are in place to insure full and timely recovery of prudently  
275 incurred costs."<sup>21</sup> (emphasis added) Moody's specifically states; ". . . cost recovery or  
276 pass through provisions exist and where there have been only limited instances of  
277 regulatory challenges or delays in cost recovery, a utility would likely receive a score of  
278 A for this factor."<sup>22</sup>

279 It is important to note that where regulated utilities have unregulated operations  
280 in competitive non-regulated business they "...will likely be more at risk in passing on

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<sup>18</sup> *Id* at 6

<sup>19</sup> Moody's Investor Services; Credit Opinion: Oklahoma Public Service Company, (February 8, 2012) at 2 and 4.  
This report is included in Appendix B.

<sup>20</sup> *Id* at 7

<sup>21</sup> *Id* at 7

<sup>22</sup> *Id* at 8

281 costs, and thus would receive lower scores.”<sup>23</sup> I have included in Appendix A rating  
282 guidelines for this factor.

283 **Q.** HOW IMPORTANT ARE COST RECOVERY PROVISIONS FOR UTILITY  
284 RATINGS AND CREDIT QUALITY?

285 **A.** While this ratings factor includes a 25 percent weight in the overall rating evaluation,  
286 Moody’s states; “[a] utility’s ability to recover its costs and earn an adequate return are  
287 among the most important analytical considerations when assessing utility credit quality  
288 and assigning credit ratings.”<sup>24</sup> Moody’s further states that a high allowed return on  
289 equity is a “potentially misleading indicator,”<sup>25</sup> and cannot be viewed in isolation, but  
290 “...must be viewed in relation to a utility’s cost recovery provisions that impact actual  
291 earned return...”<sup>26</sup> Moody’s goes on to state that “...this is one of several reasons why  
292 both allowed and requested ROE’s have trended downward...”<sup>27</sup>

293 In terms of cost recovery mechanisms and cost trackers, Moody’s points to (i) fuel and  
294 purchased power recovery clauses,<sup>28</sup> (ii) use of forecasted test years,<sup>29</sup> (iii) decoupling of  
295 volumes<sup>30</sup> as a few mechanisms supportive of credit quality.

296 In summary, among the factors considered when assessing credit quality and risk is the  
297 ability of a utility to earn its authorized return.<sup>31</sup> Regulatory authorities that employ  
298 regulatory mechanisms to enhance or assure revenue recovery for regulated utilities will  
299 result in higher credit ratings.

300

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<sup>23</sup> *Id*

<sup>24</sup> *Id* at 8

<sup>25</sup> Moody’s Investor Services: Cost Recovery Provisions Key to Investor Owned Utility Ratings and Credit Quality; Special Comment (June 18, 2010) at 1

<sup>26</sup> *Id*

<sup>27</sup> *Id*

<sup>28</sup> *Id* at 5

<sup>29</sup> *Id* at 8

<sup>30</sup> *Id* at 11

<sup>31</sup> *Id* at 13

301 Q. HOW DOES MOODY'S RATE PSO'S ABILITY TO RECOVER COSTS AND EARN  
302 RETURNS?

303 A. Based on the Moody's credit analysis contained in Appendix B, the Company score is a  
304 Baa. Again, PSO's rating for this second factor is consistent with the current bond  
305 rating.

306 Q. PLEASE DESCRIBE HOW RATINGS FACTOR 3 "DIVERSIFICATION" IS  
307 CONSIDERED AND EVALUATED FOR CREDITWORTHINESS.

308 A. Moody's "Diversification" factor is weighted at 10% and looks to the diversity in  
309 business operations, markets, geographic regions, regulatory authorities, generating  
310 plants and fuel sources.<sup>32</sup> The risk concern is whether there is risk mitigation if one part  
311 of the operations incurs a negative impact to one or more parts of business operations. I  
312 have included in Appendix A the Moody's ratings guidelines for this "Diversification"  
313 factor.

314 Q. WHAT TYPE OF SCORE DID PSO RECEIVE FOR THE DIVERSIFICATION  
315 FACTOR?

316 A. Based on the Moody's credit analysis contained in Appendix B, the Company credit  
317 score for Factor 3, Diversification is Baa, consistent with the Baa bond rating.

318 Q. PLEASE DESCRIBE HOW RATINGS FACTOR 4 "FINANCIAL STRENGTH AND  
319 LIQUIDITY" IS EVALUATED FOR DETERMINING CREDIT RISK.

320 A. A utility's financial ratios or metrics are key factors in evaluating credit quality. Thus,  
321 this factor has a 40% weighting factor in the overall weighting and evaluation analysis.  
322 Moody's evaluates liquidity along with access to funding sources as well as four key  
323 financial ratios or metrics.<sup>33</sup> These four metrics are (i) cash from operations plus interest  
324 divided by interest; (ii) cash from operations divided by debt capital; (iii) cash from  
325 operations less dividends divided by total debt; and (iv) debt divided by total

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<sup>32</sup> Moody's Investor Services; Ratings Methodology: Regulated Electric and Gas Utilities (August 2009) at page 9.

<sup>33</sup> *Id* at 11

326 capitalization. Liquidity is given a 10% weight while the four financial metrics are  
327 weighted at 7.5% each.

328 I have included in Appendix A a summary of the ratings guidelines for each financial  
329 metric.

330 **Q.** HOW DID PSO SCORE UNDER MOODY'S EVALUATION OF FACTOR 4,  
331 FINANCIAL STRENGTH, AND LIQUIDITY?

332 **A.** Based on the credit report by Moody's for PSO which is included in Appendix B the  
333 Moody's Factor 4 forward looking view is as follows:

|     |                                |                |     |
|-----|--------------------------------|----------------|-----|
| 334 | a.) Liquidity (10%)            |                | Baa |
| 335 |                                | Expected Range |     |
| 336 | b.) CFO/Interest (7.5%)        | 3.7 – 4.3%     | Baa |
| 337 | c.) CFO/Debt (7.5%)            | 17 – 21%       | Baa |
| 338 | d.) CFO/Dividends (7.5%)       | 13 – 17%       | Baa |
| 339 | e.) Debt/Capitalization (7.5%) | 45 – 55%       | Baa |
| 340 |                                |                |     |

341 PSO scored in the solid Baa range for all measures of its creditworthiness

342 **Q.** HAVE YOU REVIEWED OTHER RATING AGENCY CREDIT RESEARCH  
343 REPORTS FOR PSO AND ITS PARENT COMPANY AMERICAN ELECTRIC  
344 POWER COMPANY, INC.?

345 **A.** Yes. The most current S&P Credit Research Report for PSO indicates the following:

- 346 • Credit Rating: BBB/Stable;
- 347 • Business Risk Profile: Excellent
- 348 • Financial Risk Profile: Aggressive; and
- 349 • Outlook: The stable outlook on the ratings for AEP and its subsidiaries  
350 assumes timely recovery of rate base investments for environmental

351 compliance, system reliability, and continued strategic emphasis on  
352 regulated operations.<sup>34</sup>

353 PSO ratings are based on the consolidated credit profile of the parent company AEP.<sup>35</sup>  
354 This is consistent with how S&P has evaluated PSO's credit historically and is  
355 consistent with how S&P evaluates holding companies with various or multiple  
356 operating subsidiaries.

357 The bottom line is that the Company's financial integrity and financial forecasts  
358 support the current BBB rating or higher. Denial of the Company's current request for  
359 earnings on purchase power contracts should have no impact on the ultimate decision of  
360 the rating agencies regarding PSO's credit quality.

361 Q. DO YOU HAVE COMMENTS ON MOODY'S CREDIT OPINION OF PSO?

362 A. Yes. The current credit Issuer Rating by Moody's for PSO is Baa1.<sup>36</sup> Moody's rating  
363 rationale reflects the "supportive regulatory environment in Oklahoma, continued solid  
364 financial performance and credit metrics...."<sup>37</sup>

365 Moody's future outlook is based on the expectation that the Company will  
366 maintain a reasonably constructive relationship with the regulator, along with  
367 maintaining key financial metrics that support the current credit rating.<sup>38</sup>

368 **SECTION V: PSO Financials**

369  
370 Q. WHAT DO YOU ADDRESS IN THIS SECTION OF YOUR TESTIMONY?

371  
372 A. In an effort to evaluate the impact of a \$3 million change in earnings, and Mr. Decker's  
373 claim of increased risk, I have attempted to estimate the impact of a \$3 million earnings

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<sup>34</sup> Standard & Poor's Credit Research December 17, 2012 at 1 (Attached hereto as Appendix B).

<sup>35</sup> Id.

<sup>36</sup> Moody's Investor Services, Credit Opinion: Public Service of Oklahoma, February 8, 2012, at 1 (Attached hereto as Appendix B).

<sup>37</sup> Id at 2.

<sup>38</sup> Id at 3.

374 change on cash flow metrics. While this analysis is only an estimate – the bottom line  
375 conclusion is obvious. A \$3 million adjustment up or down to earnings has no material  
376 impact on the Company’s financial metrics, and will have no impact on PSO’s bond  
377 rating or credit worthiness and resulting financial integrity.  
378

379 **Q.** PLEASE DEFINE THE TERM FINANCIAL INTEGRITY AS YOU USE IT IN YOUR  
380 ANALYSIS.

381 **A.** The term financial integrity is a term or concept that addresses a firm’s ability to access  
382 capital at reasonable rates and on reasonable terms. Financial integrity includes the  
383 ability to to attract capital under a variety of market and economic conditions. The  
384 utility, the shareholders, the regulatory authority and the customers all have a stake in  
385 the utility maintaining financial integrity and access to capital markets. Generally, a  
386 firm is said to have financial integrity so long as it has an investment grade rating of  
387 BBB – or above.

388 **Q.** WHAT ARE KEY CREDIT METRICS THAT ARE INDICATORS OF CREDIT  
389 QUALITY?

390 **A.** As discussed earlier, the two primary rating agencies that provide credit ratings for  
391 utility companies are Moody’s and Standard & Poor’s (“S&P”) and both emphasize  
392 similar credit metrics. For example, among the key financial metrics considered by  
393 Moody’s are: (i) cash from operations as a percentage of debt (CFO/Debt), (ii) cash from  
394 operations plus interest divided by interest (CFO/Interest), and (iii) Debt/Capitalization.  
395 Financial metrics such as CFO/Debt and CFO/Interest are measures of cash flow, while  
396 Debt/Capitalization measures the degree to which debt leverage is used to fund  
397 operations.

398 S&P employs three similar financial metrics in evaluating financial integrity and  
399 ratings of a company. For example, S&P employs (i) Funds From Operations as a  
400 percentage of Debt (FFO/Debt). This financial measure evaluates cash flow support of

401 debt, which is similar to Moody's CFO/Debt measure. Another S&P metric is the size  
 402 of debt compared to earnings before income tax, depreciation and amortization  
 403 (Debt/EBITDA). This metric (Debt/EBITDA) is a measure of a company's ability to  
 404 pay off debt and is similar to Moody's (CFO/Interest) metric. A third S&P financial  
 405 metric is Debt to Capital (Debt/Capital) and is the same indicator of financial leverage  
 406 employed by Moody's as discussed earlier.

407 **Q.** PLEASE DESCRIBE AND ADDRESS THE ASPECTS OF S&P'S RATING  
 408 METHODOLOGY THAT ARE HELPFUL IN UNDERSTANDING A CREDIT  
 409 RATING AND FINANCIAL INTEGRITY.

410 **A.** One aspect of the S&P evaluation is the employment of a ratings matrix to facilitate the  
 411 development of credit ratings that combines the consideration of financial risk and  
 412 business risk. The following table summarizes the S&P ratings matrix matching credit  
 413 ratings to financial and business risk as shown:

| Table 2<br>S&P Ratings Matrix |                        |        |              |             |            |                  |
|-------------------------------|------------------------|--------|--------------|-------------|------------|------------------|
| Business Risk Profile         | Financial Risk Profile |        |              |             |            |                  |
|                               | Minimal                | Modest | Intermediate | Significant | Aggressive | Highly Leveraged |
| 1. Excellent                  | AAA                    | AA     | A            | A-          | BBB        | --               |
| 2. Strong                     | AA                     | A      | A-           | BBB         | BB         | BB-              |
| 3. Satisfactory               | A                      | BBB    | BBB          | BB+         | BB-        | B+               |
| 4. Fair                       | --                     | BBB-   | --           | BB          | BB-        | B                |
| 5. Weak                       | --                     | --     | --           | BB-         | B+         | B-               |
| 6. Vulnerable                 | --                     | --     | --           | B+          | B          | CCC+             |

414 For example S&P ranks PSO as having a Business Risk Profile of "Excellent"  
 415 category.<sup>39</sup> S&P ranks these same entities Financial Risk Profile as "Aggressive."<sup>40</sup>  
 416 PSO's current S&P Bond credit rating is BBB, which is consistent with the rating  
 417 indicated by the matrix.

<sup>39</sup> See Appendix B, S&P Credit Reports

<sup>40</sup> *Id*

418 Q. DOES S&P PROVIDE A LIST OF FINANCIAL BENCHMARKS OR  
419 EXPECTATIONS FOR VARIOUS FINANCIAL RISK LEVELS?

420 A. Yes. Below is a summary of Financial Benchmarks from S&P by each of the six  
421 financial risk measures:

| Financial Risk Level | (FFO/Debt %) | (Debt/EBITDA<br>x) | (Debt/Capital<br>%) |
|----------------------|--------------|--------------------|---------------------|
| 1. Minimal           | >60          | <1.5               | <25                 |
| 2. Modest            | 45-60        | 1.5-2              | 25-35               |
| 3. Intermediate      | 30-45        | 2.0-3.0            | 35-45               |
| 4. Significant       | 20-30        | 3.0-4.0            | 45-50               |
| 5. Aggressive        | 12-20        | 4.0-5.0            | 50-60               |
| 6. Highly Leveraged  | <12          | >5.0               | >60                 |

422 It should be noted, S&P views these benchmark levels as typical outcomes for the  
423 various ratings levels. But, these benchmark levels are not precise guarantees of future  
424 rating outcomes – as many factors go into the financial integrity and ultimate ratings  
425 analyses.

426 Q. DOES MOODY’S PROVIDE A LIST OF BENCHMARKS OR EXPECTATIONS  
427 FOR VARIOUS FINANCIAL METRICS FOR THE DIFFERENT RISK LEVELS?

428 A. Yes. Like the S&P benchmarks outlined above, Moody’s also provides similar financial  
429 metric expectations for the various risk levels.

430

---

<sup>41</sup> Standard & Poor’s Ratings Direct Criteria Methodology: Business Risk/Financial Risk Matrix Expanded (May 27, 2009) (Attached hereto as Appendix A).

| Table 4 <sup>42</sup>             |           |              |              |
|-----------------------------------|-----------|--------------|--------------|
| Moody's Financial Risk Benchmarks |           |              |              |
| Moody's Bond Rating               | CFO/Debt  | CFO/Interest | Debt/Capital |
| Aaa                               | >40%      | >8.0x        | <25%         |
| Aa                                | 30% - 50% | 6.0x - 8.0x  | 25% - 35%    |
| A                                 | 22% - 30% | 4.5x - 6.0x  | 35% - 45%    |
| Baa                               | 13% - 22% | 2.7x - 4.5x  | 45% - 55%    |
| Ba                                | 5% - 13%  | 1.5x - 2.7x  | 55% - 65%    |
| B                                 | <5%       | <1.5x        | >65%         |

432 Like S&P, Moody's views these benchmarks as typical expectations for the various risk  
 433 ratings levels. Again, these benchmarks are not precise guarantees of future ratings  
 434 outcomes – as many factors both qualitative and quantitative go into financial ratings  
 435 analyses.

436 **Q.** PLEASE EXPLAIN HOW YOU EVALUATED THE IMPACT OF THE COMPANY'S  
 437 PROPOSED \$3 MILLION CHANGE IN EARNINGS ON FINANCIAL METRICS.

438 **A.** I examined three key financial metrics that are considered by S&P and Moody's that I  
 439 described earlier. These financial metrics are as follows:

| Moody's        | S&P          |
|----------------|--------------|
| _____          | _____        |
| 1 CFO/Debt     | FFO/Debt     |
| 2 CFO/Interest | Debt/EBITDA  |
| 3 Debt/Capital | Debt/Capital |

440 All of these metrics can be found on my Schedule (DJI-2). The financial metrics for  
 441 each scenario are compared to the S&P and Moody's benchmarks for "BBB" bond  
 442 rating to determine if these results are consistent with maintaining financial integrity.

<sup>42</sup> Moody's Infrastructure Finance; Regulated Electric and Gas Utilities/Ratings Methodology at 13 (August 2009).  
 Responsive Testimony of Daniel J. Lawton Page 19 of 21

443 Q. PLEASE EXPLAIN HOW YOU CALCULATED FUNDS FROM OPERATIONS  
444 (FFO) FOR THE S&P METRIC EVALUATION.

445 A. FFO is operating profit after tax plus depreciation, amortization and current deferred  
446 taxes. This is after tax return plus depreciation, amortization or EBIDA. These values  
447 are included in my Schedules (DJI- 2 ) and are based on data from the company's last  
448 base rate case filing which generally forms the basis of the Company's current rates,  
449 revenues and earnings.

450 Q. HOW DID YOU CALCULATE CASH FLOW FROM OPERATIONS (CFO) FOR  
451 THE MOODY'S METRIC EVALUATION?

452 A. I employed earnings (return on investment) after taxes less interest plus depreciation for  
453 this calculation. These values are presented in my Schedules (DJI- 2 ).

454 Q. WHAT ARE THE RESULTS OF YOUR FINANCIAL METRIC ANALYSIS?

455 A. As is shown in my Schedule DJL-2 the impact of a \$3 million earnings change is not  
456 material. There should be no impact on the Company's creditworthiness. Mr. Decker's  
457 conclusions are wrong on this matter. PSO continues to maintain financial metrics well  
458 above the minimum requirements.

459 I have also measured the impact of a \$15 million change in bottomline earnings.  
460 As is shown in Schedule DJL-2, PSO maintains cash flow metrics within the Moody's  
461 and S&P guidelines in such a scenario.

462 **SECTION VI: Summary and Conclusions**

463 Q. PLEASE SUMMARIZE YOUR CONCLUSIONS?

464 A. The Company's claim of a lost earnings opportunity is in fact a more costly and  
465 inefficient approach when compared to the lower cost purchase power alternative. Thus,  
466 the Company's self-build option is not a real alternative if the goals are to pursue  
467 economic efficiency along with just and reasonable rates. Given the facts and

468 circumstances in this case, there are no lost opportunities or lost earnings to PSO. The  
469 Company's request for earnings recovery is not supported and should be denied.

470 **Q.** DOES THIS CONCLUDE YOUR TESTIMONY?

471 **A.** Yes, at this time.

472 1626965.1:620435:01210



**DANIEL J. LAWTON**  
**LAWTON CONSULTING**  
**B.A. ECONOMICS, MERRIMACK COLLEGE**  
**M.A. ECONOMICS, TUFTS UNIVERSITY**

Prior to beginning his own consulting practice Diversified Utility Consultants, Inc., in 1986 where he practiced as a firm principal through December 31, 2005, Mr. Lawton had been in the utility consulting business with a national engineering and consulting firm. In addition, Mr. Lawton has been employed as a senior analyst and statistical analyst with the Department of Public Service in Minnesota. Prior to Mr. Lawton's involvement in utility regulation and consulting he taught economics, econometrics, statistics and computer science at Doane College.

Mr. Lawton has conducted numerous financial and cost of capital studies on electric, gas and telephone utilities for various interveners before local, state and federal regulatory bodies. In addition, Mr. Lawton has provided studies, analyses, and expert testimony on statistics, econometrics, accounting, forecasting, and cost of service issues. Other projects in which Mr. Lawton has been involved include rate design and analyses, prudence analyses, fuel cost reviews and regulatory policy issues for electric, gas and telephone utilities. Mr. Lawton has developed software systems, databases and management systems for cost of service analyses.

In addition, Mr. Lawton has developed and reviewed numerous forecasts of energy and demand used for utility generation expansion studies as well as municipal financing. Mr. Lawton has represented numerous municipalities as a negotiator in utility related matters. Such negotiations ranges from the settlement of electric rate cases to the negotiation of provisions in purchase power contracts.

A list of cases in which Mr. Lawton has provided testimony is attached.

## UTILITY RATE PROCEEDINGS IN WHICH TESTIMONY HAS BEEN PRESENTED BY DANIEL J. LAWTON

| JURISDICTION/COMPANY                | DOCKET NO. | TESTIMONY TOPIC |
|-------------------------------------|------------|-----------------|
| <b>ALASKA REGULATORY COMMISSION</b> |            |                 |
| Beluga Pipe Line Company            | P-04-81    | Cost of Capital |

|  |         |                 |
|--|---------|-----------------|
| <b>PUBLIC UTILITIES COMMISSION OF CALIFORNIA</b> |         |                 |
| Southern California Edison                       | 12-0415 | Cost of Capital |
| San Diego Gas and Electric                       | 12-0416 | Cost of Capital |
| Southern California Gas                          | 12-0417 | Cost of Capital |
| Pacific Gas and Electric                         | 12-0418 | Cost of Capital |

|  |         |                 |
|--|---------|-----------------|
| <b>GEORGIA<br/>PUBLIC SERVICE COMMISSION</b> |         |                 |
| Georgia Power Co.                            | 25060-U | Cost of Capital |

|   |              |   |
|---|--------------|---|
| <b>FEDERAL ENERGY REGULATORY COMMISSION</b> |              |   |
| Alabama Power Company                       | ER83-369-000 | Cost of Capital                               |
| Arizona Public Service Company              | ER84-450-000 | Cost of Capital                               |
| Florida Power & Light                       | EL83-24-000  | Cost Allocation, Rate Design                  |
| Florida Power & Light                       | ER84-379-000 | Cost of Capital, Rate Design, Cost of Service |
| Southern California Edison                  | ER82-427-000 | Forecasting                                   |

| LOUISIANA<br>PUBLIC SERVICE COMMISSION |         |                                   |
|--|---------|-----------------------------------|
| Louisiana Power & Light                | U-15684 | Cost of Capital, Depreciation     |
| Louisiana Power & Light                | U-16518 | Interim Rate Relief               |
| Louisiana Power & Light                | U-16945 | Nuclear Prudence, Cost of Service |

| MARYLAND<br>PUBLIC SERVICE COMMISSION |      |           |
|---------------------------------------|------|-----------|
| Baltimore Gas and Electric Company    | 9173 | Financial |

| MINNESOTA<br>PUBLIC UTILITIES COMMISSION |                |  |
|--|----------------|--|
| Continental Telephone                    | P407/GR-81-700 | Cost of Capital                          |
| Interstate Power Co.                     | E001/GR-81-345 | Financial                                |
| Montana Dakota Utilities                 | G009/GR-81-448 | Financial, Cost of Capital               |
| New ULM Telephone Company                | P419/GR81767   | Financial                                |
| Norman County Telephone                  | P420/GR-81-230 | Rate Design, Cost of Capital             |
| Northern States Power                    | G002/GR80556   | Statistical Forecasting, Cost of Capital |
| Northwestern Bell                        | P421/GR80911   | Rate Design, Forecasting                 |

| MISSOURI<br>PUBLIC SERVICE COMMISSION |              |           |
|---------------------------------------|--------------|-----------|
| Missouri Gas Energy                   | GR-2009-0355 | Financial |
| Ameren UE                             | ER-2010-0036 | Financial |

| FLORIDA<br>PUBLIC SERVICE COMMISSION |           |               |
|--------------------------------------|-----------|---------------|
| Progress Energy                      | 070052-EI | Cost Recovery |
| Florida Power and Light              | 080677-EI | Financial     |

|                         |           |                   |
|-------------------------|-----------|-------------------|
| Florida Power and Light | 090130-EI | Depreciation      |
| Progress Energy         | 090079-EI | Depreciation      |
| Florida Power and Light | 120015-EI | Financial Metrics |

| NORTH CAROLINA<br>UTILITIES COMMISSION |               |   |
|--|---------------|---|
| North Carolina Natural Gas             | G-21, Sub 235 | Forecasting, Cost of Capital, Cost of Service |

| OKLAHOMA<br>PUBLIC SERVICE COMMISSION |           |                 |
|---------------------------------------|-----------|-----------------|
| Arkansas Oklahoma Gas Corporation     | 200300088 | Cost of Capital |
| Public Service Company of Oklahoma    | 200600285 | Cost of Capital |
| Public Service Company of Oklahoma    | 200800144 | Cost of Capital |

| PUBLIC SERVICE COMMISSION OF<br>INDIANA |       |                 |
|---|-------|-----------------|
| Kokomo Gas & Fuel Company               | 38096 | Cost of Capital |

| PUBLIC UTILITY COMMISSION OF<br>NEVADA |          |                 |
|--|----------|-----------------|
| Nevada Bell                            | 99-9017  | Cost of Capital |
| Nevada Power Company                   | 99-4005  | Cost of Capital |
| Sierra Pacific Power Company           | 99-4002  | Cost of Capital |
| Nevada Power Company                   | 08-12002 | Cost of Capital |
| Southwest Gas Corporation              | 09-04003 | Cost of Capital |

|   |                                  |                             |
|---|----------------------------------|-----------------------------|
| Sierra Pacific Power Company                  | 10-06001 &<br>10-06002           | Cost of Capital & Financial |
| Nevada Power Co. and Sierra Pacific Power Co. | 11-06006<br>11-06007<br>11-06008 | Cost of Capital             |

| PUBLIC SERVICE COMMISSION OF UTAH |            |                 |
|-----------------------------------|------------|-----------------|
| PacifiCorp                        | 04-035-42  | Cost of Capital |
| Rocky Mountain Power              | 08-035-38  | Cost of Capital |
| Rocky Mountain Power              | 09-035-23  | Cost of Capital |
| Rocky Mountain Power              | 10-035-124 | Cost of Capital |
| Rocky Mountain Power              | 11-035-200 | Cost of Capital |

| SOUTH CAROLINA PUBLIC SERVICE COMMISSION |          |             |
|--|----------|-------------|
| Piedmont Municipal Power                 | 82-352-E | Forecasting |

| PUBLIC UTILITY COMMISSION OF TEXAS |       |  |
|------------------------------------|-------|--|
| Central Power & Light Company      | 6375  | Cost of Capital, Financial Integrity   |
| Central Power & Light Company      | 9561  | Cost of Capital, Revenue Requirements  |
| Central Power & Light Company      | 7560  | Deferred Accounting  |
| Central Power & Light Company      | 8646  | Rate Design, Excess Capacity   |
| Central Power & Light Company      | 12820 | STP Adj. Cost of Capital, Post Test-year adjustments, Rate Case Expenses   |
| Central Power & Light Company      | 14965 | Salary & Wage Exp., Self-Ins. Reserve, Plant Held for Future use, Post Test Year Adjustments, Demand Side Management, Rate Case Exp. |
| Central Power & Light Company      | 21528 | Securitization of Regulatory Assets  |
| El Paso Electric Company           | 9945  | Cost of Capital, Revenue Requirements,   |

|                                     |           |  |
|-------------------------------------|-----------|--|
|                                     |           | Decommissioning Funding  |
| El Paso Electric Company            | 12700     | Cost of Capital, Rate Moderation Plan, CWIP, Rate Case Expenses  |
| Entergy Gulf States Incorporated    | 16705     | Cost of Service, Rate Base, Revenues, Cost of Capital, Quality of Service  |
| Entergy Gulf States Incorporated    | 21111     | Cost Allocation  |
| Entergy Gulf States Incorporated    | 21984     | Unbundling   |
| Entergy Gulf States Incorporated    | 22344     | Capital Structure  |
| Entergy Gulf States Incorporated    | 22356     | Unbundling   |
| Entergy Gulf States Incorporated    | 24336     | Price to Beat  |
| Gulf States Utilities Company       | 5560      | Cost of Service  |
| Gulf States Utilities Company       | 6525      | Cost of Capital, Financial Integrity   |
| Gulf States Utilities Company       | 6755/7195 | Cost of Service, Cost of Capital, Excess Capacity  |
| Gulf States Utilities Company       | 8702      | Deferred Accounting, Cost of Capital, Cost of Service  |
| Gulf States Utilities Company       | 10894     | Affiliate Transaction  |
| Gulf States Utilities Company       | 11793     | Section 63, Affiliate Transaction  |
| Gulf States Utilities Company       | 12852     | Deferred acctng., self-Ins. reserve, contra AFUDC adj., River Bend Plant specifically assignable to Louisiana, River Bend Decomm., Cost of Capital, Financial Integrity, Cost of Service, Rate Case Expenses |
| GTE Southwest, Inc.                 | 15332     | Rate Case Expenses   |
| Houston Lighting & Power            | 6765      | Forecasting  |
| Houston Lighting & Power            | 18465     | Stranded costs   |
| Lower Colorado River Authority      | 8400      | Debt Service Coverage, Rate Design   |
| Southwestern Electric Power Company | 5301      | Cost of Service  |

|                                     |       |   |
|-------------------------------------|-------|---|
| Southwestern Electric Power Company | 4628  | Rate Design, Financial Forecasting              |
| Southwestern Electric Power Company | 24449 | Price to Beat Fuel Factor                       |
| Southwestern Bell Telephone Company | 8585  | Yellow Pages                                    |
| Southwestern Bell Telephone Company | 18509 | Rate Group Re-Classification                    |
| Southwestern Public Service Company | 13456 | Interruptible Rates                             |
| Southwestern Public Service Company | 11520 | Cost of Capital                                 |
| Southwestern Public Service Company | 14174 | Fuel Reconciliation                             |
| Southwestern Public Service Company | 14499 | TUCO Acquisition                                |
| Southwestern Public Service Company | 19512 | Fuel Reconciliation                             |
| Texas-New Mexico Power Company      | 9491  | Cost of Capital, Revenue Requirements, Prudence |
| Texas-New Mexico Power Company      | 10200 | Prudence  |
| Texas-New Mexico Power Company      | 17751 | Rate Case Expenses                              |
| Texas-New Mexico Power Company      | 21112 | Acquisition risks/merger benefits               |
| Texas Utilities Electric Company    | 9300  | Cost of Service, Cost of Capital                |
| Texas Utilities Electric Company    | 11735 | Revenue Requirements                            |
| TXU Electric Company                | 21527 | Securitization of Regulatory Assets             |
| West Texas Utilities Company        | 7510  | Cost of Capital, Cost of Service                |
| West Texas Utilities Company        | 13369 | Rate Design                                     |

| RAILROAD COMMISSION OF TEXAS       |           |  |
|------------------------------------|-----------|--|
| Energas Company                    | 5793      | Cost of Capital  |
| Energas Company                    | 8205      | Cost of Capital  |
| Energas Company                    | 9002-9135 | Cost of Capital, Revenues, Allocation                                  |
| Lone Star Gas Company              | 8664      | Rate Design, Cost of Capital, Accumulated Depr. & DFIT, Rate Case Exp. |
| Lone Star Gas Company-Transmission | 8935      | Implementation of Billing Cycle Adjustment                             |
| Southern Union Gas Company         | 6968      | Rate Relief  |
| Southern Union Gas Company         | 8878      | Test Year Revenues, Joint and Common Costs                             |
| Texas Gas Service Company          | 9465      | Cost of Capital, Cost of Service, Allocation                           |
| TXU Lone Star Pipeline             | 8976      | Cost of Capital, Capital Structure                                     |
| TXU-Gas Distribution               | 9145-9151 | Cost of Capital, Transport Fee, Cost Allocation, Adjustment Clause     |
| TXU-Gas Distribution               | 9400      | Cost of Service, Allocation, Rate Base, Cost of Capital, Rate Design   |
| Westar Transmission Company        | 4892/5168 | Cost of Capital, Cost of Service                                       |
| Westar Transmission Company        | 5787      | Cost of Capital, Revenue Requirement                                   |
| Atmos                              | 10000     | Cost of Capital  |

| TEXAS WATER COMMISSION     |        |                                  |
|----------------------------|--------|----------------------------------|
| Southern Utilities Company | 7371-R | Cost of Capital, Cost of Service |

| SCOTSBUFF, NEBRASKA CITY COUNCIL |  |                 |
|----------------------------------|--|-----------------|
| K. N. Energy, Inc.               |  | Cost of Capital |

**HOUSTON  
CITY COUNCIL**

|                                  |  |             |
|----------------------------------|--|-------------|
| Houston Lighting & Power Company |  | Forecasting |
|----------------------------------|--|-------------|

**PUBLIC UTILITY REGULATION BOARD OF  
EL PASO, TEXAS**

|                            |  |                 |
|----------------------------|--|-----------------|
| Southern Union Gas Company |  | Cost of Capital |
|----------------------------|--|-----------------|

**DISTRICT COURT  
CAMERON COUNTY, TEXAS**

|  |            |                  |
|--|------------|------------------|
| City of San Benito, et. al. vs. PGE Gas Transmission et. al. | 96-12-7404 | Fairness Hearing |
|--|------------|------------------|

**DISTRICT COURT  
HARRIS COUNTY, TEXAS**

|   |           |                |
|---|-----------|----------------|
| City of Wharton, et al vs. Houston Lighting & Power | 96-016613 | Franchise fees |
|---|-----------|----------------|

**DISTRICT COURT  
TRAVIS COUNTY, TEXAS**

|  |            |          |
|--|------------|----------|
| City of Round Rock, et al vs. Railroad Commission of Texas et al | GV 304,700 | Mandamus |
|--|------------|----------|

**SOUTH DAYTONA, FLORIDA**

|  |                 |                |
|--|-----------------|----------------|
| City of South Daytona v. Florida Power and Light | 2008-30441-CICI | Stranded Costs |
|--|-----------------|----------------|

Schedule DJL-2





## APPENDIX A

MOODY'S GLOBAL INFRASTRUCTURE FINANCE REGULATED ELECTRIC AND GAS UTILITIES  
(AUGUST 2009) RATINGS METHODOLOGY (SELECTED PAGES)

STANDARD & POOR'S CRITERIA METHODOLOGY: BUSINESS RISK/ FINANCIAL RISK MATRIX  
EXPANDED (MAY 2009)

# Rating Methodology

# Moody's Global Infrastructure Finance

August 2009

## Regulated Electric and Gas Utilities

### Summary

This rating methodology provides guidance on Moody's approach to assigning credit ratings to electric and gas utility companies worldwide whose credit profile is influenced to a large degree by the presence of regulation. It replaces the Global Regulated Electric Utilities methodology published in March 2006 and the North American Regulated Gas Distribution Industry (Local Distribution Companies) methodology published in October 2006. While reflecting similar core principles as these previous methodologies, this updated framework incorporates refinements that better reflect the changing dynamics of the regulated electric and gas industry and the way Moody's applies its industry methodologies.

The goal of this rating methodology is to assist investors, issuers, and other interested parties in understanding how Moody's arrives at company-specific ratings, what factors we consider most important for this sector, and how these factors map to specific rating outcomes. Our objective is for users of this methodology to be able to estimate a company's ratings (senior unsecured ratings for investment-grade issuers and Corporate Family Ratings for speculative-grade issuers) within two alpha-numeric rating notches.

Regulated electric and gas companies are a diverse universe in terms of business model (ranging from vertically integrated to unbundled generation, transmission and/or distribution entities) and regulatory environment (ranging from stable and predictable regulatory regimes to those that are less developed or undergoing significant change). In seeking to differentiate credit risk among the companies in this sector, Moody's analysis focuses on four key rating factors that are central to the assignment of ratings for companies in the sector. The four key rating factors encompass nine specific elements (or sub-factors), each of which map to specific letter ratings (see Appendix A). The four factors are as follows:

1. Regulatory Framework
2. Ability to Recover Costs and Earn Returns
3. Diversification
4. Financial Strength and Liquidity

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(Continued on back page)



Moody's Investors Service

Regulated Electric and Gas Utilities

Appendix A: Regulated Electric and Gas Utilities Methodology Factor Grid

| Factor 1: Regulatory Framework  |  |
|---|--|
| <p>Regulatory framework is fully developed, has a long track record of being predictable and stable, and is highly supportive of utilities. Utility regulatory body is a highly independent regulator with unquestioned authority over utility regulation that is national in scope.</p>  | <p>Regulatory framework is fully developed, has been mostly predictable and stable in recent years, and is mostly supportive of utilities. Utility regulatory body is a sovereign, provincial, or independent regulator with authority over most utility regulation that is national in scope.</p>   |
| <p>Regulatory framework is fully developed, has above average predictability and reliability, although it sometimes less supportive of utilities. Utility regulatory body may be a state commission or national, state, provincial or independent regulator.</p>  | <p>Regulatory framework is well-developed, with evidence of some inconsistency or unpredictability in the way framework has been applied, or framework is new and untested, but based on well-developed precedent, or by jurisdiction has history of independent and transparent regulation in other sectors. Regulatory enforcement may sometimes be challenging and politically divergent.</p>       |
| <p>Regulatory framework is developed, but there is a high degree of inconsistency or unpredictability in the way framework has been applied. Regulatory enforcement is consistently challenging and politically charged. There has been a history of difficult or less supportive regulatory decisions, or regulatory authority has been or may be challenged or eroded by political or legislative action.</p> | <p>Regulatory framework is less developed, is unclear, is undergoing substantial change or has a history of being unpredictable or adverse to utilities. Utility regulatory body has a consistent track record or appears unresponsive, untested, or highly unpredictable. May be high risk of nationalization or other significant government intervention in utility operations or markets.</p>      |
| 25%   | 25%  |
| Factor 2: Ability to Recover Costs and Earn Returns   |  |
| <p>Rate/tariff formula allows unquestoned full and timely cost recovery, with statutory provisions in place to preclude any possibility of challenges to rate increases or cost recovery mechanisms.</p>  | <p>Rate/tariff formula generally allows full and timely cost recovery. Full return on all investments. Minimal challenges by regulators to companies' cost assumptions consistent track record of meeting efficiency tests.</p>  |
| <p>Rate/tariff reviews and cost recovery outcomes are fairly predictable (with automatic fuel and purchased power recovery provisions in place where generally fair return on investments. limited pressure of regulatory challenges, although efficiency tests may be more challenging; limited delators to rate or tariff increases or cost recovery.</p>   | <p>Rate/tariff reviews and cost recovery outcomes are usually predictable, although application of tariff formula may be relatively unclear or untested. Potentially greater tendency for regulatory intervention, or greater disallowance (e.g. challenging efficiency assumptions) or delaying of some costs (even where automatic fuel and purchased power recovery provisions are applicable).</p> |
| <p>Rate/tariff reviews and cost recovery outcomes are inconsistent with some history of unfavorable regulatory decisions or unwilligness by regulators to make timely rate changes to address market volatility or higher fuel or purchased power costs.</p>  | <p>Rate/tariff reviews and cost recovery outcomes are inconsistent with some history of unfavorable regulatory decisions or unwilligness by regulators to make timely rate changes to address market volatility or higher fuel or purchased power costs.</p>   |
| <p>Tariff formula may not take into account all cost components; investments are not clearly or fairly remunerated.</p>   | <p>Tariff formula may not take into account all cost components; investments are not clearly or fairly remunerated.</p>  |
| <p>Difficult or highly uncertain rate and cost recovery outcomes. Regulators may engage in second-guessing of spending decisions or deny rate increases or cost recovery needed by utilities to fund ongoing operations, or high likelihood of politically motivated interference in the rate/tariff review process.</p>  | <p>Difficult or highly uncertain rate and cost recovery outcomes. Regulators may engage in second-guessing of spending decisions or deny rate increases or cost recovery needed by utilities to fund ongoing operations, or high likelihood of politically motivated interference in the rate/tariff review process.</p>   |
| AND/OR  | AND/OR   |
| <p>Tariff formula may not cover return on investments, only cash operating costs may be remunerated.</p>  | <p>Tariff formula may not cover return on investments, only cash operating costs may be remunerated.</p>   |

Regulated Electric and Gas Utilities

Factor 3: Diversification

|   |  |   |  |   |   |           |
|---|--|---|--|---|---|-----------|
| <p>A high degree of multistate/regional diversification in terms of market and/or regulatory regime.</p>  | <p>Material operations in more than three states or geographic regions providing diversification of market and/or regulatory regime.</p>   | <p>Material operations in two or three states, nation, or geographic regions and exhibits some diversification of market and/or regulatory regime.</p>  | <p>Operates in a single state, nation, or economic region with low volatility with some concentration of market and/or regulatory regime.</p>                                  | <p>Operates in a limited market area with material concentration in market and/or regulatory regime.</p>  | <p>Operates in a single market which may be an emerging market or higher environment, with high concentration risk.</p>   | <p>52</p> |
| <p>For LDCs, extremely low reliance on industrial customers and/or exceptionally large residential and commercial customer base and well above average growth.</p>                                    | <p>For LDCs, very low reliance on industrial customers and/or very large residential and commercial customer base with very high growth.</p>   | <p>For LDCs, low reliance on industrial customers and/or high residential and commercial customer base with high growth.</p>  | <p>For LDCs, moderate reliance on industrial customers in defensive sectors, moderate residential and customer base.</p>   | <p>For LDCs, high reliance on industrial customers in somewhat cyclical sectors, small residential and commercial customer base.</p>  | <p>For LDCs, very high reliance on industrial customers in cyclical sectors, very small residential and commercial customer base.</p>   | <p>53</p> |
| <p>A high degree of diversification in terms of generation and/or fuel source, well insulated from commodity price changes, no generation concentration, or 0-20% of generation from carbon fuel.</p> | <p>Some diversification in terms of generation and/or fuel source, affected only minimally by commodity price changes, little generation concentration, or 20-40% of generation from carbon fuels.</p> | <p>May have some concentration in one particular type of generation or fuel source, although mostly diversified, modest exposure to commodity price changes, or 40-55% of generation from carbon fuels.</p> | <p>Some reliance on a single type of generation or fuel source, limited diversification, moderate exposure to commodity prices, or 55-70% of generation from carbon fuels.</p> | <p>Operates with little diversification in terms of generation and/or fuel source, high exposure to commodity price changes, or 70-85% of generation from carbon fuels.</p> | <p>High concentration in a single type of generation or highly reliant on a single fuel source, little diversification, may be exposed to commodity price shocks, or 85-100% of generation from carbon fuels.</p> | <p>54</p> |

70% weight for issuers that lack generation 70% weight for issuers that lack generation

Regulated Electric and Gas Utilities

Factor 4: Financial Strength, Liquidity and Key Financial Metrics

|                              | Financially robust under all scenarios with no need for external funding, unquestioned access to the capital markets, and excellent liquidity. | Financially robust under virtually all scenarios with little to no need for external funding, superior access to the capital markets, and very strong liquidity. | Financially strong under most scenarios with some reliance on external funding, solid access to the capital markets, and strong liquidity. | Some reliance on external funding and liquidity is more likely to be affected by external events, good access to the capital markets, and adequate liquidity under most scenarios. | Weak liquidity with more susceptibility to external shocks or unexpected events. Significant reliance on debt funding. Bank financing may be required and there may be limited headroom under covenants. | Very weak liquidity with limited ability to withstand external shocks or unexpected events. Must use debt to finance investments. Bank financing is normally secured and there may be a high likelihood of breaching one or more covenants. | 10%          |
|------------------------------|--|--|--|--|--|---|--------------|
| GPO pre-W/C + Interest/Debt  | > 8.0x   | 6.0x - 8.0x  | 4.5x - 6.0x  | 2.7x - 4.5x  | 1.5x - 2.7x  | < 1.5x  | 7.5%         |
| GPO pre-W/C Debt             | > 40%  | 30% - 40%  | 22% - 30%  | 13% - 22%  | 3% - 13%   | < 5%  | 7.5%         |
| GPO pre-W/C - Dividends/Debt | > 35%  | 25% - 35%  | 17% - 25%  | 9% - 17%   | 0% - 9%  | < 0%  | 7.5%         |
| Debt/Capitalization Debt/RAV | < 25%<br>< 30%   | 25% - 35%<br>30% - 45%   | 35% - 45%<br>45% - 60%   | 45% - 55%<br>60% - 75%   | 55% - 65%<br>75% - 90%   | > 65%<br>> 90%  | 7.5%<br>7.5% |

## Criteria | Corporates | General:

# Criteria Methodology: Business Risk/Financial Risk Matrix Expanded

*(Editor's Note: In the previous version of this article published on May 26, certain of the rating outcomes in the table 1 matrix were misspelled. A corrected version follows.)*

Standard & Poor's Ratings Services is refining its methodology for corporate ratings related to its business risk/financial risk matrix, which we published as part of 2008 Corporate Ratings Criteria on April 15, 2008, on RatingsDirect at [www.ratingsdirect.com](http://www.ratingsdirect.com) and Standard & Poor's Web site at [www.standardandpoors.com](http://www.standardandpoors.com).

This article amends and supersedes the criteria as published in Corporate Ratings Criteria, page 21, and the articles listed in the "Related Articles" section at the end of this report.

This article is part of a broad series of measures announced last year to enhance our governance, analytics, dissemination of information, and investor education initiatives. These initiatives are aimed at augmenting our independence, strengthening the rating process, and increasing our transparency to better serve the global markets.

We introduced the business risk/financial risk matrix four years ago. The relationships depicted in the matrix represent an essential element of our corporate analytical methodology.

We are now expanding the matrix, by adding one category to both business and financial risks (see table 1). As a result, the matrix allows for greater differentiation regarding companies rated lower than investment grade (i.e., 'BB' and below).

Table 1

| Business And Financial Risk Profile Matrix |                        |        |              |             |            |                  |
|--|------------------------|--------|--------------|-------------|------------|------------------|
| Business Risk Profile                      | Financial Risk Profile |        |              |             |            |                  |
|  | Minimal                | Modest | Intermediate | Significant | Aggressive | Highly Leveraged |
| Excellent                                  | AAA                    | AA     | A            | A-          | BBB        | --               |
| Strong                                     | AA                     | A      | A-           | BBB         | BB         | BB-              |
| Satisfactory                               | A-                     | BBB+   | BBB          | BB+         | BB-        | B+               |
| Fair                                       | --                     | BBB-   | BB+          | BB          | BB-        | B                |
| Weak                                       | --                     | --     | BB           | BB-         | B+         | B-               |
| Vulnerable                                 | --                     | --     | --           | B+          | B          | CCC+             |

*These rating outcomes are shown for guidance purposes only. Actual rating should be within one notch of indicated rating outcomes.*

The rating outcomes refer to issuer credit ratings. The ratings indicated in each cell of the matrix are the midpoints of a range of likely rating possibilities. This range would ordinarily span one notch above and below the indicated rating.

## Business Risk/Financial Risk Framework

Our corporate analytical methodology organizes the analytical process according to a common framework, and it divides the task into several categories so that all salient issues are considered. The first categories involve fundamental business analysis; the financial analysis categories follow.

Our ratings analysis starts with the assessment of the business and competitive profile of the company. Two companies with identical financial metrics can be rated very differently, to the extent that their business challenges and prospects differ. The categories underlying our business and financial risk assessments are:

### Business risk

- Country risk
- Industry risk
- Competitive position
- Profitability/Peer group comparisons

### Financial risk

- Accounting
- Financial governance and policies/risk tolerance
- Cash flow adequacy
- Capital structure/asset protection
- Liquidity/short-term factors

We do not have any predetermined weights for these categories. The significance of specific factors varies from situation to situation.

## Updated Matrix

We developed the matrix to make explicit the rating outcomes that are typical for various business risk/financial risk combinations. It illustrates the relationship of business and financial risk profiles to the issuer credit rating.

We tend to weight business risk slightly more than financial risk when differentiating among investment-grade ratings. Conversely, we place slightly more weight on financial risk for speculative-grade issuers (see table 1, again). There also is a subtle compounding effect when both business risk and financial risk are aligned at extremes (i.e., excellent/minimal and vulnerable/highly leveraged.)

The new, more granular version of the matrix represents a refinement--not any change in rating criteria or standards--and, consequently, holds no implications for any changes to existing ratings. However, the expanded matrix should enhance the transparency of the analytical process.

## Financial Benchmarks

Table 2

|                  | FFO/Debt (%)    | Debt/EBITDA (x) | Debt/Capital (%) |
|------------------|-----------------|-----------------|------------------|
| Minimal          | greater than 60 | less than 1.5   | less than 25     |
| Modest           | 45-60           | 1.5-2           | 25-35            |
| Intermediate     | 30-45           | 2-3             | 35-45            |
| Significant      | 20-30           | 3-4             | 45-50            |
| Aggressive       | 12-20           | 4-5             | 50-60            |
| Highly Leveraged | less than 12    | greater than 5  | greater than 60  |

## How To Use The Matrix--And Its Limitations

The rating matrix indicative outcomes are what we typically observe--but are not meant to be precise indications or guarantees of future rating opinions. Positive and negative nuances in our analysis may lead to a notch higher or lower than the outcomes indicated in the various cells of the matrix.

In certain situations there may be specific, overarching risks that are outside the standard framework, e.g., a liquidity crisis, major litigation, or large acquisition. This often is the case regarding credits at the lowest end of the credit spectrum--i.e., the 'CCC' category and lower. These ratings, by definition, reflect some impending crisis or acute vulnerability, and the balanced approach that underlies the matrix framework just does not lend itself to such situations.

Similarly, some matrix cells are blank because the underlying combinations are highly unusual--and presumably would involve complicated factors and analysis.

The following hypothetical example illustrates how the tables can be used to better understand our rating process (see tables 1 and 2).

We believe that Company ABC has a satisfactory business risk profile, typical of a low investment-grade industrial issuer. If we believed its financial risk were intermediate, the expected rating outcome should be within one notch of 'BBB'. ABC's ratios of cash flow to debt (35%) and debt leverage (total debt to EBITDA of 2.5x) are indeed characteristic of intermediate financial risk.

It might be possible for Company ABC to be upgraded to the 'A' category by, for example, reducing its debt burden to the point that financial risk is viewed as minimal. Funds from operations (FFO) to debt of more than 60% and debt to EBITDA of only 1.5x would, in most cases, indicate minimal.

Conversely, ABC may choose to become more financially aggressive--perhaps it decides to reward shareholders by borrowing to repurchase its stock. It is possible that the company may fall into the 'BB' category if we view its financial risk as significant. FFO to debt of 20% and debt to EBITDA 4x would, in our view, typify the significant financial risk category.

Still, it is essential to realize that the financial benchmarks are guidelines, neither gospel nor guarantees. They can vary in nonstandard cases: For example, if a company's financial measures exhibit very little volatility, benchmarks may be somewhat more relaxed.

Moreover, our assessment of financial risk is not as simplistic as looking at a few ratios. It encompasses:

- a view of accounting and disclosure practices;
- a view of corporate governance, financial policies, and risk tolerance;
- the degree of capital intensity, flexibility regarding capital expenditures and other cash needs, including acquisitions and shareholder distributions; and
- various aspects of liquidity—including the risk of refinancing near-term maturities.

The matrix addresses a company's standalone credit profile, and does not take account of external influences, which would pertain in the case of government-related entities or subsidiaries that in our view may benefit or suffer from affiliation with a stronger or weaker group. The matrix refers only to local-currency ratings, rather than foreign-currency ratings, which incorporate additional transfer and convertibility risks. Finally, the matrix does not apply to project finance or corporate securitizations.

## Related Articles

Industrials' Business Risk/Financial Risk Matrix--A Fundamental Perspective On Corporate Ratings, published April 7, 2005, on RatingsDirect.

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Standard & Poor's RatingsDirect | May 27, 2009



## APPENDIX B

MOODY'S CREDIT OPINION: PUBLIC SERVICE COMPANY OF OKLAHOMA (FEBRUARY 2012)

STANDARD & POOR'S CREDIT RESEARCH PUBLIC SERVICE COMPANY OF OKLAHOMA  
(DECEMBER 2012)

STANDARD & POOR'S CREDIT RESEARCH PUBLIC SERVICE COMPANY OF OKLAHOMA (JUNE  
2012)

STANDARD & POOR'S RATINGS DIRECT PUBLIC SERVICE COMPANY OF OKLAHOMA (DECEMBER  
2011)

# MOODY'S

## INVESTORS SERVICE

### Credit Opinion: Public Service Company of Oklahoma

Global Credit Research - 08 Feb 2012

Tulsa, Oklahoma, United States

#### Ratings

| Category   | Moody's Rating |
|--|----------------|
| Outlook  | Stable         |
| Issuer Rating  | Baa1           |
| Senior Unsecured                                     | Baa1           |
| Pref. Stock  | Baa3           |
| <b>Parent: American Electric Power Company, Inc.</b> |                |
| Outlook  | Stable         |
| Senior Unsecured                                     | Baa2           |
| Jr Subordinate                                       | Baa3           |
| Commercial Paper                                     | P-2            |

#### Contacts

| Analyst                       | Phone        |
|-------------------------------|--------------|
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#### Key Indicators

[1] Public Service Company of Oklahoma

|   | LTM 9/30/2011 | 2010 | 2009 | 2008 |
|---|---------------|------|------|------|
| (CFO Pre-W/C + Interest) / Interest Expense | 6.0x          | 4.7x | 4.7x | 3.6x |
| (CFO Pre-W/C) / Debt                        | 27%           | 22%  | 22%  | 21%  |
| (CFO Pre-W/C - Dividends) / Debt            | 22%           | 18%  | 19%  | 21%  |
| Debt / Book Capitalization                  | 43%           | 44%  | 45%  | 46%  |

[1] All ratios calculated in accordance with the Global Regulated Electric Utilities Rating Methodology using Moody's standard adjustments.

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

#### Opinion

##### Rating Drivers

Historically supportive regulatory environment

Continued strong financial metrics

Sizeable capital expenditures

Service territory provides bright spot for AEP

## Corporate Profile

Public Service Company of Oklahoma (PSO; Baa1 issuer rating, stable outlook) is a vertically integrated electric utility company serving 532,000 customers and is a wholly owned subsidiary of American Electric Power Company (AEP, Baa2 senior unsecured, stable outlook). PSO is primarily regulated by the Oklahoma Corporation Commission (OCC). By nameplate capacity PSO is 23% coal generation and 77% natural gas, yet coal production accounted for approximately 55% of the 14,348 GWh produced in 2010, mostly from the Northeastern Plant. PSO's rate base is 12.4% of AEP's total state jurisdictional rate base. PSO has a split service territory, operating in the east half of the state which includes Tulsa as well as the southwestern corner below Oklahoma City. The service territory contains areas of the Woodford and Excello-Mulky shale basins. PSO has an even mix of electric sales with 34% residential, 26% commercial, 25% industrial, with the remainder consisting of government and wholesale sales. Derived from 2010 data, PSO had a reserve margin of only 8.5%; however, PSO entered a ten year PPA with Exelon Generation in 2009 which will supply 520 MW of capacity beginning June 1, 2012, which on a pro-forma basis would imply a 21% reserve margin.

## SUMMARY RATING RATIONALE

PSO's Baa1 senior unsecured rating reflects the operations and the supportive regulatory environment in Oklahoma, continued solid financial performance and credit metrics that are strong for the Baa1 rating, the active management of operating costs and expenses during a weak economic period, and an increased capital expenditures program.

## DETAILED RATING CONSIDERATIONS

### HISTORICALLY SUPPORTIVE REGULATORY ENVIRONMENT

PSO operates under the jurisdiction of the Oklahoma Corporation Commission (OCC), which we view as providing a generally credit-supportive framework. Historically, the OCC has provided reasonable costs recovery and returns in its rate decisions, including authorized ROEs that have been in-line with regional averages. Although Oklahoma has few recovery mechanisms overall, there is a Fuel Adjustment Clause (FAC). This FAC allows PSO to true up fuel costs as often as quarterly when costs have changed or the under- or over-recovered balance exceeds 5% of the annual Oklahoma-jurisdictional fuel cost. Once the adjustment has been filed, the OCC Staff has five days to object, which would open a formal inquiry, or the rates will be adjusted for the new cost level. State statutes permit a cash return on construction work in progress for environmental and transmission expenditures.

PSO's last rate case authorized on January 5, 2011 stipulated a 10.15% ROE on a rate base of \$1,706 million, 37% of PSO's requested rate increase. This outcome exemplifies pressures on the commission to keep rates low during the state's economic recovery. Nevertheless, we do not expect a shift in regulatory supportiveness in Oklahoma, but rather that the OCC will continue to be credit supportive towards the state's electric utilities.

### CONTINUED STRONG FINANCIAL METRICS

PSO has been able maintain stable metrics over the 2008 to 2010 timeframe ranging from 21 - 22% for CFO pre-WC to Debt and 3.6x to 4.7x for CFO pre-WC plus interest over interest. Total debt to total capitalization has improved as well, from 46% at 12/31/2008 to 43% at 9/30/2011. These consistently strong metrics score to a high Baa under Moody's Global Regulated Electric and Gas Methodology. We forecast PSO's metrics to remain near current levels despite an expectation of increasing capital expenditures in the coming years.

### SIZEABLE CAPITAL SPENDING PROGRAM

AEP has stated that it plans to invest \$700 - 940 million before 2020 to retrofit Northeastern units 3 & 4 and Oklaunion. These units represent approximately 20% of capacity and are all coal burning units built between 1979 and 1986. We expect that these capital investments will occur over the 2013 - 2016 timeframe, rather than closer to 2020. PSO's total capital expenditures decreased in 2009 and 2010 to \$179 million and \$197 million, respectively, from the \$315 million and \$290 million spent in 2007 and 2008, respectively. Going forward, we expect non-environmental capex to be around \$170 million annually. Consequently, the increase over the next years for environmental retrofits should be able to be absorbed, assuming supportive regulatory treatment, without pressuring the rating.

### SERVICE TERRITORY PROVIDES BRIGHT SPOT FOR AEP

PSO has two significantly sized service territories in Oklahoma. The eastern territory contains Tulsa and abuts

Arkansas. PSO also operates in the southwestern corner of Oklahoma below Oklahoma City. Oklahoma has been a bright spot among AEP's service territories, with an unemployment rate of 6.1% as of November 2011 that is well below the national average, supported by continued energy-related expansion. Shale development has aided the resilience of the state through the economic malaise and should allow Oklahoma to continue to outperform national averages in the near and medium terms.

#### **Liquidity**

PSO's liquidity is adequate. PSO participates in the AEP Utility Money Pool with a borrowing limit of \$300 million, which provides access to the parent company's liquidity. As of 9/30/11, PSO had a balance of \$105 million invested in the Money Pool, compared to \$91 million borrowed from the Money Pool as of 12/31/10.

For the twelve months ending September 2011, PSO generated approximately \$364 million of cash from operations, invested approximately \$139 million in capital expenditures and made \$66 million in upstream dividend payments to AEP, resulting in approximately \$159 million of positive free cash flow. In the 2012, we expect PSO to generate cash from operations of \$290 - \$300 million (decreased, mostly due to working capital swings), invest up to approximately \$200-225 million in capital expenditures and continue to contribute approximately \$60 million in upstream dividends to its parent. PSO has no significant maturities until \$34 million of Pollution Control Bonds come due in 2014.

AEP has two syndicated credit facilities totaling \$3.25 billion that were renewed and extended in mid-2011. One is a \$1.5 billion facility expiring June 2015. The other is a \$1.75 billion facility (upsized from \$1.5 billion) expiring in July 2016. The combined letter of credit sub-limits under these facilities is \$1.35 billion. The facilities contain a covenant requiring that AEP's consolidated debt to capitalization (as defined) will not exceed 67.5% (AEP states the actual ratio was 50.3% at 9/30/11, indicating substantial headroom). AEP is not required to make a representation with respect to either material adverse change or material litigation in order to borrow under the facility. Default provisions exclude payment defaults and insolvency/bankruptcy of subsidiaries that are not significant subsidiaries per the SEC definition (in general, this would exclude subsidiaries representing less than 10% of assets and income, but AEP Texas Central and Southwestern Electric Power Company are also effectively excluded as significant subsidiaries due to definitional adjustments in the credit facilities). Also in 2011, AEP allowed a \$478 million letter of credit facility to expire but renewed its \$750 million accounts receivable securitization (only the multi-year portion of the latter is included as an available source in Moody's liquidity testing).

As of 9/30/11, AEP had \$546 million of cash on hand and approximately \$2.6 billion of availability under the syndicated revolving credit facilities after giving effect to \$529 million of commercial paper outstanding and \$103 million of issued letters of credit.

For the 12 months ended 9/30/11, AEP generated approximately \$4.6 billion in cash from operations, made approximately \$3.1 billion in capital investments and net asset purchases and paid about \$890 million in dividends, resulting in roughly \$610 million of positive free cash flow.

Including securitization bonds, AEP has approximately \$690 million of long-term debt due in 2012, \$1.7 billion due in 2013, and \$1.0 billion in 2014. Over the next two years, we estimate that AEP will generate roughly \$3.5 billion in cash from operations, spend about \$3.3 billion annually in capital expenditures and pay approximately \$900-950 million in dividends annually, yielding negative free cash flow of about \$700 million per year.

#### **Rating Outlook**

The stable rating outlook for PSO is primarily based on our expectation that the company will continue to maintain a reasonably constructive relationship with the OCC, be successful in meeting its infrastructure spending plans and attain reasonably good recovery on a timely basis while maintaining key financial credit metrics that support the rating.

#### **What Could Change the Rating - Up**

Rating upgrades appears unlikely over the near to intermediate term horizon. Despite strong metrics and cash flow for the Baa-category, uncertainty over the capital expenditure program and potential effects on PSO's financial profile constrain the rating; however, PSO could be considered for a ratings upgrade if it were to achieve key financial credit metrics, including a ratio of CFO pre-WC plus interest over interest above 5x and CFO pre-WC to debt in the mid 20% range on a sustainable basis.

#### **What Could Change the Rating - Down**

Ratings could be downgraded if the regulatory environment took a more adversarial tone, if there were material cost over-runs in the construction of environmental upgrades, or if the key financial credit metrics began to exhibit a prolonged deterioration. These metrics would include a ratio of CFO pre-WC to interest closer to 3.5x or CFO pre-WC to debt in the mid teens.

**Rating Factors**

**Public Service Company of Oklahoma**

| Regulated Electric and Gas Utilities Industry [1][2]                           | Current<br>12/31/2010 |       | Moody's<br>12-18<br>month<br>Forward<br>View* As<br>of<br>February<br>2012 |       |
|--|-----------------------|-------|--|-------|
|  | Measure               | Score | Measure  | Score |
| <b>Factor 1: Regulatory Framework (25%)</b>                                    |                       |       |  |       |
| a) Regulatory Framework  |                       | Baa   |  | Baa   |
| <b>Factor 2: Ability To Recover Costs And Earn Returns (25%)</b>               |                       |       |  |       |
| a) Ability To Recover Costs And Earn Returns                                   |                       | Baa   |  | Baa   |
| <b>Factor 3: Diversification (10%)</b>   |                       |       |  |       |
| a) Market Position (5%)  |                       | Baa   |  | Baa   |
| b) Generation and Fuel Diversity (5%)  |                       | Baa   |  | Baa   |
| <b>Factor 4: Financial Strength, Liquidity And Key Financial Metrics (40%)</b> |                       |       |  |       |
| a) Liquidity (10%)   |                       | Baa   |  | Baa   |
| b) CFO pre-WC + Interest / Interest (3 Year Avg) (7.5%)                        | 4.3x                  | Baa   | 3.7 - 4.3x   | Baa   |
| c) CFO pre-WC / Debt (3 Year Avg) (7.5%)                                       | 21.4%                 | Baa   | 17 - 21%   | Baa   |
| d) CFO pre-WC - Dividends / Debt (3 Year Avg) (7.5%)                           | 19.1%                 | A     | 13 - 17%   | Baa   |
| e) Debt/Capitalization (3 Year Avg) (7.5%)                                     | 44.9%                 | A     | 45 - 55%   | Baa   |
| <b>Rating:</b>   |                       |       |  |       |
| a) Indicated Rating from Grid  |                       | Baa2  |  | Baa2  |
| b) Actual Rating Assigned  |                       | Baa1  |  | Baa1  |

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[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2010; Source: Moody's Financial Metrics



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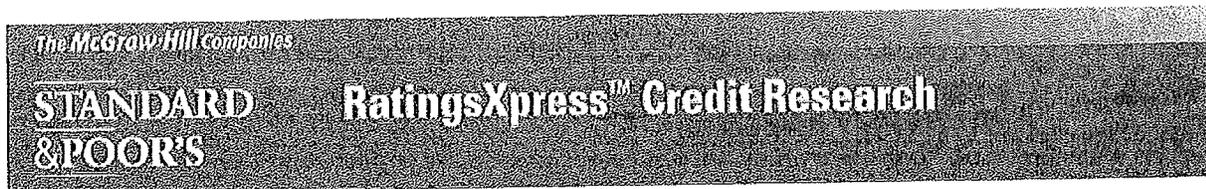
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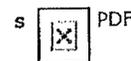
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## RESEARCH



## Summary:

**Public Service Co. of Oklahoma**

**Publication date:** 17-Dec-2012  
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**Credit Rating:** BBB/Stable/--

**Rationale**

Standard & Poor's Ratings Services bases its ratings on Public Service Co. of Oklahoma (PSO) on the consolidated credit profile of its parent **American Electric Power Co. Inc. (AEP)**, which includes regulated and unregulated operations. We consider PSO's business risk profile as "excellent" and financial risk profile as "aggressive". PSO is a vertically integrated, fully regulated electric utility that provides service in eastern and southwestern Oklahoma. It participates in the AEP West Power Pool, sharing the revenues and costs of pool sales to utilities and power marketers, and also sells directly at wholesale to utilities, municipalities, and rural electric cooperatives. Operations are integrated with the AEP West system. We consider AEP's business risk profile as excellent and its financial risk profile as aggressive.

The excellent consolidated business risk profile primarily reflects AEP's status as a large public utility holding company that owns regulated electric utility subsidiaries operating in 11 states in the Midwest and Southwest. These subsidiaries consist of low-risk transmission and distribution wires-only businesses in Texas; fully integrated regulated utilities in states such as Indiana and West Virginia; and higher-risk hybrid operations in Ohio. Although a portion of generation assets are outside rate base, most of the consolidated generating capacity is under stabilizing regulatory oversight. The company's generating and transmission facilities are interconnected, and its operations are coordinated as an integrated electric utility system.

Electric utility operations are slightly above average, characterized by competitive rates, good reliability, a strong collection of low-cost, coal-fired generation in the eastern part of the system, and supportive regulatory relationships in numerous jurisdictions. Service territories vary widely, ranging from manufacturing and rural areas with lower-growth economies to higher-growth, service-oriented economies, like in the Columbus, Ohio, metropolitan area, that are more stable. The diversity in markets and in regulation somewhat elevates credit quality, but managing the complex variety of regulatory environments can be challenging and requires constant vigilance.

Ohio Power continues to transition to a competitive generation market with shopping for generation service available to all retail customers and Public Utilities Commission of Ohio (PUCO) approval to transfer all its generation assets out of the utility, including to an unregulated generation affiliate.

Over the longer term, with roughly 25,000 megawatts (MW) of coal-fired generation, including those owned by Ohio Power, material compliance costs related to numerous environmental rules could pressure credit quality without adequate cost recovery. In addition to these coal assets, AEP has 9,700 MW of gas generation and a 2,200 MW nuclear plant.

The company's unregulated operations will grow to include about 8,900 MW of former Ohio Power generation assets following Ohio Power's 2,400 MW transfer to affiliate utilities and its coal plant closures. We expect AEP's track record of good operating performance in its unregulated business operations to continue. Stricter environmental regulation will erode the fleet's competitiveness, but we do not expect these pressures to completely eliminate the advantages of AEP's coal plants. AEP has indicated that it will retire roughly 5,500 MW of additional coal-fired assets, including Ohio Power's closures, and retrofit other coal assets with pollution-control equipment. Although AEP's Ohio-based generation accounts for only a portion of its credit profile, absent more robust financial measures, a shift to a greater reliance on market prices to generate cash would increase business risk and could ultimately weaken credit quality.

Reflected in the business risk profile is our assessment of the company's management and governance as "satisfactory".

PSO's financial risk profile reflects AEP's consolidated financial risk profile, which we consider aggressive, and includes adjusted financial measures that are in line with the rating. This assessment reflects large capital expenditures, mostly for environmental-compliance programs and for new generation and transmission. We forecast that the elevated spending and recurring dividend payments could result in negative discretionary cash flow for several years and will require vigilant cost recovery to maintain cash flow measures. We expect consolidated financial measures, including ratios of debt to EBITDA, funds from operations (FFO) to total debt, and debt to capital, to remain in line with the rating. For the 12 months ended Sept. 30, 2012, FFO to total debt was about 18.3%, total debt to total capital was about 57%, and debt to EBITDA was 4.5x. After reducing cash flow from operations by capital expenditures and dividends, discretionary cash flow was a negative \$470 million and net cash flow (FFO after dividends) to capital expenditures was 91%. Both indicate a need for external financing to fund both capital expenditures and dividends. FFO interest coverage was robust at 4.2x and the dividend payout ratio was manageable at 62%. In addition, even though committed to credit quality, we consider the company's financial policies to be aggressive. Adjustments include capital and operating leases, pension-related items, intermediate equity treatment of the junior subordinated notes, and securitized debt.

Our base forecast of between 15% and 16% adjusted FFO to total debt, 4.4x adjusted debt to EBITDA, and about 58% adjusted total debt to total capital continues to reflect steady operating cash flows and execution on the transition in Ohio. Our rating on AEP reflects our view of a mostly regulated utility strategy that will include continuous capital spending and timely cost recovery through various regulatory mechanisms. We expect this to lead to steady cash flow measures and manageable debt leverage.

### Liquidity

The company's liquidity depends on and is managed by parent AEP. We consider AEP's liquidity position "adequate" under Standard & Poor's liquidity methodology. We base our liquidity assessment on the following factors and assumptions:

- We expect AEP's liquidity sources over the next 12 months, including cash, FFO, and credit facility availability, to exceed uses by 1.2x. Uses include necessary capital spending, working capital, debt maturities, and shareholder distributions.
- Debt maturities are manageable over the next 12 months.
- We believe liquidity sources would exceed uses even if EBITDA decreased 15%.
- In our assessment, AEP has good relationships with its banks and has a good standing in the credit markets, having successfully issued debt during the recent credit crisis.

In our analysis of liquidity over the next 12 months, we assume \$5.8 billion of liquidity sources, including FFO and credit facility availability. We estimate liquidity uses of \$4.6 billion for capital spending, maturing debt, working capital, and shareholder distributions.

AEP's credit agreements include a financial covenant requiring that debt to total capitalization, excluding securitization debt, junior subordinated notes, and debt of AEP Credit, to be no greater than 67.5%. As of Sept. 30, 2012, the company was in compliance with the covenant at 49.5%.

Debt maturities are manageable through 2016. Including amortizing AEP Texas Central Co. securitization bonds, \$1.8 billion is due in 2013, \$1 billion in 2014, \$1.3 billion in 2015, \$940 million in 2016, and \$1.2 billion in 2017. We expect that the company will refinance most of the maturing debt.

### Outlook

The stable outlook on the ratings on AEP and its subsidiaries assumes timely recovery of rate base investments for environmental compliance, system reliability, and continued strategic emphasis on regulated operations. Our base forecast includes adjusted FFO to total debt of at least 15%, debt to EBITDA of less than 5x, and debt leverage to total capital of no more than 60%, all of which are consistent with our expectations for the 'BBB' rating. We could lower the ratings if financial measures fall short of our base forecast on a sustained basis to adjusted FFO to total debt of less than 12%, debt to EBITDA of more than 5.2x, and debt leverage of more than 62%. We could raise the ratings if there is greater certainty regarding business risks and if financial measures exceed our baseline forecast, including FFO to total debt in excess of 20%, debt to EBITDA of less than 4x, and debt to total capital of less than 55%.

### Related Criteria And Research

- [Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011](#)

- **Business Risk/Financial Risk Matrix Expanded**, Sept. 18, 2012
- **2008 Corporate Criteria: Analytical Methodology**, April 15, 2008
- **Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers**, Nov. 13, 2012

Temporary contact numbers: Gerrit Jepsen 917-584-2786; Dimitri Nikas 646-584-8438

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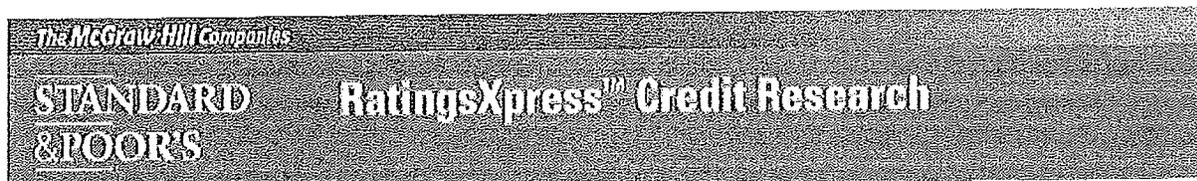
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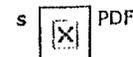
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## RESEARCH



## Summary:

**Public Service Co. of Oklahoma**

**Publication date:** 19-Jun-2012  
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**Credit Rating:** BBB/Stable/--

**Rationale**

Standard & Poor's Ratings Services bases its ratings on Public Service Co. of Oklahoma (PSO) on the consolidated credit profile of its parent **American Electric Power Co. Inc. (AEP)**, which includes regulated and unregulated operations. We consider PSO's business risk profile as "excellent" and financial risk profile as "aggressive". PSO is a vertically integrated, fully regulated electric utility that provides service in eastern and southwestern Oklahoma. It participates in the AEP West Power Pool, sharing the revenues and costs of pool sales to utilities and power marketers, and also sells directly at wholesale to utilities, municipalities, and rural electric cooperatives. Operations are integrated with the AEP West system. We consider AEP's business risk profile as excellent and its financial risk profile as aggressive.

The excellent consolidated business risk profile primarily reflects AEP's status as a large public utility holding company that owns regulated electric utility subsidiaries operating in 11 states in the Midwest and Southwest. These subsidiaries consist of low-risk transmission and distribution wires-only businesses in Texas; fully integrated regulated utilities in states such as Indiana and West Virginia; and higher-risk hybrid operations in Ohio. Although a portion of generation assets are outside rate base, most of the consolidated generating capacity is under stabilizing regulatory oversight. The company's generating and transmission facilities are interconnected, and its operations are coordinated as an integrated electric utility system.

Electric utility operations are slightly above average, characterized by competitive rates, good reliability, a strong collection of low-cost, coal-fired generation in the eastern part of the system, and supportive regulatory relationships in numerous jurisdictions. Service territories vary widely, ranging from manufacturing and rural areas with lower-growth economies to higher-growth, service-oriented economies, like in the Columbus, Ohio, metropolitan area, that are more stable. The diversity in markets and in regulation somewhat elevates credit quality, but managing the complex variety of regulatory environments can be challenging and requires constant vigilance. This is evident in Ohio, where the regulatory commission approved a stipulated resolution to transition utility customers to competitive generation. Ohio Power Co. was also to transfer its generation assets to an unregulated affiliate. The Ohio commission subsequently retracted its approval of this stipulated resolution and initially opened up generation shopping to all the utility's retail customers, but subsequently limited shopping to a certain percentage of customers. This has provided greater cash flow certainty to Ohio Power. The commission's ruling in the utility's electricity security plan by mid-summer 2012 should provide more clarity around the level of shopping that can take place. Over the longer term, with roughly 25,000 megawatts (MW) of coal-fired generation, including those owned by Ohio Power, material compliance costs related to numerous environmental rules could pressure credit quality. In addition to these coal assets, AEP has 9,000 MW of gas generation and a 2,200 MW nuclear plant.

The company's unregulated operations consist mostly of a large portfolio of quasi-regulated electric generating plants, mainly in Ohio, that to date have been primarily serving AEP's retail utility customers at a commission approved generation rate. We expect AEP's track record of good operating performance in its unregulated business operations to continue. Stricter environmental regulation will place financial stress on the company and erode the fleet's competitiveness, but we don't expect these pressures to completely eliminate the advantages of AEP's coal plants. AEP has indicated that it will retire roughly 5,500 MW of additional coal-fired assets and retrofit other coal assets with pollution-control equipment. Although AEP's Ohio-based generation accounts for only a portion of the company's credit profile, absent more robust financial measures, a shift to a greater reliance on market prices to generate cash would increase business risk and could ultimately weaken credit quality.

PSO's financial risk profile reflects AEP's consolidated financial risk profile, which we consider aggressive and includes adjusted financial measures that are in line with the rating. This assessment reflects large capital expenditures mostly for environmental-compliance programs and for new generation and transmission. The elevated spending and dividend payments could result in negative discretionary cash flow for several years, and will require vigilant cost recovery to maintain cash flow measures. We expect consolidated financial measures, including ratios of debt to EBITDA, funds from operations (FFO) to total debt, and debt to capital, to remain in line with the rating. For the 12 months ended March 31, 2012, FFO to total debt was about 17.5%, total debt to total capital was about 57%, and debt to EBITDA was 4.7x. After reducing cash flow from operations by capital expenditures and dividends, discretionary cash flow was a negative \$250 million and net cash flow (FFO after dividends) to capital expenditures dropped to 81%. Both indicate a need for external financing to fund both capital expenditures and dividends. FFO interest coverage continued to be around 3.9x and the dividend payout ratio was manageable at 56%. Adjustments include capital and operating leases, pension-related items, intermediate equity treatment of the junior subordinated notes, and securitized debt.

## Liquidity

The company's liquidity depends on and is managed by parent AEP. We consider AEP's liquidity position "adequate" under Standard & Poor's liquidity methodology. We base our liquidity assessment on the following factors and assumptions:

- We expect AEP's liquidity sources over the next 12 months, including cash, FFO, and credit facility availability, to exceed uses by 1.2x. Uses include necessary capital spending, working capital, debt maturities, and shareholder distributions.
- Debt maturities are manageable over the next 12 months.
- We believe liquidity sources would exceed uses even if EBITDA declined 15%.
- In our assessment, AEP has good relationships with its banks, and has a good standing in the credit markets, having successfully issued debt during the recent credit crisis.

In our analysis of liquidity over the next 12 months, we assume \$7.3 billion of liquidity sources, consisting of FFO and credit facility availability. We estimate liquidity uses of \$4.8 billion for capital spending, maturing debt, working capital, and shareholder distributions.

AEP's credit agreements include a financial covenant requiring that debt to total capitalization be no greater than 67.5%. As of year-end 2011, the company was in compliance with the covenant at 51%.

Debt maturities are manageable through 2016. Including amortizing AEP Texas Central Co. securitization bonds, \$1.4 billion is due in 2012, \$1.4 billion in 2013, \$1.1 billion in 2014, \$1.5 billion in 2015, and \$700 million in 2016. We expect that the company will refinance most of the maturing debt.

## Outlook

The stable outlook for the ratings on AEP and its subsidiaries assumes timely recovery of rate base investments for environmental compliance, system reliability, and continued strategic emphasis on regulated operations. Our base forecast includes adjusted FFO to total debt of at least 15%, debt to EBITDA under 5x, and debt leverage to total capital of no more than 60%, all of which are consistent with our expectations for the 'BBB' rating. We could lower the ratings if financial measures fall short of our base forecast on a sustained basis to adjusted FFO to total debt below 12%, debt to EBITDA over 5.2x, and debt leverage over 62%. We could raise the ratings if there is greater certainty regarding business risks and if financial measures exceed our baseline forecast, including FFO to total debt in excess of 20%, debt to EBITDA below 4x, and debt to total capital under 55%.

## Related Criteria And Research

- **Liquidity Descriptors For Global Corporate Issuers**, Sept. 28, 2011
- **Business Risk/Financial Risk Matrix Expanded**, May 27, 2009
- **Ratios And Adjustments**, April 15, 2008
- **Analytical Methodology**, April 15, 2008

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# Public Service Co. of Oklahoma

## Major Rating Factors

### Strengths:

- Steady utility operating cash flow;
- Part of a electric utility company that is geographically diverse and has a large customer base; and
- Low-cost generation fleet.

### Weaknesses:

- Financial measures could be pressured from exposure to environmental regulations;
- Marketing operations weaken creditworthiness; and
- Increased unregulated generation may pressure business profile.



## Rationale

Standard & Poor's Ratings Services' ratings on Public Service Co. of Oklahoma (PSO) are based on the consolidated credit profile of its parent American Electric Power Co. Inc. (AEP), which includes regulated and unregulated operations. We consider PSO's business risk profile excellent and financial risk profile aggressive. PSO is a vertically integrated, fully regulated electric utility that provides service in eastern and southwestern Oklahoma. It participates in the AEP West Power Pool, sharing the revenues and costs of pool sales to utilities and power marketers, and also sells directly at wholesale to utilities, municipalities, and rural electric cooperatives. Operations are integrated with the AEP West system. We consider AEP's business risk profile excellent and its financial risk profile aggressive. (For more on business risk and financial risk, see "Business Risk/Financial Risk Matrix Expanded," published on May 27, 2009, on RatingsDirect.)

The excellent consolidated business profile primarily reflects AEP's status as a large public utility holding company that owns regulated electric utility subsidiaries operating in 11 states in the Midwest and Southwest. The company operates low-risk transmission and distribution wires-only businesses in Texas; fully integrated regulated utilities in states such as Indiana and West Virginia; and higher-risk hybrid utilities in Ohio. Although a portion of generation assets are outside the rate base, most of the consolidated generating capacity is under stabilizing regulatory oversight. The company's generating and transmission facilities are interconnected, and its operations are coordinated as an integrated electric utility system.

Electric utility operations are slightly above average, characterized by competitive rates, good reliability, a strong collection of low-cost, coal-fired generation in the eastern part of the system, and mostly supportive regulatory relationships. Service territories vary widely, ranging from manufacturing and rural areas with lower-growth economies to higher-growth, service-oriented economies, like the Columbus, Ohio, metropolitan area, that are more stable. The diversity in markets and in regulation somewhat elevates credit quality, but managing the complex variety of regulatory environments can be challenging and requires constant vigilance. This is evident in Arkansas, where the company is continuing to build the Turk coal unit while multiple legal challenges are pending, including litigation in connection with the unit's water intake. Over the longer term, with roughly 25,000 megawatts (MW) of coal-fired generation, including those in Ohio, material compliance costs related to numerous environmental rules

could pressure credit quality. In addition to these coal assets, there are 9,000 MW of gas generation and 2,200 MW of nuclear.

The company's unregulated operations consist mostly of a large portfolio of quasi-regulated electric generating plants, mainly in Ohio, that have been primarily serving AEP's retail utility customers. We expect AEP's long track record of solid operating performance in its unregulated business operations to continue. Stricter environmental regulation will place financial stress on the company and erode the fleet's competitiveness, but we don't expect these pressures to completely eliminate the advantages of AEP's coal fleet. AEP has indicated that it will retire 5,109 MW of coal-fired assets and retrofit part of the fleet with pollution control equipment. Although AEP's Ohio-based generation accounts for only a portion of the company's credit profile, absent more robust financial measures, a strategic shift to a greater reliance on wholesale market prices to generate cash would increase business risk and could ultimately weaken credit quality.

PSO's financial risk profile reflects AEP's consolidated financial risk profile, which we consider aggressive. This assessment reflects financial measures that are in line with the rating, along with large capital expenditures. The company's considerable capital spending is mostly for environmental compliance programs and for new generation and transmission. The elevated spending levels and dividend payments could result in negative discretionary cash flow for several years, and will require vigilant cost recovery to maintain cash flow measures. For the 12 months ended Sept. 30, 2011, funds from operations (FFO) to total debt was 21%, total debt to total capital was around 58%, and debt to EBITDA was 4.3x. The ratios are in line with the rating. Discretionary cash flow is positive and net cash flow (FFO after dividends) to capital expenditures exceeded 130%. FFO interest coverage was 4.5x and the dividend payout ratio was a manageable 58%. Adjustments include capital and operating leases, pension-related items, intermediate equity treatment of the junior subordinated notes, and securitized debt.

### Liquidity

The company's liquidity depends on and is managed by parent AEP. We consider AEP's liquidity adequate under Standard & Poor's liquidity methodology. (We categorize liquidity in five standard descriptors. See "Liquidity Descriptors For Global Corporate Issuers," published on Sept. 28, 2011.) We base our liquidity assessment on the following factors and assumptions:

- We expect AEP's liquidity sources over the next 12 months, including cash, FFO, and credit facility availability, to exceed uses by 1.2x. Uses include necessary capital spending, working capital, debt maturities, and shareholder distributions.
- Debt maturities are manageable over the next 12 months.
- We believe liquidity sources would exceed uses even if EBITDA declined 15%.
- In our assessment, AEP has good relationships with its banks, and has a good standing in the credit markets, having successfully issued debt during the recent credit crisis.

In our analysis of liquidity over the next 12 months, we assume \$7.2 billion of liquidity sources, consisting of FFO and credit facility availability. We estimate liquidity uses of \$4.9 billion for capital spending, maturing debt, working capital, and shareholder distributions.

AEP's credit agreements include a financial covenant requiring that debt to total capitalization be no greater than 67.5%. As of Sept. 30, 2011, the company was in compliance with the covenant at 50.3%.

Debt maturities are manageable through 2016. Excluding amortizing AEP Texas Central securitization bonds, \$690

million is due in 2012, \$1.4 billion in 2013, \$1 billion in 2014, \$1.3 billion in 2015, and \$500 million in 2016. We expect that the company will refinance a majority of the maturing debt.

## Outlook

The stable outlook for the ratings on AEP and its subsidiaries assumes timely recovery of rate base investments for environmental compliance, system reliability, and continued strategic emphasis on regulated operations. Our base forecast includes adjusted FFO to total debt of at least 15%, debt to EBITDA under 5x, and debt leverage to total capital of no more than 60%, all of which are consistent with our expectations for the 'BBB' rating. We could lower the ratings if financial measures fall short of our base forecast on a sustained basis to adjusted FFO to total debt below 12%, debt to EBITDA over 5.2x, and debt leverage over 62%. We could raise the ratings if there is greater certainty regarding business risks and if financial measures exceed our baseline forecast, including FFO to total debt in excess of 20%, debt to EBITDA below 4x, and debt to total capital under 55%.

## Related Criteria And Research

- Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Ratios And Adjustments, April 15, 2008
- Analytical Methodology, April 15, 2008

Table 1

| <b>American Electric Power Co. Inc. -- Peer Comparison</b> |                                  |                   |              |                      |                  |
|--|----------------------------------|-------------------|--------------|----------------------|------------------|
| Industry Sector: Energy                                    |                                  |                   |              |                      |                  |
|  | American Electric Power Co. Inc. | Duke Energy Corp. | Southern Co. | Progress Energy Inc. | Xcel Energy Inc. |
| Rating as of Dec. 14, 2011                                 | BBB/Stable/A-2                   | A-/Stable/A-2     | A/Stable/A-1 | BBB+/Watch Pos/A-2   | A-/Stable/A-2    |
| --Average of past three fiscal years--                     |                                  |                   |              |                      |                  |
| (Mil. \$)  |                                  |                   |              |                      |                  |
| Revenues   | 13,871.7                         | 13,403.3          | 15,645.6     | 9,747.3              | 10,385.6         |
| EBITDA   | 4,190.0                          | 4,474.4           | 4,921.6      | 3,089.4              | 2,524.8          |
| Net income from cont. oper.                                | 1,314.7                          | 1,219.7           | 1,664.9      | 823.0                | 694.4            |
| Funds from operations (FFO)                                | 3,256.9                          | 3,985.8           | 3,955.5      | 2,218.9              | 2,004.8          |
| Capital expenditures                                       | 3,182.0                          | 4,530.2           | 4,191.1      | 2,547.3              | 2,052.6          |
| Free operating cash flow                                   | (568.1)                          | (549.7)           | (596.1)      | (459.7)              | (67.7)           |
| Dividends paid   | 762.6                            | 1,232.7           | 1,402.8      | 724.3                | 422.9            |
| Discretionary cash flow                                    | (1,330.7)                        | (1,782.4)         | (1,998.8)    | (1,184.0)            | (490.5)          |
| Cash and short-term investments                            | 767.0                            | 1,416.3           | 498.9        | 505.3                | 155.1            |
| Debt   | 20,743.2                         | 18,503.2          | 21,358.2     | 14,718.8             | 10,963.4         |
| Preferred stock  | 187.8                            | 0.0               | 747.0        | 182.5                | 252.5            |
| Equity   | 12,672.8                         | 21,896.7          | 15,532.3     | 9,574.2              | 7,698.0          |
| Debt and equity  | 33,416.0                         | 40,399.9          | 36,890.6     | 24,293.0             | 18,659.4         |

Table 1

| <b>American Electric Power Co. Inc. -- Peer Comparison (cont.)</b> |       |       |       |       |       |
|--|-------|-------|-------|-------|-------|
| <b>Adjusted ratios</b>   |       |       |       |       |       |
| EBITDA margin (%)  | 30.2  | 33.4  | 31.5  | 31.7  | 24.3  |
| EBIT interest coverage (x)   | 2.5   | 3.2   | 3.3   | 2.5   | 2.7   |
| Return on capital (%)  | 7.7   | 6.8   | 8.3   | 8.8   | 8.0   |
| FFO int. cov. (X)  | 3.5   | 5.1   | 4.5   | 3.4   | 4.1   |
| FFO/debt (%)   | 15.7  | 21.5  | 18.5  | 15.1  | 18.3  |
| Free operating cash flow/debt (%)                                  | (2.7) | (3.0) | (2.8) | (3.1) | (0.6) |
| Discretionary cash flow/debt (%)                                   | (6.4) | (9.6) | (9.4) | (8.0) | (4.5) |
| Net cash flow/capex (%)  | 78.4  | 60.8  | 60.9  | 58.7  | 77.1  |
| Debt/EBITDA (x)  | 5.0   | 4.1   | 4.3   | 4.8   | 4.3   |
| Total debt/debt plus equity (%)                                    | 62.1  | 45.8  | 57.9  | 60.6  | 58.8  |
| Return on capital (%)  | 7.7   | 6.8   | 8.3   | 8.8   | 8.0   |
| Return on common equity (%)  | 9.9   | 4.3   | 10.4  | 7.4   | 8.2   |
| Common dividend payout ratio (un-adj.) (%)                         | 56.8  | 99.7  | 86.4  | 84.1  | 64.2  |

Table 2

| <b>Public Service Co. of Oklahoma -- Financial Summary</b> |               |               |               |               |               |
|--|---------------|---------------|---------------|---------------|---------------|
| <b>Industry Sector: Electric</b>                           |               |               |               |               |               |
| <b>--Fiscal year ended Dec. 31--</b>                       |               |               |               |               |               |
|  | <b>2010</b>   | <b>2009</b>   | <b>2008</b>   | <b>2007</b>   | <b>2006</b>   |
| <b>Rating history</b>                                      | BBB/Stable/-- | BBB/Stable/-- | BBB/Stable/-- | BBB/Stable/-- | BBB/Stable/-- |
| <b>(Mil. \$)</b>   |               |               |               |               |               |
| Revenues   | 1,273.7       | 1,124.8       | 1,655.9       | 1,395.6       | 1,441.8       |
| EBITDA   | 288.9         | 283.1         | 268.1         | 88.6          | 180.0         |
| Net income from continuing operations                      | 72.8          | 75.6          | 78.5          | (24.1)        | 36.9          |
| Funds from operations (FFO)                                | 172.3         | 186.6         | 270.5         | 85.0          | 206.9         |
| Capital expenditures                                       | 194.3         | 175.8         | 288.5         | 315.8         | 242.1         |
| Dividends paid   | 51.1          | 32.1          | 0.1           | 0.1           | 0.2           |
| Debt   | 1,143.2       | 1,076.0       | 1,127.4       | 1,057.9       | 892.2         |
| Preferred stock  | 2.4           | 2.6           | 2.6           | 2.6           | 5.3           |
| Equity   | 844.9         | 814.4         | 750.9         | 643.5         | 590.7         |
| Debt and equity  | 1,988.1       | 1,890.4       | 1,878.2       | 1,701.4       | 1,482.9       |
| <b>Adjusted ratios</b>                                     |               |               |               |               |               |
| EBITDA margin (%)  | 22.7          | 25.2          | 16.2          | 6.3           | 12.5          |
| EBIT interest coverage (x)                                 | 2.8           | 2.7           | 2.3           | 0.0           | 1.9           |
| FFO int. cov. (x)  | 3.4           | 3.8           | 3.8           | 2.2           | 4.8           |
| FFO/debt (%)   | 15.1          | 17.3          | 24.0          | 8.0           | 23.2          |
| Discretionary cash flow/debt (%)                           | (12.4)        | 3.2           | (13.1)        | (19.2)        | (10.8)        |
| Net cash flow/capex (%)                                    | 62.4          | 87.9          | 93.7          | 26.9          | 85.4          |
| Debt/debt and equity (%)                                   | 57.5          | 56.9          | 60.0          | 62.2          | 60.2          |

Table 2

| Public Service Co. of Oklahoma -- Financial Summary (cont.) |      |      |      |       |     |
|---|------|------|------|-------|-----|
| Return on capital (%)                                       | 7.3  | 7.4  | 8.8  | 0.1   | 5.2 |
| Return on common equity (%)                                 | 8.6  | 9.3  | 10.7 | (5.0) | 6.1 |
| Common dividend payout ratio (un-adj.) (%)                  | 70.3 | 42.4 | 0.0  | 0.0   | 0.0 |

Table 3

**Reconciliation Of Public Service Co. of Oklahoma Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. \$)**

--Fiscal year ended Dec. 31, 2010--

**Public Service Co. of Oklahoma reported amounts**

|   | Debt    | Shareholders' equity | Revenues | EBITDA | Operating income | Interest expense | Cash flow from operations | Cash flow from operations | Dividends paid | Capital expenditures |
|---|---------|----------------------|----------|--------|------------------|------------------|---------------------------|---------------------------|----------------|----------------------|
| Reported  | 1,062.6 | 847.4                | 1,273.7  | 286.9  | 182.0            | 63.4             | 93.9                      | 93.9                      | 51.2           | 194.9                |
| <b>Standard &amp; Poor's adjustments</b>              |         |                      |          |        |                  |                  |                           |                           |                |                      |
| Trade receivables sold or securitized                 | --      | --                   | --       | --     | --               | 0.0              | --                        | --                        | --             | --                   |
| Operating leases                                      | 7.2     | --                   | --       | 0.9    | 0.9              | 0.9              | 3.1                       | 3.1                       | --             | --                   |
| Intermediate hybrids reported as equity               | 2.4     | (2.4)                | --       | --     | --               | 0.1              | (0.1)                     | (0.1)                     | (0.1)          | --                   |
| Postretirement benefit obligations                    | 57.0    | --                   | --       | (0.3)  | (0.3)            | --               | 10.9                      | 10.9                      | --             | --                   |
| Capitalized interest                                  | --      | --                   | --       | --     | --               | 0.6              | (0.6)                     | (0.6)                     | --             | (0.6)                |
| Asset retirement obligations                          | 14.0    | --                   | --       | 1.3    | 1.3              | 1.3              | (3.8)                     | (3.8)                     | --             | --                   |
| Reclassification of nonoperating income (expenses)    | --      | --                   | --       | --     | 4.3              | --               | --                        | --                        | --             | --                   |
| Reclassification of working capital cash flow changes | --      | --                   | --       | --     | --               | --               | --                        | 68.8                      | --             | --                   |
| Total adjustments                                     | 80.6    | (2.4)                | 0.0      | 2.0    | 6.2              | 2.9              | 9.5                       | 78.3                      | (0.1)          | (0.6)                |

**Standard & Poor's adjusted amounts**

|          | Debt    | Equity | Revenues | EBITDA | EBIT  | Interest expense | Cash flow from operations | Funds from operations | Dividends paid | Capital expenditures |
|----------|---------|--------|----------|--------|-------|------------------|---------------------------|-----------------------|----------------|----------------------|
| Adjusted | 1,143.2 | 844.9  | 1,273.7  | 288.9  | 188.2 | 66.3             | 103.5                     | 172.3                 | 51.1           | 194.3                |

**Ratings Detail (As Of December 15, 2011)**

Public Service Co. of Oklahoma

Corporate Credit Rating

BBB/Stable/

| <b>Ratings Detail (As Of December 15, 2011) (cont.)</b> |                   |
|---|-------------------|
| Preferred Stock (2 Issues)                              | BB+               |
| Senior Unsecured (5 Issues)                             | BBB               |
| Senior Unsecured (1 Issue)                              | BBB/Developing    |
| <b>Corporate Credit Ratings History</b>                 |                   |
| 07-Mar-2003   | BBB/Stable/--     |
| 24-Jan-2003   | BBB+/Watch Neg/-- |
| 23-May-2002   | BBB+/Stable/--    |
| <b>Business Risk Profile</b>                            | Excellent         |
| <b>Financial Risk Profile</b>                           | Aggressive        |
| <b>Related Entities</b>                                 |                   |
| <b>AEP Texas Central Co.</b>                            |                   |
| Issuer Credit Rating                                    | BBB/Stable/--     |
| Preferred Stock (2 Issues)                              | BB+               |
| Senior Secured (1 Issue)                                | BBB/Developing    |
| Senior Unsecured (6 Issues)                             | BBB               |
| Senior Unsecured (1 Issue)                              | BBB/Developing    |
| <b>AEP Texas North Co.</b>                              |                   |
| Issuer Credit Rating                                    | BBB/Stable/--     |
| Senior Unsecured (1 Issue)                              | BBB               |
| Senior Unsecured (1 Issue)                              | BBB/Developing    |
| <b>American Electric Power Co. Inc.</b>                 |                   |
| Issuer Credit Rating                                    | BBB/Stable/A-2    |
| Commercial Paper  |                   |
| Local Currency  | A-2               |
| Junior Subordinated (1 Issue)                           | BB+               |
| Senior Unsecured (1 Issue)                              | BBB               |
| <b>Appalachian Power Co.</b>                            |                   |
| Issuer Credit Rating                                    | BBB/Stable/--     |
| Senior Unsecured (18 Issues)                            | BBB               |
| Senior Unsecured (1 Issue)                              | BBB/Developing    |
| <b>Columbus Southern Power Co.</b>                      |                   |
| Issuer Credit Rating                                    | BBB/Stable/--     |
| Senior Unsecured (8 Issues)                             | BBB               |
| Senior Unsecured (2 Issues)                             | BBB/Negative      |
| <b>Indiana Michigan Power Co.</b>                       |                   |
| Issuer Credit Rating                                    | BBB/Stable/--     |
| Senior Unsecured (11 Issues)                            | BBB               |
| <b>Kentucky Power Co.</b>                               |                   |
| Issuer Credit Rating                                    | BBB/Stable/--     |
| Senior Unsecured (2 Issues)                             | BBB               |
| <b>Ohio Power Co.</b>                                   |                   |
| Issuer Credit Rating                                    | BBB/Stable/--     |
| Senior Unsecured (13 Issues)                            | BBB               |

**Ratings Detail (As Of December 15, 2011) (cont.)**

|                                    |              |
|------------------------------------|--------------|
| <b>RGS (AEGCO) Funding Corp.</b>   |              |
| Issuer Credit Rating               | BBB/Stable/- |
| Senior Unsecured (2 Issues)        | BBB-         |
| <b>RGS (I&amp;M) Funding Corp.</b> |              |
| Issuer Credit Rating               | BBB/Stable/- |
| Senior Unsecured (2 Issues)        | BBB-         |

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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