2011

American Electric Power

Transforming Our Business for Sustainable Growth

Balancing Energy Supply, Affordability & the Environment

AEP's 2011 Corporate Accountability Report is available at **www.AEPsustainability.com**

A Message from the Chairman & CEO

Dear Friends:

Our sustainability journey has already carried us far. Our accomplishments include significant reductions in air emissions; improved employee safety and health; improved system reliability; investments in technologies that will shape the future of energy production, transmission, distribution and use; the growth of our modern transmission business; reductions in our own energy use; increases in our fuel diversity, including the use of renewable resources; sustainable dividends for our shareholders; a stronger balance sheet; new partnerships with many stakeholders; and improved service to our customers. We are proud of these achievements.

But the future looks much different than just a few years ago. The road ahead is paved with significant challenges for our company and our customers that were not on the radar even three years ago. A combination of factors is forcing us to look at our business in a new light. Key drivers include eroding tolerance by customers for rate increases; denial by state regulators to recover our investments in carbon capture and renewable energy; slow economic recovery in most of our states; more complex and stringent environmental regulations that will push customer costs still higher; the rising cost to operate older, less efficient coal units; the cost-competitiveness of natural gas compared with other fuels; a dramatically different political landscape; and new concerns about the future of nuclear power in the wake of the Japanese nuclear crisis.

We are engaged in candid, ongoing discussions about our concerns with regulators, legislators and many other stakeholders. These are difficult and complicated issues, and there are no easy solutions. If we work together, we think the outcome can be positive for stakeholders, customers, the environ-

ment and society. We believe sensible regulation and policy can be crafted that balances the costs and benefits. If done right, it would create jobs and economic opportunity, achieve the long-term environmental goals, and spread the costs over time to avoid unnecessary financial hardship for customers. This brochure outlines some of the issues we see and our concerns about current proposals. We will continue to connect with our stakeholders and seek their input as we move forward.

We are in a time of great transformation. Our vision for cleaner, more affordable and more reliable electricity is central to America's economic recovery and growth. As a nation, we must embrace energy as a powerful engine for our country's economic growth; as a company, we must strive continually to balance the needs of our customers and shareholders with measurable benefits to the environment and society. The men and women of AEP are making bold changes that will lead us toward a more secure energy future; I invite you to join us in leading this exciting transformation.

Sincerely,

Michael G. Morris
Chairman & Chief Executive Officer

The Cost of Electricity

The cost of electricity is critical to our customers. Even though our rates remain below the national average, our customers generally live in lower-income regions and are particularly sensitive to rate increases. This is especially true in our Appalachian Power and Kentucky Power service areas. Both companies have seen rising customer complaints due to recent rate increases. Customers of both operating companies have voiced protest in person, in petitions, on social media outlets and through legislators who are taking a more active role in opposing rate increases for their constituents. As the economy remains weak in both areas, we can expect continued resistance and opposition to future rate increases – and vocal criticism from customers who are finding it increasingly difficult to pay their electric bills, particularly during the coldest and hottest times of the year.

The fact remains that coal-fired generation is still among the most affordable in the nation and largely is the reason behind our low rates. But as the nation addresses issues such as climate change and the need to further reduce sulfur dioxide, nitrogen oxide, mercury and other emissions, electricity will become more expensive. AEP has spent more than $5 billion on environmental upgrades since 2000. These expenses ultimately are reflected in rates and make energy more expensive. In fact, the American Coalition for Clean Coal Electricity, an advocacy group we support that promotes the use of coal, reports that half of U.S. households will devote at least 20 percent of their after-tax income to residential and transportation energy in 2011. That number was 12 percent in 2001. Higher gasoline prices are a large part of this increase. Even so, it's clear that escalating energy prices have a disproportionate effect on lower-income households.

That's why it is critical that new environmental regulations be developed and phased in with an eye toward their impact on customers and the economy. Recent proposals from the U.S. Environmental Protection Agency that require a short time frame for compliance are not realistic and will result in significant cost increases for all customers. It will also

jeopardize the reliability of the grid and impact local economies where plants are closed, temporarily or permanently. Higher electricity rates also affect industry competitiveness, which can affect jobs. This is especially true for industries that rely heavily on electricity for their industrial or manufacturing processes. Some customers on fixed incomes could be forced to make increasingly difficult choices about which bills to pay.

We know we can achieve the same long-term environmental benefits without the short-term rate shock that would otherwise occur if we phase in compliance through 2020. It will have a lesser impact on our communities, on jobs and our customers while achieving desired environmental benefits.

Our Customers Speak Out about Rate Increases

As energy bills continue to increase, customers in some of our hardest-hit service territories have expressed their anger. We are sensitive to the effect that higher rates have on our customers. Our goal is to deliver reliable energy at the lowest cost possible, but new environmental regulations will require significant investments in our plants to comply. Customers posted these comments about their bills in online forums:

"I think there will be a lot of people this winter whose electricity will get turned off because they can't pay their bill. I will probably be one of them. We have three kids and we have to have electricity and we have to have food. But if worse comes to worse, I will burn candles and use kerosene if I have to 'cause food is more important."

– *A Kentucky Power customer writing in an online forum in response to an increase in electricity rates*

"Last month my bill was $188 for 1,888 kWh. In December 2008, it was $128 for 1,890 kWh. …Something is wrong with this picture. …I have e-mailed AEP several times, SCC (Virginia's State Corporation Commission) several times so now I am on to my congressman, my senator and delegates. I hope you guys will join me in making your voice heard."

– *An Appalachian Power customer's comments on Facebook about higher electricity bills in Virginia*

Environmental Performance

For more than 100 years, our customers have relied on us to deliver dependable, affordable electricity and our shareholders have relied on us to deliver a return on their investment. We must also comply with all applicable environmental laws and regulations, and manage our impacts beyond compliance when appropriate.

Our company and our industry are on the cusp of a major transformation – driven, in part, by proposed changes to environmental regulations. The U. S. Environmental Protection Agency (EPA) has announced new or revised regulations governing coal ash disposal, air emissions, cooling systems and wastewater effluent.

We recognize that environmental regulation is connected directly to our social and economic issues. Well-designed regulations with realistic compliance requirements and reasonable timelines for implementation can protect the delicate economic recovery of communities, preserve and create jobs, ensure grid reliability and keep electric rates reasonable for consumers and businesses.

We are, however, very concerned about the EPA's proposed timing and lack of coordination for implementation and the consequences of disjointed approaches. We believe the implementation process must be thoughtful and take into account the impacts to the economy, reliability of the electric grid and costs to customers, as well as the environmental and public health benefits.

We support the Clean Air Act, but we need more time to comply. We believe that both the industry and the EPA need to consider the full range of regulatory proposals in context to ensure the most efficient and effective approach to timing and implementation of overlapping requirements.

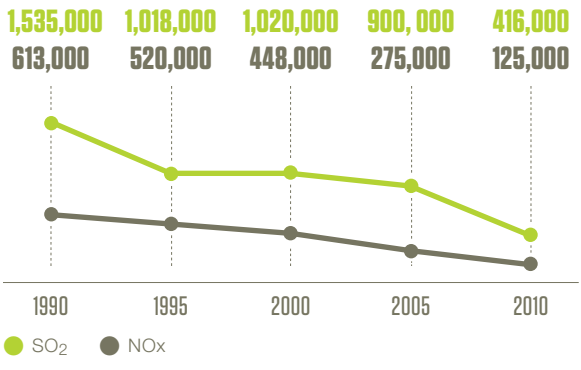
We believe the EPA needs to consider the emissions reductions that have already occurred and will continue to occur as a result of the industry's compliance with the Clean Air Interstate Rule. Those emissions reductions will achieve essentially all of the air quality benefits EPA is targeting with the Clean Air Transport Rule.

We have already made significant progress toward reducing emissions by installing state-of-the-art pollution controls during the past decade. We have built nine scrubbers on 7,900 megawatts (MW) of our coal-fired generating capacity between 2003 and 2011 and selective catalytic reduction systems (SCRs) on more than 11,000 MW since 2001. As a result of these actions and other emissions reduction actions taken before 2000, sulfur dioxide (SO_2) and nitrogen oxide (NOx) emissions have been reduced by about 80 percent from 1990 levels. In preparation for the addition of more controls on our plants, we have begun preliminary engineering and design work to build new scrubbers and other controls. In our experience, it takes four to five years to engineer, fabricate and install a scrubber. Even this early preparation won't get us to the EPA's compliance deadlines on time, but we are confident that we can do it by 2020.

For additional information on our policy positions, planned actions, and steps we have already taken to reduce our environmental impact (including changes in our coal ash management practices, recycling of coal combustion residuals, and enhanced groundwater monitoring), see ***www.AEPsustainability.com***.

SO_2 & NOx Emission Trends at AEP-Owned Plants

(measured in U.S. tons)



Energy Security & Reliability

Reliability, security and the ability to meet increased demand for energy are critical issues for us, our industry, our stakeholders and society. Our ability to meet growing demand and to deliver energy reliably from secure sources depends on a mix of economic, environmental and social factors.

We are dealing with aging infrastructure, enhanced grid security concerns, the need to develop and pay for new technology, new environmental regulations that threaten the viability of older generation assets, and community concerns about siting new facilities – all of which require a strategy that takes financial, environmental and social concerns into account.

System Reliability

New environmental proposals by the U.S. Environmental Protection Agency have the potential to affect the reliability of the transmission system, particularly in the Midwest, and the overall supply of electricity. The proposed timelines for compliance aren't adequate for construction of significant retrofits or replacement generation, so many coal-fueled plants would be prematurely retired or idled in just a few years.

AEP's compliance plan alone would abruptly cut generation capacity in the Midwest by more than 5,400 MW. Depending on the year, another 1,500 MW to 5,200 MW of AEP generation would be idled or curtailed for extended periods as pollution control equipment is installed. AEP has shared its compliance plan with PJM Interconnection, Southwest Power Pool and North American Electric Reliability Corp. for use in their evaluation of the impacts of the EPA's proposed rules.

Secure Fuel Sources

Coal is an abundant, indigenous resource used to produce roughly half of the nation's electricity supply. It has been our most cost-effective fuel for more than a century, enabling us to provide a source of reliable, affordable electricity to our customers. Coal will play an important role in our energy future, but natural gas looks increasingly attractive given the

promise of continued relatively low prices due to the development of shale gas and the high cost of environmental controls associated with coal-fired generation. We expect that, during the next decade, natural gas-fueled generation will increase from approximately 8 percent of our fuel portfolio today to 15 percent.

Our fuel portfolio also includes nuclear energy, which accounts for 5 percent of our generating capacity. In the wake of the Japanese nuclear crisis, a rigorous evaluation is being done by the U.S. nuclear industry to ensure the ability to safely shut down reactors in the face of similar circumstances.

Construction continues on the John W. Turk, Jr. Plant in Arkansas, but it still faces many legal challenges. The Turk Plant is needed to serve growing demand in that region and to provide long-term energy security for customers.

A robust and reliable transmission grid is another element of a secure energy future. Unfortunately, regulatory delays and negotiations with stakeholders over siting, planning and cost allocation have caused significant delays in transmission project approvals across the country. As the economy improves, demand for electricity will naturally increase, and could create unbearable pressure on the existing infrastructure. We urgently need to modernize the grid now.

Energy efficiency and demand response systems are also important ways to bolster energy security. For more information on initiatives in these areas, including smart meters being rolled out through our gridSMART® project, visit ***www.AEPsustainability.com***.

Three-Year Rolling Average Systemwide Reliability Performance

	2006	2007	2008	2009	2010
SAIFI*	1.526	1.548	1.526	1.471	1.397
SAIDI**	203.0	199.0	201.0	198.1	194.7

*System Average Interruption Frequency Index is the average number of interruptions a customer experiences annually.

**System Average Interruption Duration Index represents the total minutes of interruption the average customer experiences annually.

Our Concerns

For more than 100 years, AEP has provided affordable, reliable electricity for our customers; steady, competitive returns for our shareholders; and safe, rewarding jobs for our employees. While doing so, we have worked to protect the environment and to support our communities.

Our goal is to continue to provide safe and reliable energy in the most efficient, cost effective manner we can while improving our environment. That's why we believe we can develop a better approach to environmental regulation that helps keep electricity affordable while achieving the longer-term goals of reducing sulfur dioxide, nitrogen oxide, particulate matter, mercury, acid gases and other emissions.

First, let's recognize the progress the power industry has already made. The air quality benefits from already achieved or planned for compliance with the Clean Air Interstate Rule (CAIR) have not been properly recognized by the U.S. EPA. In fact, a modeling analysis of the ozone and fine particulate air quality benefits resulting from the CAIR shows that the EPA's air quality goals will be achieved without the additional costly reductions required by the Clean Air Transport Rule.

Second, we need more time to design, permit, build and install the equipment required to reduce mercury and other hazardous air pollutants. Some argue that we've had since the Clean Air Act was last amended in 1990 to do this. But the fact is that we did not have any emissions reduction targets for these substances until the EPA issued a proposed rule in March, 2011. AEP has many years of experience building these controls and we know how much time is needed for these units. A scrubber can take up to five years to acquire permits, design, obtain regulatory approval and build. The EPA's Hazardous Air Pollutants rule allows for three years.

Other considerations are availability of capital funds and the labor and materials needed to comply. Many of the nation's utilities will be on the same timeline, competing for a finite supply of qualified workers and equipment, which will affect the cost to customers.

> “There are costs and benefits associated with these changes and we are working through all possibilities to ensure our plan addresses our financial, environmental and social responsibilities. The foundation of our action plan is communication, candor and transparency – with our shareholders, customers, regulators, legislators, policymakers and other stakeholders.”
>
> *Dennis E. Welch*
> *Executive Vice President, Environment, Safety & Health and Facilities*

Third, the EPA is not considering the full impact of these rules on the reliability of the electric system. Numerous plants across the nation will be either closed for good or closed for retrofits at the same time, making the industry’s ability to meet the demand for electricity very challenging.

Finally, we are very concerned that the impact to customers is not being seriously considered. We are already hearing from customers who are forced to decide between paying their electric bills or buying medicine or food. The EPA’s timing for these rules will exacerbate these issues.

There is a Better Way

Phasing in the comparable emissions requirements through 2020 will allow us to achieve the same benefits at much less cost. By giving utilities more time to properly plan and coordinate construction schedules, projects will cost less, older plants can be closed in a more orderly manner, some transmission mitigation expenses can be avoided, communities will have more time to plan for plant closures and the overall cost to customers will be less.

However, this change will require action from Congress. Some of the deadlines are statutory; some are the result of court settlements, which tie the EPA’s hands. That is why AEP supports a legislative approach. We are not attempting to subvert the Clean Air Act. We are simply asking for time to comply in a way that best serves our customers, our communities and the environment.

American Electric Power
1 Riverside Plaza
Columbus, OH 43215
614-716-1000
www.AEP.com

Contact Us

We welcome your feedback. Hearing from our various stakeholders helps us understand what concerns them. Please send your comments to ***smnessing@AEP.com***.

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