Q3 2012 Earnings Call

Company Participants

- Brian Tierney, EVP, CFO
- Chuck Zebula, SVP IR, Treasurer
- Nicholas Akins, President, CEO

Other Participants

- Ali Agha, Analyst, SunTrust Robinson Humphrey
- Art Massimiani, Analyst, Federal Investors
- Hugh Wynne, Analyst, Sanford C. Bernstein & Company, Inc.
- Jonathan Arnold, Analyst, Deutsche Bank
- Kit Konolige, Analyst, BGC Partners
- Neil Mehta, Analyst, Goldman Sachs
- Paul Fremont, Analyst, Jefferies & Company
- Paul Ridzon, Analyst, KeyBanc Capital Markets
- Philson Yim, Analyst, Luminus Management
- Rajeev Lalwani, Analyst, Morgan Stanley

Presentation

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Third Quarter 2012 earnings conference call. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session and the instructions will be given at that time. (Operator Instructions) As a reminder this conference is being recorded. I would now like to turn the conference over to our host, Treasurer, Mr. Chuck Zebula. Please go ahead, sir.

Chuck Zebula {BIO 6231994 <GO>}

Thank you, Lori. Good morning, and welcome to the Third Quarter 2012 earnings webcast of American Electric Power. Our earnings release, presentation slides and related financial information are available on our website, AEP.com. Today we will be making forwarding-looking statements during the call. There are many factors that may cause future results to differ materially from these statements. Please refer to our SEC filings for a discussion of these factors.

Joining me this morning for opening remarks are Nick Akins, President and CEO, and Brian Tierney, our CFO. We will take your questions following their remarks. I will now turn the call over to Nick.

Nicholas Akins {BIO 15090780 <GO>}

Thanks, Chuck. Good morning, to everyone. Thank you for taking the time to join our Third Quarter 2012 earnings call. I really call this -- these calls status calls, because we now have a long-term strategy that's been in place since February, and we are committed to continuing with that strategy and really describing -- taking the opportunity to describe the steps that we have been taking along the way in moving forward with that strategy to not only redefine AEP from a transformational perspective, but also set AEP up for the future.

It is also a discussion of the environment we find ourselves in, but most importantly what we are doing about it. Notwithstanding the derecho that certainly had an impact over our service territory, multiple storms during that time where close to 1.8 million customers over two weeks. When you have that kind of customer mix with those storms, it truly has an impact on what the record [ph] supply was during that period of time. But notwithstanding that, there is no doubt that it was a challenging quarter.

In the past couple years, the accelerator has been pressed to a four on the industrial recovery in the service territory and has gradually letting up quarter by quarter, until now, this quarter we are finding that the foot's off the accelerator. Fueled by primary metals and oil and gas activity, we made great progress in the recovery after the recession. And now we find primary metals faltering once again due to the soft international demand, primarily in the aluminum area, while certainly oil and gas activity continues to progress.

So our industrial will drop for the first time in nine quarters by 3.1%. And half of that was probably in Ormet here in Ohio where two pot lines were taken offline. So it does show the sensitivity around aluminum prices. In previous quarters the industrials were compensating for residential and commercial load decreases, and now we see commercial customer growth still continuing to improve. We saw that for the first time in a few years that last quarter, commercial improvement. That continues.

But as we said earlier, the economy is tenuous at best, and we really do have to be concerned about the issues involved with that. And now we are seeing probably the end result of 2012 year to date load growth profile being essentially flat for the year.

So one quarter doesn't make a trend, but we have to be concerned anytime we see a slow down in economic activity. Certainly issues such as international market conditions, needed tax and regulatory reform, and the need for a coherent energy policy are factors that must be resolved to spur investment and enable a recovery. We are hopeful that after the election we can make some progress on those fronts.

As Brian will discuss later, despite the load growth challenges and the continued loss of Ohio-related revenue due to movement of -- movement to competition, we delivered near consensus earnings on a $1 on a GAAP basis per share and $1.02 operating earnings per share for the Third Quarter, and $2.55 and $2.59 per share respectively for the nine months year to date.

How do we overcome the challenges that I just discussed? Well, I think it goes back to the February discussion that we had. Diversity of the AEP system is something that is very positive for us. We not only have been controlling costs, which we have done a great job of, we have various other jurisdictions that have produced rate increases. So certainly when you look at the strength of AEP, it is in that diversity we keep talking about.

There is no sense whining about the economy. It is what it is. But we can and do adjust to provide a level of discipline that the market expects. We know when the economy truly begins recovering in a sustainable fashion, the diversity of our system, of our customer mix, the fundamental resources such as shale gas, which is prevalent in our operating footprint, will enable AEP to reach our growth potential.

So we remain committed to our long-term strategy as discussed with you on February 10 of this year, and I've talked about it in all of the quarterly earnings webcasts as well, but I'll reaffirm it here. Certainly our notions have been around these issues. Movement to competitive market in Ohio with corporate separation and the formation of our competitive generation retail and marketing functions. Number two, investment in our regulated businesses and a focus on ROE optimization.

Number three, a focus on growth aspects of the business such as transmission. And then four, to reaffirm to you our commitment to be a regulated utility going forward. The dividend strength that we have is generated by the regulated businesses, and we are intent on maintaining that 86%, 14% mix we have talked about previously. And a continued commitment to the 4% to 6% earnings growth. Transformation of our generation resources is also a key component, particularly in a lot of EPA mandates and so forth.

So as we -- so as far as providing guidance, we anticipate providing guidance after we receive the final order of the Ohio ESP, which we expect hopefully by the end of the year. By then we will also complete the repositioning study we have been involved with. So we are anticipating having a February analyst day to provide guidance for 2013. At that point, I think the main risk issues we will have really center around the level of Ohio customer switching and load growth that we see post election and so forth. So I think we will be in a better position -- a much better position to give guidance at that point in time.

Our operational performance has been excellent. When you look at things we actually control, we've done an outstanding job. The repositioning study -- I am very pleased with the progress there -- will be completed by the end of the year. Andy am just pleased with the degree of thoughtfulness that the teams have gone through to achieve the objectives.

And the progress being made, we have had two or three sets of discussions with the five teams that are working on this thing. It is amazing to me you can have substantial process changes that reposition this Company for the future and focus on the growth areas, and we wind up providing a level of service that we continue to maintain. So it is a good progress there, and we fully expect to be able to talk more about that when we get to the February time frame.

Transmission has just successfully completed a $350 million debt offering, which was fully subscribed. And there was a high degree of interest in it, so it shows that we are moving in the right direction from an investment profile, and we continue to work on our capital allocation to further encourage the growth of our Transmission businesses.

We continue to focus on the advancement of Transco's in the various jurisdictions. We have four Transco's, and the others are in various levels of ongoing pending action. So we continue to be heartened by what is going on there as well. Our Turk plant is moving toward completion. We expect our first coal firing -- we had a natural gas firing for start up a couple months ago, and I was proudly showing the pictures of that. It looks like a gas burner. I guess I appreciate it more than the others did.

But nevertheless, today we should be seeing the first coal firing. We should see synchronization to grid of the Turk plant here in November, and then in December should see it go commercial. So -- and it is a beautiful plant site, being the first super ultra-supercritical pulverized coal unit in the nation, and we are very proud of that accomplishment. You look at it and wonder why we can't do those things everywhere.

The regulatory cases related to that, obviously getting the commercial operation date is critical for us. We filed a case in Texas, and it is ongoing in terms of that jurisdictional recovery there. And even with that filing we still have among of the lowest rates in Texas. So I think we stand in pretty good favor there in terms of the placement of that plant and what it means in the future for SWEPCo customers.

Other cases, such as the Indiana case, a $140 million case filed there. Case hearings have concluded, and we expect to have an outcome of that by the end of this year as well. So those things aside, probably one of the main things you are interested in is what is happening in Ohio. During the last quarter we made considerable progress there.

As many of you are aware, the Ohio PUCO provided clarity for our transition to a competitive market by issuing ESP orders, capacity orders and corporate separation orders that enable us to move forward with the FERC filings. And the result of those orders have been positive for us in that we can map out a plan for the future, focus on the filings that need to be made at FERC once again, and also pursue the other state filings on the transfers of Mitchell and Amos to APCo and Kentucky Power. So we are focused on those jurisdictions and discussions are ongoing in those areas as well.

So we will have six filings to make, just as we made last time, around the areas of separation of the Ohio assets, transfer of Mitchell and Amos, merging Wheeling and APCo and other termination agreements associated with the pool and the inner connection agreements and the various temporary joint operating agreements and those types of things. Those filings will be made -- we anticipate making those filings by the end of October. So we are moving forward step by step in this process to ensure that we continue with the progress that's being made.

Also I'm pleased with the progress of AEP Energy. Forming our AEP retail business, we put BlueStar and everything else in that business. We now have approximately 150,000 customers, and we continue to focus on margins, not quantity, in a very deliberate, disciplined fashion. So we proceed with separating out our Ohio generation. We will include that in that part of the business.

And then I am very focused on that transition to make sure it is complete. I am very happy to see that business continues to progress, and they are actually earning their own keep. So that's a great story early on in their function.

So while the economy continues to be a challenge, we have responded with an unwavering focus of commitment to our strategic plan and the discipline to provide shareholder value and quality customer service. And we are very focused on those steps. We will be very transparent about those steps as we go forward. Like I said, this is viewed as a status call to let you know that progress has indeed been made, and the fundamentals are there in our service territory because of the diversity that this system is ready you go.

So I will turn it over to Brian to give you the details of the Third Quarter. Brian?

Brian Tierney {BIO 15917272 <GO>}

Thank you, Nick, and good morning to everyone. Let's start on slide four with the quarterly comparison, where you see that operating earnings for the Third Quarter of the year were $496 million or $1.02 per share, as compared to $566 million or $1.17 per share for the last year's Third Quarter.

Ohio customers switching and the authorized capacity cost deferrals combined for a negative $0.06 comparison to last year's Third Quarter. In the Third Quarter of 2011 we recorded a $28 million carrying cost for the TCC stranded capacity auction true-up. Since we securitized this true-up earlier this year, we do not have a comparable amount this quarter, resulting in an unfavorable comparison of $0.04.

Although this was the fifth warmest quarter in the last 30 year, last year's Third Quarter was the warmest during that time frame. This results in weather having a negative $0.04 per share comparison to last year, but it is actually positive $0.07 versus normal weather.

Off-systems sales net of sharing were down $20 million or $0.03 versus last year. Physical volumes and margins were off in response to power prices that averaged 20% below last year, and natural gas prices off by over 30%. Trading and marketing results were $5 million lower than last year.

Non-utility operations and parent results accounted for a negative $0.03 last year and mostly explained by the effect of the drought on our River Operations business. Depreciation and amortization expense increased by $32 million and accounted for a negative $0.04 comparison. This was due to the accelerated depreciation at the Ohio plants that we will retire in 2015, increased depreciation rates on several of our jurisdictions, as well as the amortization of the TCC securitization.

On the positive comparisons, jurisdictional rate changes net of the loss of the Ohio provider of last resort revenues and at $0.03 per share or $20 million compared to last year. Our continued focus on spending that Nick mentioned several times resulted in operation and maintenance expenses net of offsets having a positive comparison of $0.04 per share over last year. Other, including higher Transco and TCC earnings, added $0.02 per share over last year's Third Quarter.

At this point I would like to provide an update of the cost treatment related to the June 29 derecho and the three smaller storms that occurred during the restoration efforts. The total cost of these storms is approximately $217 million, of which about $62 million were capital and removal costs. Of the remaining $155 million, about $124 million has been deferred for future recovery, leaving about $31 million to be expensed. $4 million were expensed in the Second Quarter, and the remaining $27 million were expensed in the Third Quarter.

Turning to slide five, I will review the year to date comparisons. Operating earnings for the 2012 year to date period were $1.255 billion or $2.59 a share, compared to $1.31 billion or $2.72 per share for the year to date of 2011.

Ohio customer switching, net of authorized capacity deferrals, accounted for a negative $0.19 when compared to last year’s year to date. Approximately 42% of Ohio's load has switched suppliers, versus approximately 10% of load that had switched by the end of September last year.

Weather provided a negative $0.16 comparison to last year for the year to date period. This year's mild winter did not compare favorably with the more extreme weather of 2011, and as previously mentioned, while this summer was warm, it was not as warm as last year. However, when compared to normal weather, 2012 year to date was favorable by $0.04.

Non-utility operations and parent results had a negative comparison of $21 million or $0.04 per share. This is mostly explained by the drought impacts on our River Operations and by the loss of production tax credits at our Texas wind farms. Depreciation and amortization expenses increased by $101 million or $0.13 per share for the year to date period. And the reasons for this are the same as for the quarterly comparison. Year on year rate increases from several jurisdictions were fully offset by the loss of the Ohio provider of last resort revenues, resulting in no change to the year to date period for this category.

Continued disciplined spending resulted in a positive year to year O&M comparison of $215 million or $0.28 per share. It is important to remember this line item is operational and maintenance expenses net of revenue increases to account for rate trackers and other contemporaneous rate mechanisms. The remaining positive year to date reconciliation of $0.11 per share is explained by higher Transmission earnings, the 2012 reversal of negative a fuel provision from the prior year, and a lower income tax rate.

Taking a look at retail load trends on slide six, you will see the bottom right-hand quadrant that overall weather normalized retail sales were down 1.4% for the quarter and are now down 0.30%year to date.

Before going into the sector comparisons, let me provide an overview of the economy in our service territory. On several traditional economic indicators the AEP service territories outperformed national measures. For example, employment growth for AEP's metropolitan area was up 2.1% for the quarter, versus national employment growth, which was up only 1.4%.

GDP was estimated to grow at 3% for AEP's metropolitan areas for the quarter, versus 1.8% estimated growth for the US in aggregate. Our western service territories experienced GDP growth of 3.4%, as compared to the 2.6% growth experienced in the western portion of our system. These different growth rates exemplify the diversity that Nick referred to in his comments.

Despite these positive comparisons to national indicators, AEP does not escape the reality of a struggling economy. This is evident when looking at the bottom left-hand quadrant of the slide, where you can see that industrial sales were down 3.1% for the quarter. This development is of concern because, as Nick said, it is counter to the positive industrial load trends from the previous nine quarters. Industrial sales are now positive 0.2% for the year to date period. We will explore this customer class in a little bit more detail in the next slide.

Above industrial sales you will see weather normalized residential sales declined 0.5% compared to last year's Third Quarter. We believe that about half of this negative 0.5% was attributable to the derecho.

While the customer accounts remain fairly steady at 5.3 million customers, average usage per residential customer declined 0.7% for the quarter and is down nearly 2% for the year. We believe this is related to state and federal energy efficiency initiatives and to the lingering effects of the economy.

The commercial customer class is essentially flat for the quarter and is now up 0.5% for the year to date period. We believe that the growth in employment that I mentioned earlier should have a positive impact on the commercial sector in the future.

Let's take a look at the industrial sales class on slide seven. You can see that four of our top five industrial sectors experienced negative trends for the quarter. Nick referenced the primary metal sector, which was down 9.8%for the quarter and is now down 2.5% for the year. Much of the decline is due to our largest customer, which reduced production by a third during the quarter. Excluding this customer, primary metals were down 3.9% for the quarter and 1.4% year to date.

The chemical manufacturing sector was down 5% for the quarter and is down 2.2% year to date. Nationally, chemical manufacturing is at its lowest level since 2010 due to decreases in worldwide demand. Mining, excluding oil and gas, is down in response to coal mine closures related to environmental challenges, as well as reduced coal mine production due to low utility demand and to natural gas prices.

On the bright side, petroleum and coal products manufacturing, our third largest industrial sector, was up 6% for the quarter and is now up 6.7% year to date. Our largest increase here was in SWEPCo's service area, where a large refinery expanded capacity. Other sectors showing growth are transportation equipment manufacturing, our seventh largest industry, which is up 5.3% for the quarter related to strong US auto sales, and oil and gas extraction, our ninth largest industry, which is up 2.6% for the quarter related to shale gas production.

Turning to slide eight, you can see the Company's coal capacity factors have decreased on a quarterly and year to date basis as our natural gas capacity factors have increased. Overall, our generation from natural gas has increased approximately 50% year to date. For our East combined cycle units, the increase in capacity factors in generation was more pronounced. With the addition of the Dresden generation facility to our Waterford and Lawrenceburg plants, our East combined cycle generation has increased 114% for the quarter and 160% for the year to date period.

With year to date capacity factors for these plants approaching 70% and with the recent increases in the forward natural gas prices, the ability to realize incremental coal to gas switching within our Eastern fleet is minimal. Because of the hot weather, our coal units ran more in the Third Quarter then in the Second Quarter, and our coal inventory went from 48 days at the end of the Second Quarter to 45 days at the end of the Third Quarter. Our target is 35 to 40 days. Our coal needs for 2012 are fully hedged, and our needs for 2013 are about 92% hedged, with many units fully hedged.

Turning to slide nine you will find the Company's balance sheet, credit and liquidity statistics for the end of the Third Quarter. The balance sheet reflects our conservative approach to financing the Company. At the end of the quarter total debt to total capitalization was 54.6%. In addition, our pension funding status was at 87% and includes a contribution of $100 million made in September.

Our credit statistics for the trailing 12 months remain strong, with FFO to total debt near 20% and interest coverage ratio at 4.8 times. In addition, our liquidity at the end of the quarter was over $3 billion and is supported by two core credit facilities with the total capacity of $3.25 billion.

Last week Moody's published their latest credit opinion on American Electric Power. This opinion positively highlighted the Company's diverse stream of cash flows and conservative financing policies, while at the same time identifying the increased business risk due to the transition of our Ohio generation to a deregulated market in 2015. We remain committed to managing our balance sheet and credit outlook conservatively as we approach the Ohio transition.

On page ten you will find a number of upcoming events on our calendar through the First Quarter of next year. In the next few weeks we plan to make filings at the FERC related to our corporate separation plans in Ohio. We believe that making these filings this fall puts us on track to legally separate at the beginning of 2014. These FERC filings on corporate separation will require us to evaluate the accounting recovery of our Ohio generating assets.

In the past we have evaluated the recovery of the generating assets in the East generation pool collectively as an asset group. Prospectively, we may need to review the Ohio assets individually. Of interest are the Ohio units that we have previously identified to you for retirement in 2015. We are currently depreciating these units to an end of life in mid-2015, and as of the end of the quarter the 11 units and five plants had a net book value of $284 million.

Later this year we also plan to file with West Virginia, Virginia and Kentucky to seek authority to transfer the Mitchell and Amos capacity to Appalachian Power and Kentucky Power. Also on the regulatory front we anticipate a rate order in our Indiana case by the end of the year, and we are hopeful to get the financing orders in Ohio and West Virginia by early 2013, enabling us to proceed with about $700 million in securitizations in the First Quarter of next year. Nick mentioned earlier in his comments about the Turk plant becoming operational, and he also mentioned the cases that will be used to get Turk into jurisdictional rate base as quickly as possible.

Lastly I'm sure we will see many at the EEI financial conference in Phoenix. At the meeting we will highlight many of the drivers of the financial performance of the Company, as well as an update on the Company's strategic initiatives. We will not issuing guidance at that time. Once the regulatory process concludes in Ohio and our orders are final, we plan the analyst meeting where we will address guidance, earning and dividend growth, our regulated operations and our competitive platform going forward.

Thank you for your time this morning, and at this point I will turn the call over to the operator, and Nick and I will be happy to take your questions.

Questions And Answers

Operator

(Operator Instructions) Our first question is from the line of Paul Fremont with Jefferies. Please go ahead.

Q - Paul Fremont {BIO 1745706 <GO>}

Thank you, very much. I guess my first question would be that you have made some really good progress on O&M reduction. Can you talk a little about where the O&M reduction so far has come from, and can you just generally talk about, based on what you have achieved already, what types of opportunity -- incremental opportunities do you think there are?

A - Nicholas Akins {BIO 15090780 <GO>}

Paul, there has been a lot of activity associated with that obviously. We have been very careful as the years have gone by, and this year is no different, where we look at operating type of synergies that exist, but also from an O&M operation standpoint there are things we view as -- typically we will -- we have alges [ph] move in and out, we have other things that occur as a result that changes the nature of the O&M spend.

But we make sure that those changes are sustainable going forward. It is not a matter of us not doing something and moving it into next year. We are really focused making sure we are able to do it in a sustainable fashion. What we really have done with the repositioning study is refocused that effort to say that we want to focus on process changes that enable us to make O&M reductions in the future. The teams are focused on that and --

Just to give you examples, there are areas where there are reporting things where we have done internationally that over the years the reports continue to be done, they don't need to be done. Or they can be done in consolidated fashion, the same report being produced by several business units for example. Those are synergies that we are looking at and process changes that can occur.

On the supply chain side, standardization is certainly a key for us. You would be surprised how many pairs of gloves -- 90 different pairs of gloves we buy. So it is those kinds of things that we really focus on to try to make sure we are getting as much O&M reduction as we can, but doing it in a sustainable fashion.

Typically I think you are going to see on the percentage basis roughly a two-thirds process oriented reduction change. And then when you look at changes in spans of control in terms of organizational realignment, those types of things, and because the process review enables less resources to be performed in one area versus another, a third of that will be more resource reduction types of activity. So it is those kinds of tradeoffs that we are seeing.

But it is very focused on the process side of things first, and then the resources fallout. The reason we do it that way is we want to wind up in a situation where if we are trying to expand and grow the Transmission business, we want resources to be put in the capital areas where transmission can be built, and also produce headroom from a rate perspective where more capital can be deployed. So that's why we are doing it, and I think it is coming along quite well.

Q - Paul Fremont {BIO 1745706 <GO>}

And then as a quick follow-up, in Arkansas I think you initially got a negative decision out of the commission, but they are giving you an opportunity to file additional testimony. When do you plan on filing the additional testimony, and do you believe that you're going to be able to convince Arkansas that there is benefit associated with the transaction for customers?

A - Nicholas Akins {BIO 15090780 <GO>}

We expect to get something in early December on that. And I think they have given us an opportunity, obviously, because we have a very good relationship with the Arkansas commission, and certainly to give us an opportunity to supplement the record and do additional things to reinforce our position is a good thing.

Q - Paul Fremont {BIO 1745706 <GO>}

Thank you.

Operator

Our next question is from the line of Jonathan Arnold with Deutsche Bank.

Q - Jonathan Arnold {BIO 1505843 <GO>}

Good morning, guys.

A - Nicholas Akins {BIO 15090780 <GO>}

Hi, Jonathan.

Q - Jonathan Arnold {BIO 1505843 <GO>}

My question is on coal gas, burn and switching and the like [ph]. You mentioned you reached a 70% cap factor on the CCGTs in the East and not having much room for further switching. So I guess firstly, whether you'd expect to see some reversal of the dynamic in calendar 13, given current forwards [ph] and considering your contract position, which I guess is maybe less of a factor than it was this year?

A - Nicholas Akins {BIO 15090780 <GO>}

Jonathan, actually we have seen switching going back the other direction. The capacity factors of the gas units are starting to drop. The coal capacity is picking back up. For us, you get into the gas price of $3 to $3.25 per MMbtu, and you going to start that switch to -- back to coal.

I think for other utilities it is higher, because our mines are located close to the plants, and their mainly -- coal comes in by the river, and we have pretty advantageous contracts. It certainly helps us keeping the switchover price lower.

So I think it is a very good proposition for us, because we are able to move back and forth in that perspective when we have the contractual ability to adjust from that perspective as well. And it really says something good about the ongoing nature of our unregulated business, because it will be particularly two-thirds our fully controlled coal units, and as well our gas units -- third gas will be able to take advantage of the economies as well.

Q - Jonathan Arnold {BIO 1505843 <GO>}

Great, thank you, Nick. Can I just put in [ph] a second? Timing-wise, do you have -- can you give us a sense of when on the forward monthly calendar you would stop seeing year-over-year increases in gas fired comps? Is that before year-end, or is that sometime in the first half of next year?

A - Nicholas Akins {BIO 15090780 <GO>}

Well, I think certainly year over year from a gas standpoint, I think we will continue to see participation from a gas standpoint. Gas prices have gone up slightly through this time frame, but when you look at next year the strip is still pretty low, and you'll still see coal consumption, but I think you'll still see a considerable amount of gas consumption as well. And it also depends on whether the economy comes back the way it should to fill in the valleys.

Q - Jonathan Arnold {BIO 1505843 <GO>}

Okay. Thank you.

Operator

And we have a question from the line of Kit Konolige with BGC Partners.

Q - Kit Konolige {BIO 1507691 <GO>}

Good morning, everyone.

A - Nicholas Akins {BIO 15090780 <GO>}

Hi, Kit.

Q - Kit Konolige {BIO 1507691 <GO>}

So a quick follow on, Nick, your comments that the rising gas price now, it may have positive -- if heard you correctly, may have positive implications for the unregulated business? Are you talking specifically about looking at a dark spread kind of calculation there, where earnings and cash flow improved more or less directly with gas price?

A - Nicholas Akins {BIO 15090780 <GO>}

Yes, I think certainly the dark spread will be critical in that analysis, but I also think that because we do have advantageous coal pricing, and certainly the switchover price is lower, and we also have coal units that participate well in the market, that we will have a degree of flexibility there, and certainly the flexibility in the contracting to take advantage of price swings, whether they go one way or another.

So I think certainly from our perspective, we look at it, and our coal units are still in the money. Our gas units are clearly in the money, because we have newer gas fired units that are hot in terms of efficiency. So -- and our coal efficiency is pretty good as well. So I think we are in a good spot there.

Q - Kit Konolige {BIO 1507691 <GO>}

Very good. And can you tell us a little bit more about how things are looking at BlueStar and the retail business? I believe you said you're making money there or they are covering their costs or something to that effect? Can you talk to us about what kind of margins you are seeing in the retail business?

A - Nicholas Akins {BIO 15090780 <GO>}

Well, I probably can't comment on the margins, but I can tell you that we are after margins rather than volume. But as far as the integration of BlueStar, the systems integration continues, and it is in a good place at this point. And certainly from the effort placed in that business there is a consistent philosophy of BlueStar and our philosophy, which are one in the same today that we are participating in many markets. It's not -- I mean, certainly the Ohio market is critical for us, but we are participating in Illinois, Pennsylvania, Maryland and others, and that is one way in which we can hedge this generation in the future with quality contracts with customers across the board. Particularly in the areas that we understand, like PJM, MISO and so forth.

Like I said, they have 150,000 customers. I think that is like a 28%, 29% increase from last quarter. And they continue to make progress. But I'm really hesitant to talk about volume increases, because once again, I think we are focused on the margin piece.

Q - Kit Konolige {BIO 1507691 <GO>}

Very good. Okay, thank you very much.

Operator

Our next question from the line of Neil Mehta with Goldman Sachs. Your line is open.

Q - Neil Mehta {BIO 16213187 <GO>}

Good morning. This is Neil in for Michael here. On industrial demand, how would it have looked in the Third Quarter if we were to exclude Ormet from the calculation?

A - Nicholas Akins {BIO 15090780 <GO>}

Brian, you have those numbers.

A - Brian Tierney {BIO 15917272 <GO>}

I do. It would obviously be slightly better. Industrial overall would drop to something like 2% negative for the Third Quarter rather than the 3.1% that it was.

Q - Neil Mehta {BIO 16213187 <GO>}

Okay.

A - Nicholas Akins {BIO 15090780 <GO>}

Yes, because we had in the primary metals, which is where Ormet is in, you still had approximately a 9% to 10% reduction in activity on the industrial side. In the primary metal piece of it. Obviously, it was compensating oil and gas activity and other things, but when you look at the industrial piece of it, we have to be concerned that either inventories are catching up or the economy is slowing down to where they are having to drop their consumption. So we are certainly keeping an eye on that, particularly after the election.

Q - Neil Mehta {BIO 16213187 <GO>}

And on Ormet, I think regulators said they can defer the electricity payments to you? How should we think about the earnings impact in this deferral?

A - Nicholas Akins {BIO 15090780 <GO>}

Certainly we work together with the Ohio commission on this. And when you have a customer in southeast Ohio that is 500 megawatts -- I guess, with the two pot lines off its 300 megawatts. But they employ a 1,000 customers and -- I mean, a 1,000 employees, so it is pretty important to the economy you keep them going. And certainly the Ohio commission stepped up with us to try to arrange a solution, a stop gap measure to keep them going. And the deferral mechanism the commission set up for approximately $20 million on the deferral, we -- and that is -- certainly for us it is no earnings impact, but we are still deferring that.

Q - Neil Mehta {BIO 16213187 <GO>}

Got it. Last question, could you provide some color on the timing and sizing of the securitizations in Ohio and West Virginia?

A - Brian Tierney {BIO 15917272 <GO>}

Neil, in West Virginia we are talking about $400 million, and in Ohio we are talking about $300 million. We anticipate getting those orders later this year, very early next year, and anticipate the securitizations for the gross amount of about $700 million in the First Quarter of next year.

Q - Neil Mehta {BIO 16213187 <GO>}

Great, thanks very much.

A - Nicholas Akins {BIO 15090780 <GO>}

We still have outstanding the other fuel deferral in Ohio too.

A - Brian Tierney {BIO 15917272 <GO>}

Fuel deferral and hopefully a capacity deferral in Ohio as well.

A - Nicholas Akins {BIO 15090780 <GO>}

Yes.

A - Brian Tierney {BIO 15917272 <GO>}

To come in later years. Thank you, Neil.

Operator

Our next question from the line of Paul Ridzon from KeyBanc. Go ahead.

Q - Paul Ridzon {BIO 1984100 <GO>}

Talk about the impact of the accelerated depreciation on the merchant assets? I think you said book value is $284 million, and you're depreciating them. They will be down to zero by 2015.

What's going to happen there? I mean, are these lives going to be extended when you get an order?

A - Brian Tierney {BIO 15917272 <GO>}

No, I don't anticipate their lives will be extended. What we are going to do is -- Paul, we are going to go from a methodology where we used to look at those on a collective basis in the East generating pool, and now we will need to look at them on an individual basis. So certainly the lives won't be extended beyond 2015, because that's where we have to be to be compliant with MATS. There could be some type of impairment that might be associated with those assets, but in any event we are depreciating them at a pretty aggressive schedule right now and have been since late 2011 when the final MATS rule came out.

A - Nicholas Akins {BIO 15090780 <GO>}

And this only applies to the units we anticipate retiring in 2015. The others are fine.

Q - Paul Ridzon {BIO 1984100 <GO>}

Got it. Thank you for the explanation [ph].

Operator

Our next question is from the line of Ali Agha with SunTrust. Please go ahead.

Q - Ali Agha {BIO 1509168 <GO>}

Thank you, good morning.

A - Nicholas Akins {BIO 15090780 <GO>}

Good morning.

Q - Ali Agha {BIO 1509168 <GO>}

Nick, going back to your opening remarks, when you talked about the goals, et cetera, for the Company, you again mentioned the EPS growth of 4% to 6% a year. I want to just clarify, you talked about the concern on the economy, et cetera, so is that 4% to 6% an aspirational goal, or should we see, given everything that is going on, that off the 2012 base next couple years you can generate 4% to 6% a year growth?

A - Nicholas Akins {BIO 15090780 <GO>}

No, I think as we said in February, that growth rate just by the invested capital in the regulated business will support the 4% to 6% growth rate. So -- and that is things that we -- I think if you looked at capital allocation chart that we had, we used to have chart in there that had the spend on each area. Much of that is block and tackling and things that we have to do. So when you look at the level of that capital spend and the earnings profile associated with that, it gets you in the 4% to 6% range.

And then of course we are still working on the Transmission piece, and certainly very pleased with the progression of Transmission and its business case. So I think the issue for us is to define what the base start is when we give 2013 guidance, but we fully intend on the 4% and 6% rate to still be there. And of course the dividend policy to be commensurate with the earnings growth as well.

Q - Ali Agha {BIO 1509168 <GO>}

Also on the Transmission piece of it, guys have laid out for us a couple of times I think in your slide deck a ramp from 12 to 15 in terms of the earnings contribution. Are those numbers still solid? Are those projects now in hand, and you are still confident that ramp is pretty much locked in?

A - Nicholas Akins {BIO 15090780 <GO>}

Yes, we are only showing projects that we know are real. Those numbers are still real. We continue to grow the Transmission business. We continue to work to allocate more capital in the Transmission, because there's a lot of projects out there, and when we refocus this effort on the indigenous projects within AEP and the service territory and things that need to get done to benefit reliability for our customers, there is a lot of work to get done. So we are happy with those numbers, and you can look at those as numbers we are going to deliver on.

Q - Ali Agha {BIO 1509168 <GO>}

Last question. I believe you said at the end of September customer switching in Ohio was 42%. Are the trends so far you are seeing in the switching pretty much consistent with your expectations and also consistent with what was baked into the final ESP order?

A - Nicholas Akins {BIO 15090780 <GO>}

They are a little bit lower than we anticipated, but as this process moves forward, it is difficult to tell how quickly it will move along, particularly when we go to auctions and other things. So it is one of those things where there is 42% there, and there is a queue associated with people switching as well.

A - Brian Tierney {BIO 15917272 <GO>}

About 8%.

A - Nicholas Akins {BIO 15090780 <GO>}

About 8%. So it continues to grow.

A - Brian Tierney {BIO 15917272 <GO>}

It is a pretty aggressive switching schedule. I think some of the things that happened with the timing of capacity orders and the like slowed the rate over the summer, but we have seen a pick up since there has been some clarity with the recent orders that the commission has brought.

Q - Ali Agha {BIO 1509168 <GO>}

I see. Thank you.

Operator

Our next question from the line of Philson Yim with Luminus Management. Please go ahead.

Q - Philson Yim {BIO 16003699 <GO>}

Hi. Just following up on that question, I think there was an 8-K filed in July that talked about, if you included the queue, you would have seen 45% switching. So does that mean you guys are doing better with the net adds to end up at 42% at the end of September?

A - Nicholas Akins {BIO 15090780 <GO>}

Well, 42% and an additional 8% or 9% the queue, you are at 50, 51%. So --

Q - Philson Yim {BIO 16003699 <GO>}

Okay. So the guys in the queue in July are -- haven't all been processed yet, I guess?

A - Nicholas Akins {BIO 15090780 <GO>}

Well -- or there is more in the queue to be processed. I mean, it is difficult to tell, but I'm sure we have processed some of them. Probably all of those in July have been processed, but we have new people in the queue.

Q - Philson Yim {BIO 16003699 <GO>}

Got it. Okay. And that -- so that 42% is a gross number?

A - Brian Tierney {BIO 15917272 <GO>}

42% is gross of load, and there is the other 8% that is still waiting.

A - Nicholas Akins {BIO 15090780 <GO>}

Yes.

Q - Philson Yim {BIO 16003699 <GO>}

Right. Have you mentioned what BlueStar is picking up?

A - Nicholas Akins {BIO 15090780 <GO>}

No, we have not, and we probably won't mention that either.

Q - Philson Yim {BIO 16003699 <GO>}

Got it. Okay. Thank you.

Operator

Our next question from the line of Hugh Wynne with Sanford Bernstein. Please go ahead.

Q - Hugh Wynne {BIO 5516654 <GO>}

Hi, if I remember correctly, you all mentioned you had seen a reduction in usage per residential customer this year on the order of 2%. I was wondering if you expected that to continue to decline and possibly accelerate over the next year as the incandescent light bulbs begin to be phased out.

A - Nicholas Akins {BIO 15090780 <GO>}

I think the verdict is still out on that, because there is two issues there. One is efficiency obviously, which Brian talked about. And the other is what happens to the economy. And it is yet to be seen really what the true effect is. I think you can still have growth when you have energy efficiency when you have an economy that supports the growth, but right now the denominator continues to decrease because have you both issues occurring.

And I fully agree with you, Hugh, energy efficiency is here to stay. And I think energy efficient appliances and certainly bulb replacements, all of those types of things will have an effect. But we don't know the effect of the economy in the future, and really, the further electrification of the economy that still needs to be resolved.

Q - Hugh Wynne {BIO 5516654 <GO>}

That's helpful. Can I trouble you all to comment on how the regulators at Appalachian Power and Kentucky Power have responded to date to your proposal to move over the Mitchell and Amos 3 plants, and how you see those regulatory proceedings playing out over time?

A - Nicholas Akins {BIO 15090780 <GO>}

Yes, I think those conversations are going very well. Certainly there has been plenty of time based on what we have gone through the last year for there to be a complete understanding of what we are trying to do. The fact of the matter is, though, we are transferring over at net book, something that they are already paying for. And certainly their assets located within the service territory.

So when the states look at it, and typically in the past they have been focused on FRR. In other words, supplying their own needs for customers and securing a consistent supply for their -- power supply for their customers. I think these are fully controlled assets that clearly are in the money and produce value for customers in the long-term. So those discussions have been positive.

Q - Hugh Wynne {BIO 5516654 <GO>}

Right. Thanks very much.

Operator

(Operator Instructions) Our next question from the line of Art Massimiani [ph] with Federal Investors [ph]. Your line is open.

Q - Art Massimiani {BIO 19154711 <GO>}

Thanks. Hi, guys.

A - Nicholas Akins {BIO 15090780 <GO>}

Hi, Art.

Q - Art Massimiani {BIO 19154711 <GO>}

Just a quick question. If you could just give maybe a little bit more color on the dividend. I know you have talked about the dividend policy focuses to be commensurate with earnings growth, and you've talked about 4% to 6% earnings growth. Any color on the payout ratio? I know you are running toward the higher end of 60%. With the increase in your earnings coming from the regulated, could we maybe potentially see that payout ratio go up, or if you could give a little color on the growth?

A - Nicholas Akins {BIO 15090780 <GO>}

Yes, well, if you look at just the regulated portion and you look at pure regulated utilities, that ratio is higher than that, up in the 70% range. So -- but that being said, our Board certainly understands the importance to our shareholders of a dividend policy that makes sense. And we -- when we come out with the February guidance, certainly our Board will be -- as they usually do, look at considerations relative to the dividend as well. So I would not be too concerned about us tapping out at the 60%. That's a guidance that we put in place ourselves, but we will certainly evaluate our dividend appropriately.

A - Brian Tierney {BIO 15917272 <GO>}

Art, we would like to have a complete story around that in February when we talk to the investors. And I think Nick's comments about the Board being committed to rewarding shareholders with a strong dividend is something they have demonstrated over time, and we would like to discuss that in more detail in February.

Q - Art Massimiani {BIO 19154711 <GO>}

Thank you.

Operator

Our next question from the line of Rajeev Lalwani with Morgan Stanley. Please go ahead.

Q - Rajeev Lalwani {BIO 15031126 <GO>}

Hi, I wanted to ask a bit more about the repositioning study and what that is going to encompass, whether it is reviewing your cost structure or your asset mix overall.

A - Nicholas Akins {BIO 15090780 <GO>}

Yes, Rajeev, so the study is focused on several areas. Our generation side -- and very heartened by the evaluation there. Lean management practices, those types of things. Over 80% of the plant people are involved in the evaluation of how the plant moves forward, and there are some pretty interesting things they have come up with. So there are some structural changes in the way the plants operate, and really the use of contractors and things like that. So -- which that's something that they are looking at.

From an IT perspective, it certainly is focused on that piece as well. The finance piece, they are looking at their reporting obligations and all of these types of things of where the efficiencies lie. Certainly an organizational review is going on as well. But I wouldn't say it is an asset change. Certainly it could be some capital deployed to make things more efficient in some manner.

But most of it is process -- pure process oriented, and then looking at spans of control, looking at organizational structure alignment with the new reality of where we are taking the business. But the big issue is to make sure whatever changes we make are sustainable for the future and with our long-term strategy in mind. That really gets us to a point where we can start to think about, as I said earlier, once we go through the steps that we've lined out in our long-term plan, to get to a point where we can effectively optimize our asset mix to improve ROE.

Q - Rajeev Lalwani {BIO 15031126 <GO>}

Okay. And then just on the asset mix side in terms of the unregulated side of the business, it seems like you are still comfortable keeping the longer term. Or is that subject to change if commodity prices are weaker or capacity prices are weaker?

A - Nicholas Akins {BIO 15090780 <GO>}

I think our -- as I as we said previously, we are going to continue to grow this competitive business, but we are a regulated utility. And if we can make it look [ph] with long-term contracts, FERC [ph]-based contracts, and long-term retail contracts, all of those types of things that make it appear to be quasi-regulated in some fashion, either FERC [ph] regulated or otherwise, then --

and it makes sense to our shareholders to keep, we'll keep it. But I would say that we are going to continue to grow the business as if we are going to be in that business, and then we will make the ultimate determination when the time comes.

Q - Rajeev Lalwani {BIO 15031126 <GO>}

Thank you.

A - Chuck Zebula {BIO 6231994 <GO>}

Lori we have time for one more question.

Operator

We have no additional questions at this time.

A - Chuck Zebula {BIO 6231994 <GO>}

Good, thank you for joining us on today's call. As always our IR team will be available to answer any additional questions throughout the day. Lori, can you go ahead and give the replay information?

Operator

Yes. Ladies and gentlemen, the conference call will be made available for replay. That begins today at 11 AM Eastern Time. The replay runs for one week until October 31 at midnight Eastern. You can access the AT&T teleconference replay system by dialing 1-800-475-6701 and enter the access code 266809. International parties can dial 320-365-3844. Those numbers again, 1-800-475-6701, and international participants, 320-365-3844. The access code 266809. This will conclude our conference. We thank you for your participation and for using AT&T Executive Teleconference Service. You may now disconnect.