

AEP Texas Central Company and Subsidiaries

2012 Annual Report

Audited Consolidated Financial Statements



TABLE OF CONTENTS

	Page Number
Glossary of Terms	1
Independent Auditors' Report	2
Consolidated Statements of Income	3
Consolidated Statements of Comprehensive Income (Loss)	4
Consolidated Statements of Changes in Common Shareholder's Equity	5
Consolidated Balance Sheets	6
Consolidated Statements of Cash Flows	8
Index of Notes to Consolidated Financial Statements	9

- THIS PAGE INTENTIONALLY LEFT BLANK -

GLOSSARY OF TERMS

When the following terms and abbreviations appear in the text of this report, they have the meanings indicated below.

Term	Meaning
AEP or Parent	American Electric Power Company, Inc., an electric utility holding company.
AEP System	American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AFUDC	Allowance for Funds Used During Construction.
AOCI	Accumulated Other Comprehensive Income.
CAA	Clean Air Act.
CO ₂	Carbon dioxide and other greenhouse gases.
CWIP	Construction Work in Progress.
EIS	Energy Insurance Services, Inc., a nonaffiliated captive insurance company and consolidated variable interest entity of AEP.
ERCOT	Electric Reliability Council of Texas regional transmission organization.
ETT	Electric Transmission Texas, LLC, an equity interest joint venture between AEP and MidAmerican Energy Holdings Company Texas Transco, LLC formed to own and operate electric transmission facilities in ERCOT.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FTR	Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices.
IRS	Internal Revenue Service.
MTM	Mark-to-Market.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
REP	Texas Retail Electric Provider.
PUCT	Public Utility Commission of Texas.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
Transition Funding	AEP Texas Central Transition Funding I LLC, AEP Texas Central Transition Funding II LLC and AEP Texas Central Transition Funding III LLC, wholly-owned subsidiaries of TCC and consolidated variable interest entities formed for the purpose of issuing and servicing securitization bonds related to Texas restructuring law.
Texas Restructuring Legislation	Legislation enacted in 1999 to restructure the electric utility industry in Texas.
True-up Proceeding	A filing made under the Texas Restructuring Legislation to finalize the amount of stranded costs and other true-up items and the recovery of such amounts.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholder of
AEP Texas Central Company:

We have audited the accompanying consolidated financial statements of AEP Texas Central Company and its subsidiaries (the "Company"), which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income (loss), changes in common shareholder's equity, and cash flows for each of the three years in the period ended December 31, 2012, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of AEP Texas Central Company and its subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012 in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Columbus, Ohio
February 26, 2013

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
For the Years Ended December 31, 2012, 2011 and 2010
(in thousands)

	Years Ended December 31,		
	2012	2011	2010
REVENUES			
Electric Transmission and Distribution	\$ 983,591	\$ 917,647	\$ 886,611
Sales to AEP Affiliates	3,702	3,739	4,168
Other Revenues	1,565	1,446	1,686
TOTAL REVENUES	988,858	922,832	892,465
EXPENSES			
Other Operation	246,361	247,962	279,637
Maintenance	36,614	40,592	35,290
Depreciation and Amortization	340,955	280,567	260,829
Taxes Other Than Income Taxes	74,574	70,889	74,572
TOTAL EXPENSES	698,504	640,010	650,328
OPERATING INCOME	290,354	282,822	242,137
Other Income (Expense):			
Interest Income	269	4,535	472
Carrying Costs Income	7,775	322,608	-
Allowance for Equity Funds Used During Construction	1,967	2,642	4,653
Interest Expense	(138,903)	(139,526)	(148,848)
INCOME BEFORE INCOME TAX EXPENSE	161,462	473,081	98,414
Income Tax Expense	51,996	165,821	30,147
INCOME BEFORE EXTRAORDINARY ITEM	109,466	307,260	68,267
EXTRAORDINARY ITEM, NET OF TAX	-	373,093	-
NET INCOME	109,466	680,353	68,267
Preferred Stock Dividend Requirements Including Capital Stock Expense	-	469	236
EARNINGS ATTRIBUTABLE TO COMMON STOCK	\$ 109,466	\$ 679,884	\$ 68,031

The common stock of TCC is owned by a wholly-owned subsidiary of AEP.

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Years Ended December 31, 2012, 2011 and 2010
(in thousands)

	Years Ended December 31,		
	2012	2011	2010
Net Income	\$ 109,466	\$ 680,353	\$ 68,267
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES			
Cash Flow Hedges, Net of Tax of \$60, \$107 and \$26 in 2012, 2011 and 2010, Respectively	112	(198)	(48)
TOTAL COMPREHENSIVE INCOME	\$ 109,578	\$ 680,155	\$ 68,219

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY
For the Years Ended December 31, 2012, 2011 and 2010
(in thousands)

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2009	\$ 55,292	\$ 171,263	\$ 368,126	\$ 163	\$ 594,844
Common Stock Dividends			(41,820)		(41,820)
Preferred Stock Dividends			(236)		(236)
Gain on Reacquired Preferred Stock		32			32
Subtotal - Common Shareholder's Equity					<u>552,820</u>
Net Income			68,267		68,267
Other Comprehensive Loss				(48)	(48)
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2010	<u>55,292</u>	<u>171,295</u>	<u>394,337</u>	<u>115</u>	<u>621,039</u>
Common Stock Dividends			(62,500)		(62,500)
Preferred Stock Dividends			(200)		(200)
Loss on Reacquired Preferred Stock		(233)			(233)
Subtotal - Common Shareholder's Equity					<u>558,106</u>
Net Income			680,353		680,353
Other Comprehensive Loss				(198)	(198)
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2011	<u>55,292</u>	<u>171,062</u>	<u>1,011,990</u>	<u>(83)</u>	<u>1,238,261</u>
Common Stock Dividends			(689,824)		(689,824)
Subtotal - Common Shareholder's Equity					<u>548,437</u>
Net Income			109,466		109,466
Other Comprehensive Income				112	112
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2012	<u>\$ 55,292</u>	<u>\$ 171,062</u>	<u>\$ 431,632</u>	<u>\$ 29</u>	<u>\$ 658,015</u>

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

ASSETS

December 31, 2012 and 2011

(in thousands)

	December 31,	
	2012	2011
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 100	\$ 422
Restricted Cash for Securitized Transition Funding	215,218	190,995
Accounts Receivable:		
Customers	70,178	73,696
Affiliated Companies	6,733	4,810
Accrued Unbilled Revenues	41,678	37,606
Miscellaneous	-	3,452
Allowance for Uncollectible Accounts	(1,293)	(374)
Total Accounts Receivable	117,296	119,190
Materials and Supplies	37,423	31,181
Prepayments and Other Current Assets	1,884	3,056
TOTAL CURRENT ASSETS	371,921	344,844
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Transmission	1,194,582	1,135,982
Distribution	2,120,155	2,002,508
Other Property, Plant and Equipment	264,328	259,410
Construction Work in Progress	104,788	58,906
Total Property, Plant and Equipment	3,683,853	3,456,806
Accumulated Depreciation and Amortization	771,854	737,522
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	2,911,999	2,719,284
OTHER NONCURRENT ASSETS		
Regulatory Assets	282,404	1,022,680
Securitized Transition Assets		
(December 31, 2012 and 2011 Amounts Include \$2,057,817 and \$1,561,658, Respectively, Related to Transition Funding)	2,116,833	1,626,511
Deferred Charges and Other Noncurrent Assets	26,191	25,122
TOTAL OTHER NONCURRENT ASSETS	2,425,428	2,674,313
TOTAL ASSETS	\$ 5,709,348	\$ 5,738,441

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
December 31, 2012 and 2011
(dollars in thousands)

	December 31,	
	2012	2011
CURRENT LIABILITIES		
Advances from Affiliates	\$ 103,335	\$ 36,043
Accounts Payable:		
General	35,066	38,331
Affiliated Companies	15,736	7,785
Long-term Debt Due Within One Year – Nonaffiliated (December 31, 2012 and 2011 Amounts Include \$243,378 and \$171,574, Respectively, Related to Transition Funding)	243,378	231,574
Customer Deposits	20,283	13,283
Accrued Taxes	40,486	54,175
Accrued Interest (December 31, 2012 and 2011 Amounts Include \$40,045 and \$44,482, Respectively, Related to Transition Funding)	50,436	55,097
Other Current Liabilities	37,779	34,009
TOTAL CURRENT LIABILITIES	546,499	470,297
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated (December 31, 2012 and 2011 Amounts Include \$2,037,690 and \$1,515,697, Respectively, Related to Transition Funding)	2,681,188	2,159,142
Deferred Income Taxes	1,308,163	1,334,421
Regulatory Liabilities and Deferred Investment Tax Credits	467,888	430,980
Deferred Credits and Other Noncurrent Liabilities	47,595	105,340
TOTAL NONCURRENT LIABILITIES	4,504,834	4,029,883
TOTAL LIABILITIES	5,051,333	4,500,180
Commitments and Contingencies (Note 4)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – \$25 Per Share:		
Authorized – 12,000,000 Shares		
Outstanding – 2,211,678 Shares	55,292	55,292
Paid-in Capital	171,062	171,062
Retained Earnings	431,632	1,011,990
Accumulated Other Comprehensive Income (Loss)	29	(83)
TOTAL COMMON SHAREHOLDER'S EQUITY	658,015	1,238,261
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	\$ 5,709,348	\$ 5,738,441

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2012, 2011 and 2010
(in thousands)

	Years Ended December 31,		
	2012	2011	2010
OPERATING ACTIVITIES			
Net Income	\$ 109,466	\$ 680,353	\$ 68,267
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:			
Depreciation and Amortization	340,955	280,567	260,829
Deferred Income Taxes	(27,328)	127,155	4,572
Extraordinary Item, Net of Tax	-	(373,093)	-
Carrying Costs Income	(7,775)	(322,608)	-
Net Recovery of (Deferral of) Storm Costs	1,300	206	(2,676)
Allowance for Equity Funds Used During Construction	(1,967)	(2,642)	(4,653)
Change in Other Noncurrent Assets	(12,323)	(11,296)	(2,656)
Change in Other Noncurrent Liabilities	(9,224)	(27,181)	15,985
Changes in Certain Components of Working Capital:			
Accounts Receivable, Net	1,894	(5,193)	10,108
Materials and Supplies	(6,242)	(5,554)	1,299
Accounts Payable	5,406	(25,315)	27,852
Customer Deposits	7,000	410	642
Accrued Taxes, Net	(10,887)	2,070	(30,806)
Accrued Interest	(4,661)	(4,740)	(3,769)
Other Current Assets	281	51	2,873
Other Current Liabilities	4,766	2,728	(13,943)
Net Cash Flows from Operating Activities	<u>390,661</u>	<u>315,918</u>	<u>333,924</u>
INVESTING ACTIVITIES			
Construction Expenditures	(277,964)	(209,945)	(177,728)
Change in Restricted Cash for Securitized Transition Funding	(24,223)	(6,955)	(4,012)
Change in Advances to Affiliates, Net	-	141,584	(27,591)
Proceeds from Sales of Assets	7,517	15,327	67,790
Other Investing Activities	(471)	(1,487)	(1,071)
Net Cash Flows Used for Investing Activities	<u>(295,141)</u>	<u>(61,476)</u>	<u>(142,612)</u>
FINANCING ACTIVITIES			
Issuance of Long-term Debt – Nonaffiliated	793,304	59,656	-
Change in Advances from Affiliates, Net	67,292	36,043	-
Retirement of Long-term Debt – Nonaffiliated	(266,308)	(279,708)	(147,833)
Retirement of Cumulative Preferred Stock	-	(5,936)	(169)
Principal Payments for Capital Lease Obligations	(1,929)	(1,739)	(1,542)
Dividends Paid on Common Stock	(689,824)	(62,500)	(41,820)
Dividends Paid on Cumulative Preferred Stock	-	(200)	(236)
Other Financing Activities	1,623	90	362
Net Cash Flows Used for Financing Activities	<u>(95,842)</u>	<u>(254,294)</u>	<u>(191,238)</u>
Net Increase (Decrease) in Cash and Cash Equivalents	(322)	148	74
Cash and Cash Equivalents at Beginning of Period	422	274	200
Cash and Cash Equivalents at End of Period	<u>\$ 100</u>	<u>\$ 422</u>	<u>\$ 274</u>
SUPPLEMENTARY INFORMATION			
Cash Paid for Interest, Net of Capitalized Amounts	\$ 135,975	\$ 144,285	\$ 144,653
Net Cash Paid for Income Taxes	93,584	33,375	64,859
Noncash Acquisitions Under Capital Leases	3,252	718	887
Construction Expenditures Included in Current Liabilities as of December 31,	19,976	20,747	14,620

See Notes to Consolidated Financial Statements beginning on page 9.

INDEX OF NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies
2. Extraordinary Item
3. Effects of Regulation
4. Commitments, Guarantees and Contingencies
5. Dispositions
6. Benefit Plans
7. Business Segments
8. Derivatives and Hedging
9. Fair Value Measurements
10. Income Taxes
11. Leases
12. Financing Activities
13. Related Party Transactions
14. Variable Interest Entities
15. Property, Plant and Equipment
16. Cost Reduction Programs
17. Unaudited Quarterly Financial Information

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

As a public utility, TCC engages in the transmission and distribution of electric power to 799,000 retail customers through REPs in its service territory in southern and central Texas. TCC consolidates AEP Texas Central Transition Funding LLC, AEP Texas Central Transition Funding II LLC and AEP Texas Central Transition Funding III LLC, its wholly-owned subsidiaries.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Rates and Service Regulation

TCC's transmission and distribution rates are regulated by the PUCT. The FERC regulates TCC's affiliated transactions, including AEPSC intercompany service billings which are generally at cost, under the 2005 Public Utility Holding Company Act and the Federal Power Act. The FERC also has jurisdiction over the issuances and acquisitions of securities of the public utility subsidiaries, the acquisition or sale of certain utility assets and mergers with another electric utility or holding company. For non-power goods and services, the FERC requires that a nonregulated affiliate can bill an affiliated public utility company no more than market while a public utility must bill the higher of cost or market to a nonregulated affiliate. The PUCT also regulates certain intercompany transactions under its affiliate statutes. Both the FERC and state regulatory commissions are permitted to review and audit the relevant books and records of companies within a public utility holding company system.

The PUCT also regulates TCC's wholesale transmission operations and rates. The FERC claims jurisdiction over retail transmission rates when retail rates are unbundled in connection with restructuring. TCC's retail transmission rates in Texas are unbundled. Although TCC's retail transmission rates in Texas are unbundled, retail transmission rates are regulated, on a cost basis, by the PUCT.

Principles of Consolidation

TCC's consolidated financial statements include TCC and its wholly-owned subsidiaries. Intercompany items are eliminated in consolidation. See Note 14 – Variable Interest Entities.

Accounting for the Effects of Cost-Based Regulation

As a rate-regulated electric public utility company, TCC's financial statements reflect the actions of regulators that result in the recognition of certain revenues and expenses in different time periods than enterprises that are not rate-regulated. In accordance with accounting guidance for "Regulated Operations," TCC records regulatory assets (deferred expenses) and regulatory liabilities (deferred revenue reductions or refunds) to reflect the economic effects of regulation in the same accounting period by matching expenses with their recovery through regulated revenues and by matching income with its passage to customers in cost-based regulated rates.

Use of Estimates

The preparation of these financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include, but are not limited to, inventory valuation, allowance for doubtful accounts, long-lived asset impairment, unbilled electricity revenue, valuation of long-term energy contracts, the effects of regulation, long-lived asset recovery, storm costs, the effects of contingencies and certain assumptions made in accounting for pension and postretirement benefits. The estimates and assumptions used are based upon management's evaluation of the relevant facts and circumstances as of the date of the financial statements. Actual results could ultimately differ from those estimates.

Cash and Cash Equivalents

Cash and Cash Equivalents include temporary cash investments with original maturities of three months or less.

Restricted Cash for Securitized Transition Funding

Restricted Cash for Securitized Transition Funding includes funds held by trustees primarily for the payment of securitization bonds and to secure the payments of the REPs.

Inventory

Materials and supplies inventories are carried at average cost.

Accounts Receivable

Customer accounts receivable primarily includes receivables from REPs and receivables related to other revenue-generating activities.

Revenue is recognized when power is delivered. To the extent that deliveries have occurred but a bill has not been issued, TCC accrues and recognizes, as Accrued Unbilled Revenues on the balance sheets, an estimate of the revenues for deliveries since the last billing.

Allowance for Uncollectible Accounts

TCC records bad debt reserves using the specific identification of receivable balances greater than 120 days delinquent, and for those balances less than 120 days where the collection is doubtful. For miscellaneous accounts receivable, bad debt expense is recorded for all amounts outstanding 180 days or greater at 100%, unless specifically identified. Miscellaneous accounts receivable items open less than 180 days may be reserved using specific identification for bad debt reserves.

Concentrations of Credit Risk and Significant Customers

TCC has significant customers which on a combined basis account for the following percentages of total operating revenues for the years ended December 31 and Accounts Receivable – Customers as of December 31:

Significant Customers of TCC: Centrica and Reliant Energy	2012	2011	2010
Percentage of Operating Revenues	34 %	34 %	37 %
Percentage of Accounts Receivable - Customers	28 %	28 %	29 %

Management monitors credit levels and the financial condition of TCC's customers on a continuing basis to minimize credit risk. The PUCT allows recovery in rates for a reasonable level of bad debt costs. Management believes adequate provision for credit loss has been made in the accompanying financial statements.

Property, Plant and Equipment

Electric utility property, plant and equipment are stated at original cost. Additions, major replacements and betterments are added to the plant accounts. Under the group composite method of depreciation, continuous interim routine replacements of items such as poles, transformers, etc. result in the original cost, less salvage, being charged to accumulated depreciation. The group composite method of depreciation assumes that on average, asset components are retired at the end of their useful lives and thus there is no gain or loss. The equipment in each primary electric plant account is identified as a separate group. The depreciation rates that are established take into account the past history of interim capital replacements and the amount of salvage received. These rates and the related lives are subject to periodic review. Removal costs are charged to regulatory liabilities. The costs of labor, materials and overhead incurred to operate and maintain the facilities are included in operating expenses.

Long-lived assets are required to be tested for impairment when it is determined that the carrying value of the assets may no longer be recoverable or when the assets meet the held-for-sale criteria under the accounting guidance for “Impairment or Disposal of Long-lived Assets.” When it becomes probable that an asset in service or an asset under construction will be abandoned and regulatory cost recovery has been disallowed, the cost of that asset shall be removed from plant-in-service or CWIP and charged to expense.

The fair value of an asset or investment is the amount at which that asset or investment could be bought or sold in a current transaction between willing parties, as opposed to a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and are used as the basis for the measurement, if available. In the absence of quoted prices for identical or similar assets or investments in active markets, fair value is estimated using various internal and external valuation methods including cash flow analysis and appraisals.

Allowance for Funds Used During Construction (AFUDC)

AFUDC represents the estimated cost of borrowed and equity funds used to finance construction projects that is capitalized and recovered through depreciation over the service life of regulated electric utility plant. TCC records the equity component of AFUDC in Allowance for Equity Funds Used During Construction and the debt component of AFUDC as a reduction to Interest Expense.

Valuation of Nonderivative Financial Instruments

The book values of Cash and Cash Equivalents, Accounts Receivable, Advances from Affiliates and Accounts Payable approximate fair value because of the short-term maturity of these instruments.

Fair Value Measurements of Assets and Liabilities

The accounting guidance for “Fair Value Measurements and Disclosures” establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). Where observable inputs are available for substantially the full term of the asset or liability, the instrument is categorized in Level 2. When quoted market prices are not available, pricing may be completed using comparable securities, dealer values, operating data and general market conditions to determine fair value. Valuation models utilize various inputs such as commodity, interest rate and, to a lesser degree, volatility and credit that include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets, market corroborated inputs (i.e. inputs derived principally from, or correlated to, observable market data) and other observable inputs for the asset or liability. The AEP System’s market risk oversight staff independently monitors its valuation policies and procedures and provides members of the Commercial Operations Risk Committee (CORC) various daily, weekly and monthly reports, regarding compliance with policies and procedures. The CORC consists of AEPSC’s Chief Operating Officer, Chief Financial Officer, Executive Vice President of Energy Supply, Senior Vice President of Commercial Operations and Chief Risk Officer.

For commercial activities, exchange traded derivatives, namely futures contracts, are generally fair valued based on unadjusted quoted prices in active markets and are classified as Level 1. Level 2 inputs primarily consist of OTC broker quotes in moderately active or less active markets, as well as exchange traded contracts where there is insufficient market liquidity to warrant inclusion in Level 1. Management verifies price curves using these broker quotes and classifies these fair values within Level 2 when substantially all of the fair value can be corroborated. Management typically obtains multiple broker quotes, which are nonbinding in nature, but are based on recent trades in the marketplace. When multiple broker quotes are obtained, the quoted bid and ask prices are averaged. In certain circumstances, a broker quote may be discarded if it is a clear outlier. Management uses a historical correlation analysis between the broker quoted location and the illiquid locations and if the points are highly correlated, these locations are included within Level 2 as well. Certain OTC and bilaterally executed derivative instruments are executed in less active markets with a lower availability of pricing information. Illiquid transactions, complex structured transactions, FTRs and counterparty credit risk may require nonmarket based inputs. Some of these inputs may be internally developed or extrapolated and utilized to estimate fair value. When such inputs have a significant impact on the measurement of fair value, the instrument is categorized as Level 3. The main driver of contracts being classified as Level 3 is the inability to substantiate energy price curves in the market. A significant portion of the Level 3 instruments have been economically hedged which greatly limits potential earnings volatility.

AEP utilizes its trustee's external pricing service to estimate the fair value of the underlying investments held in the benefit plan trusts. AEP's investment managers review and validate the prices utilized by the trustee to determine fair value. AEP's management performs its own valuation testing to verify the fair values of the securities. AEP receives audit reports of the trustee's operating controls and valuation processes. The trustee uses multiple pricing vendors for the assets held in the trusts.

Assets in the benefits trusts and Restricted Cash for Securitized Transition Funding are classified using the following methods. Equities are classified as Level 1 holdings if they are actively traded on exchanges. Items classified as Level 1 are investments in money market funds, fixed income and equity mutual funds and domestic equity securities. They are valued based on observable inputs primarily unadjusted quoted prices in active markets for identical assets. Items classified as Level 2 are primarily investments in individual fixed income securities and cash equivalents funds. Fixed income securities do not trade on an exchange and do not have an official closing price but their valuation inputs are based on observable market data. Pricing vendors calculate bond valuations using financial models and matrices. The models use observable inputs including yields on benchmark securities, quotes by securities brokers, rating agency actions, discounts or premiums on securities compared to par prices, changes in yields for U.S. Treasury securities, corporate actions by bond issuers, prepayment schedules and histories, economic events and, for certain securities, adjustments to yields to reflect changes in the rate of inflation. Other securities with model-derived valuation inputs that are observable are also classified as Level 2 investments. Investments with unobservable valuation inputs are classified as Level 3 investments. Benefit plan assets included in Level 3 are primarily real estate and private equity investments that are valued using methods requiring judgment including appraisals.

Revenue Recognition

Regulatory Accounting

TCC's financial statements reflect the actions of regulators that can result in the recognition of revenues and expenses in different time periods than enterprises that are not rate-regulated. Regulatory assets (deferred expenses) and regulatory liabilities (deferred revenue reductions or refunds) are recorded to reflect the economic effects of regulation in the same accounting period by matching expenses with their recovery through regulated revenues and by matching income with its passage to customers in cost-based regulated rates.

When regulatory assets are probable of recovery through regulated rates, TCC records them as assets on its balance sheets. TCC tests for probability of recovery at each balance sheet date or whenever new events occur. Examples of new events include the issuance of a regulatory commission order or passage of new legislation. If it is determined that recovery of a regulatory asset is no longer probable, TCC writes off that regulatory asset as a charge against income.

Electricity Supply and Delivery Activities

TCC recognizes revenues from electricity transmission and distribution delivery services. TCC recognizes the revenues on the statements of income upon delivery of the energy to the customer and includes unbilled as well as billed amounts.

Maintenance

Maintenance costs are expensed as incurred. If it becomes probable that TCC will recover specifically-incurred costs through future rates, a regulatory asset is established to match the expensing of those maintenance costs with their recovery in cost-based regulated revenues.

Income Taxes and Investment Tax Credits

TCC uses the liability method of accounting for income taxes. Under the liability method, deferred income taxes are provided for all temporary differences between the book and tax basis of assets and liabilities which will result in a future tax consequence.

When the flow-through method of accounting for temporary differences is reflected in regulated revenues (that is, when deferred taxes are not included in the cost of service for determining regulated rates for electricity), deferred income taxes are recorded and related regulatory assets and liabilities are established to match the regulated revenues and tax expense.

Investment tax credits are accounted for under the deferral basis and are being amortized over the life of the plant investment.

TCC accounts for uncertain tax positions in accordance with the accounting guidance for "Income Taxes." TCC classifies interest expense or income related to uncertain tax positions as interest expense or income as appropriate and classifies penalties as Other Operation expense.

Excise Taxes

As an agent for some state and local governments, TCC collects from customers certain excise taxes levied by those state or local governments on customers. TCC does not recognize these taxes as revenue or expense.

Debt

Gains and losses from the reacquisition of debt used to finance regulated electric utility plants are deferred and amortized over the remaining term of the reacquired debt in accordance with their rate-making treatment unless the debt is refinanced. If the reacquired debt is refinanced, the reacquisition costs are generally deferred and amortized over the term of the replacement debt consistent with its recovery in rates.

Debt discount or premium and debt issuance expenses are deferred and amortized generally utilizing the straight-line method over the term of the related debt. The straight-line method approximates the effective interest method and is consistent with the treatment in rates for regulated operations. The net amortization expense is included in Interest Expense.

Investments Held in Trust for Future Liabilities

AEP has several trust funds with significant investments intended to provide for future payments of pension and OPEB benefits. All of the trust funds' investments are diversified and managed in compliance with all laws and regulations. The investment strategy for trust funds is to use a diversified portfolio of investments to achieve an acceptable rate of return while managing the interest rate sensitivity of the assets relative to the associated liabilities. To minimize investment risk, the trust funds are broadly diversified among classes of assets, investment strategies and investment managers. Management regularly reviews the actual asset allocations and periodically rebalances the investments to targeted allocations when appropriate. Investment policies and guidelines allow investment managers in approved strategies to use financial derivatives to obtain or manage market exposures and to hedge assets and liabilities. The investments are reported at fair value under the "Fair Value Measurements and Disclosures" accounting guidance.

Benefit Plans

All benefit plan assets are invested in accordance with each plan's investment policy. The investment policy outlines the investment objectives, strategies and target asset allocations by plan.

The investment philosophies for AEP's benefit plans support the allocation of assets to minimize risks and optimize net returns. Strategies used include:

- Maintaining a long-term investment horizon.
- Diversifying assets to help control volatility of returns at acceptable levels.
- Managing fees, transaction costs and tax liabilities to maximize investment earnings.
- Using active management of investments where appropriate risk/return opportunities exist.
- Keeping portfolio structure style-neutral to limit volatility compared to applicable benchmarks.
- Using alternative asset classes such as real estate and private equity to maximize return and provide additional portfolio diversification.

The investment policy for the pension fund allocates assets based on the funded status of the pension plan. The objective of the asset allocation policy is to reduce the investment volatility of the plan over time. Generally, more of the investment mix will be allocated to fixed income investments as the plan becomes better funded. Assets will be transferred away from equity investments into fixed income investments based on the market value of plan assets compared to the plan's projected benefit obligation. The target asset allocations are as follows:

<u>Pension Plan Assets</u>	<u>Target</u>
Equity	40.0 %
Fixed Income	50.0 %
Other Investments	10.0 %
<u>OPEB Plans Assets</u>	<u>Target</u>
Equity	66.0 %
Fixed Income	33.0 %
Cash	1.0 %

The investment policy for each benefit plan contains various investment limitations. The investment policies establish concentration limits for securities. Investment policies prohibit the benefit trust funds from purchasing securities issued by AEP (with the exception of proportionate and immaterial holdings of AEP securities in passive index strategies). However, the investment policies do not preclude the benefit trust funds from receiving contributions in the form of AEP securities, provided that the AEP securities acquired by each plan may not exceed the limitations imposed by law. Each investment manager's portfolio is compared to a diversified benchmark index.

For equity investments, the limits are as follows:

- No security in excess of 5% of all equities.
- Cash equivalents must be less than 10% of an investment manager's equity portfolio.
- No individual stock may be more than 10% of each manager's equity portfolio.
- No investment in excess of 5% of an outstanding class of any company.
- No securities may be bought or sold on margin or other use of leverage.

For fixed income investments, the concentration limits must not exceed:

- 3% in any single issuer
- 5% for private placements
- 5% for convertible securities
- 60% for bonds rated AA+ or lower
- 50% for bonds rated A+ or lower
- 10% for bonds rated BBB- or lower

For obligations of non-government issuers, the following limitations apply:

- AAA rated debt: a single issuer should account for no more than 5% of the portfolio.
- AA+, AA, AA- rated debt: a single issuer should account for no more than 3% of the portfolio.
- Debt rated A+ or lower: a single issuer should account for no more than 2% of the portfolio.
- No more than 10% of the portfolio may be invested in high yield and emerging market debt combined at any time.

A portion of the pension assets is invested in real estate funds to provide diversification, add return and hedge against inflation. Real estate properties are illiquid, difficult to value and not actively traded. The pension plan uses external real estate investment managers to invest in commingled funds that hold real estate properties. To mitigate investment risk in the real estate portfolio, commingled real estate funds are used to ensure that holdings are diversified by region, property type and risk classification. Real estate holdings include core, value-added and development risk classifications and some investments in Real Estate Investment Trusts (REITs), which are publicly traded real estate securities classified as Level 1.

A portion of the pension assets is invested in private equity. Private equity investments add return and provide diversification and typically require a long-term time horizon to evaluate investment performance. Private equity is classified as an alternative investment because it is illiquid, difficult to value and not actively traded. The pension plan uses limited partnerships and commingled funds to invest across the private equity investment spectrum. The private equity holdings are with multiple general partners who help monitor the investments and provide investment selection expertise. The holdings are currently comprised of venture capital, buyout and hybrid debt and equity investment instruments. Commingled private equity funds are used to enhance the holdings' diversity.

AEP participates in a securities lending program with BNY Mellon to provide incremental income on idle assets and to provide income to offset custody fees and other administrative expenses. AEP lends securities to borrowers approved by BNY Mellon in exchange for cash collateral. All loans are collateralized by at least 102% of the loaned asset's market value and the cash collateral is invested. The difference between the rebate owed to the borrower and the cash collateral rate of return determines the earnings on the loaned security. The securities lending program's objective is providing modest incremental income with a limited increase in risk.

Trust owned life insurance (TOLI) underwritten by The Prudential Insurance Company is held in the OPEB plan trusts. The strategy for holding life insurance contracts in the taxable Voluntary Employees' Beneficiary Association (VEBA) trust is to minimize taxes paid on the asset growth in the trust. Earnings on plan assets are tax-deferred within the TOLI contract and can be tax-free if held until claims are paid. Life insurance proceeds remain in the trust and are used to fund future retiree medical benefit liabilities. With consideration to other investments held in the trust, the cash value of the TOLI contracts is invested in two diversified funds. A portion is invested in a commingled fund with underlying investments in stocks that are actively traded on major international equity exchanges. The other portion of the TOLI cash value is invested in a diversified, commingled fixed income fund with underlying investments in government bonds, corporate bonds and asset-backed securities.

Cash and cash equivalents are held in each trust to provide liquidity and meet short-term cash needs. Cash equivalent funds are used to provide diversification and preserve principal. The underlying holdings in the cash funds are investment grade money market instruments including commercial paper, certificates of deposit, treasury bills and other types of investment grade short-term debt securities. The cash funds are valued each business day and provide daily liquidity.

Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive income (loss) has two components: net income (loss) and other comprehensive income (loss).

Accumulated Other Comprehensive Income (Loss) (AOCI)

AOCI is included on the balance sheets in the common shareholder's equity section. TCC's components of AOCI as of December 31, 2012 and 2011 are shown in the following table:

<u>Components</u>	December 31,	
	2012	2011
	(in thousands)	
Cash Flow Hedges, Net of Tax	\$ 29	\$ (83)

Earnings Per Share (EPS)

TCC is owned by a wholly-owned subsidiary of AEP. Therefore, TCC is not required to report EPS.

Subsequent Events

Management reviewed subsequent events through February 26, 2013, the date that TCC's 2012 annual report was issued.

2. EXTRAORDINARY ITEM

TCC Texas Restructuring

In February 2006, the PUCT issued an order that denied recovery of capacity auction true-up amounts. Based on the February 2006 PUCT order, TCC recorded the disallowance as a \$421 million (\$273 million, net of tax) extraordinary loss in the December 31, 2005 financial statements. In July 2011, the Supreme Court of Texas reversed the PUCT's February 2006 disallowance of capacity auction true-up amounts and remanded for reconsideration the treatment of certain tax balances under normalization rules. Based upon the Supreme Court of Texas reversal of the PUCT's capacity auction true-up disallowance, TCC recorded a pretax gain of \$421 million (\$273 million, net of tax) in Extraordinary Item, Net of Tax on the statements of income in 2011.

Following a remand proceeding, the PUCT allowed TCC to retain contested tax balances in full satisfaction of its true-up proceeding, including carrying charges. Based upon the PUCT order, TCC recorded the reversal of regulatory credits of \$65 million (\$42 million, net of tax) and the reversal of \$89 million of accumulated deferred investment tax credits (\$58 million, net of tax) in Extraordinary Item, Net of Tax on the statements of income in 2011.

3. EFFECTS OF REGULATION

Regulatory assets and liabilities are comprised of the following items:

Regulatory Assets:	<u>December 31,</u> <u>2012</u> <u>2011</u>		<u>Remaining</u> <u>Recovery Period</u>
	(in thousands)		
Noncurrent Regulatory Assets			
Regulatory assets not yet being recovered pending future proceedings to determine the recovery method and timing:			
<u>Regulatory Assets Currently Earning a Return</u>			
Storm Related Costs	\$ 22,866	\$ 24,166	
<u>Regulatory Assets Currently Not Earning a Return</u>			
Rate Case Expense	145	145	
Total Regulatory Assets Not Yet Being Recovered	<u>23,011</u>	<u>24,311</u>	
Regulatory assets being recovered:			
<u>Regulatory Assets Currently Earning a Return</u>			
Capacity Auction True-Up	-	691,610	
Meter Replacement Costs	39,507	31,070	10 years
Unamortized Loss on Reacquired Debt	13,569	15,412	25 years
Advanced Metering System	1,252	1,409	8 years
<u>Regulatory Assets Currently Not Earning a Return</u>			
Pension and OPEB Funded Status	183,656	234,694	12 years
Income Taxes, Net	12,900	13,683	28 years
Restructuring Transition Costs	4,908	8,499	4 years
Transmission Cost Recovery Factor	3,601	1,992	1 year
Total Regulatory Assets Being Recovered	<u>259,393</u>	<u>998,369</u>	
Total Noncurrent Regulatory Assets	<u>\$ 282,404</u>	<u>\$ 1,022,680</u>	
Regulatory Liabilities:	<u>December 31,</u> <u>2012</u> <u>2011</u>		<u>Remaining</u> <u>Refund Period</u>
	(in thousands)		
Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits			
Regulatory liabilities being paid:			
<u>Regulatory Liabilities Currently Paying a Return</u>			
Asset Removal Costs	\$ 332,086	\$ 314,892	(a)
Advanced Metering Infrastructure Surcharge	65,780	60,954	8 years
<u>Regulatory Liabilities Currently Not Paying a Return</u>			
Over-recovery of Transition Charges	56,988	40,749	15 years
Deferred Investment Tax Credits	10,810	11,614	50 years
Peak Demand Reduction/Energy Efficiency	2,224	2,771	1 year
Total Regulatory Liabilities Being Paid	<u>467,888</u>	<u>430,980</u>	
Total Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits	<u>\$ 467,888</u>	<u>\$ 430,980</u>	

(a) Relieved as removal costs are incurred.

4. COMMITMENTS, GUARANTEES AND CONTINGENCIES

TCC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, TCC's business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation cannot be predicted. For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material effect on the financial statements.

COMMITMENTS

Construction and Commitments

TCC has substantial construction commitments to support its operations and environmental investments. In managing the overall construction program and in the normal course of business, TCC contractually commits to third-party construction vendors for certain material purchases and other construction services. Management forecasts approximately \$388 million of construction expenditures, excluding equity AFUDC, for 2013. TCC also purchases materials, supplies, services and property, plant and equipment under contract as part of its normal course of business. Certain supply contracts contain penalty provisions for early termination.

The following table summarizes TCC's actual contractual commitments as of December 31, 2012:

<u>Contractual Commitments</u>	<u>Less Than 1 Year</u>	<u>2-3 Years</u>	<u>4-5 Years</u>	<u>After 5 Years</u>	<u>Total</u>
			(in thousands)		
Construction Contracts for Capital Assets (a)	\$ 13,101	\$ -	\$ -	\$ -	\$ 13,101

- (a) Represents only capital assets for which there are signed contracts. Actual payments are dependent upon and may vary significantly based upon the decision to build, regulatory approval schedules, timing and escalation of project costs.

GUARANTEES

Liabilities for guarantees are recorded in accordance with the accounting guidance for "Guarantees." There is no collateral held in relation to any guarantees. In the event any guarantee is drawn, there is no recourse to third parties unless specified below.

Indemnifications and Other Guarantees

Contracts

TCC enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. The status of certain sale agreements is discussed in the "Dispositions" section of Note 5. As of December 31, 2012, there were no material liabilities recorded for any indemnifications.

Lease Obligations

TCC leases certain equipment under master lease agreements. See "Master Lease Agreements" section of Note 11 for disclosure of lease residual value guarantees.

CONTINGENCIES

Insurance and Potential Losses

TCC maintains insurance coverage normal and customary for an electric utility, subject to various deductibles. Insurance coverage includes all risks of physical loss or damage to assets, subject to insurance policy conditions and exclusions. Covered property generally includes substations, facilities and inventories. Excluded property generally includes transmission and distribution lines, poles and towers. The insurance programs also generally provide coverage against loss arising from certain claims made by third parties and are in excess of TCC's retentions. Coverage is generally provided by a combination of the protected cell of EIS and/or various industry mutual and/or commercial insurance carriers.

Some potential losses or liabilities may not be insurable or the amount of insurance carried may not be sufficient to meet potential losses and liabilities. Future losses or liabilities, if they occur, which are not completely insured, unless recovered from customers, could reduce future net income and cash flows and impact financial condition.

Carbon Dioxide Public Nuisance Claims

In October 2009, the Fifth Circuit Court of Appeals reversed a decision by the Federal District Court for the District of Mississippi dismissing state common law nuisance claims in a putative class action by Mississippi residents asserting that CO₂ emissions exacerbated the effects of Hurricane Katrina. The Fifth Circuit held that there was no exclusive commitment of the common law issues raised in plaintiffs' complaint to a coordinate branch of government and that no initial policy determination was required to adjudicate these claims. The court granted petitions for rehearing. An additional recusal left the Fifth Circuit without a quorum to reconsider the decision and the appeal was dismissed, leaving the district court's decision in place. Plaintiffs filed a petition with the U.S. Supreme Court asking the court to remand the case to the Fifth Circuit and reinstate the panel decision. The petition was denied in January 2011. Plaintiffs refiled their complaint in federal district court. The court ordered all defendants to respond to the refiled complaints in October 2011. In March 2012, the court granted the defendants' motion for dismissal on several grounds, including the doctrine of collateral estoppel and the applicable statute of limitations. Plaintiffs appealed the decision to the Fifth Circuit Court of Appeals. Management will continue to defend against the claims. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

Alaskan Villages' Claims

In 2008, the Native Village of Kivalina and the City of Kivalina, Alaska filed a lawsuit in Federal Court in the Northern District of California against AEP, AEPSC and 22 other unrelated defendants including oil and gas companies, a coal company and other electric generating companies. The complaint alleges that the defendants' emissions of CO₂ contribute to global warming and constitute a public and private nuisance and that the defendants are acting together. The complaint further alleges that some of the defendants, including AEP, conspired to create a false scientific debate about global warming in order to deceive the public and perpetuate the alleged nuisance. The plaintiffs also allege that the effects of global warming will require the relocation of the village at an alleged cost of \$95 million to \$400 million. In October 2009, the judge dismissed plaintiffs' federal common law claim for nuisance, finding the claim barred by the political question doctrine and by plaintiffs' lack of standing to bring the claim. The judge also dismissed plaintiffs' state law claims without prejudice to refile in state court. The plaintiffs appealed the decision. In September 2012, the Ninth Circuit Court of Appeals affirmed the trial court's decision, holding that the CAA displaced Kivalina's claims for damages. Plaintiffs' petition for rehearing by the full court was denied in November 2012, but the plaintiffs could seek further review in the U.S. Supreme Court. Management believes the action is without merit and will continue to defend against the claims. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

The Comprehensive Environmental Response Compensation and Liability Act (Superfund) and State Remediation

The transmission and distribution facilities have used asbestos, polychlorinated biphenyls and other hazardous and nonhazardous materials. TCC currently incurs costs to dispose of these substances safely.

Superfund addresses clean-up of hazardous substances that have been released to the environment. The Federal EPA administers the clean-up programs. Several states have enacted similar laws. As of December 31, 2012, TCC has been named potentially liable at one site under state law. In the instance where TCC has been named a defendant, disposal or recycling activities were in accordance with the then-applicable laws and regulations. Superfund does not recognize compliance as a defense, but imposes strict liability on parties who fall within its broad statutory categories. Liability has been resolved for a number of sites with no significant effect on net income.

Management evaluates the potential liability for each site separately, but several general statements can be made about potential future liability. Allegations that materials were disposed at a particular site are often unsubstantiated and the quantity of materials deposited at a site can be small and often nonhazardous. Although Superfund liability has been interpreted by the courts as joint and several, typically many parties are named for each site and several of the parties are financially sound enterprises. At present, management's estimates do not anticipate material cleanup costs for identified sites.

Claims by the City of Brownsville, Texas Against TCC

In 2007, the City of Brownsville, Texas filed a petition in the District Court of Dallas County, Texas. The petition sought recovery against TCC based on allegations of breach of contract, breach of fiduciary duty, unjust enrichment, constructive trust, conversion, breach of the Texas theft liability act and fraud allegedly occurring in connection with a transaction in which Brownsville purchased TCC's interest in the Oklaunion electric generating station. Following court proceedings and mediations, the parties reached a resolution in December 2012 and the matter was dismissed.

5. DISPOSITIONS

2011

Texas Transmission Facilities

In 2011, TCC sold \$10 million of transmission facilities to ETT. There were no gains or losses recorded on these sale transactions.

2010

Texas Transmission Facilities

In 2010, TCC sold \$66 million of transmission facilities to ETT. There were no gains or losses recorded on these sale transactions.

6. BENEFIT PLANS

For a discussion of investment strategy, investment limitations, target asset allocations and the classification of investments within the fair value hierarchy, see "Investments Held in Trust for Future Liabilities" and "Fair Value Measurements of Assets and Liabilities" sections of Note 1.

TCC participates in an AEP sponsored qualified pension plan and an unfunded nonqualified pension plan. Substantially all of TCC's employees are covered by the qualified plan or both the qualified and nonqualified pension plans. TCC also participates in OPEB plans sponsored by AEP to provide health and life insurance benefits for retired employees.

TCC recognizes its funded status associated with defined benefit pension and OPEB plans in its balance sheets. Disclosures about the plans are required by the “Compensation – Retirement Benefits” accounting guidance. TCC recognizes an asset for a plan’s overfunded status or a liability for a plan’s underfunded status and recognizes, as a component of other comprehensive income, the changes in the funded status of the plan that arise during the year that are not recognized as a component of net periodic benefit cost. TCC records a regulatory asset instead of other comprehensive income for qualifying benefit costs of regulated operations that for ratemaking purposes are deferred for future recovery. The cumulative funded status adjustment is equal to the remaining unrecognized deferrals for unamortized actuarial losses or gains, prior service costs and transition obligations, such that remaining deferred costs result in a regulatory asset and deferred gains result in a regulatory liability.

Actuarial Assumptions for Benefit Obligations

The weighted-average assumptions as of December 31 of each year used in the measurement of TCC’s benefit obligations are shown in the following table:

Assumptions	Pension Plans		Other Postretirement Benefit Plans	
	2012	2011	2012	2011
Discount Rate	3.95 %	4.55 %	3.95 %	4.75 %
Rate of Compensation Increase	4.90 % (a)	4.90 % (a)	NA	NA

(a) Rates are for base pay only. In addition, an amount is added to reflect target incentive compensation for exempt employees and overtime and incentive pay for nonexempt employees.

NA Not applicable.

A duration-based method is used to determine the discount rate for the plans. A hypothetical portfolio of high quality corporate bonds is constructed with cash flows matching the benefit plan liability. The composite yield on the hypothetical bond portfolio is used as the discount rate for the plan.

For 2012, the rate of compensation increase assumed varies with the age of the employee, ranging from 3.5% per year to 11.5% per year, with an average increase of 4.9%.

Actuarial Assumptions for Net Periodic Benefit Costs

The weighted-average assumptions as of January 1 of each year used in the measurement of TCC’s benefit costs are shown in the following table:

	Pension Plans			Other Postretirement Benefit Plans		
	2012	2011	2010	2012	2011	2010
Discount Rate	4.55 %	5.05 %	5.60 %	4.75 %	5.25 %	5.85 %
Expected Return on Plan Assets	7.25 %	7.75 %	8.00 %	7.25 %	7.50 %	8.00 %
Rate of Compensation Increase	4.90 %	4.90 %	4.70 %	NA	NA	NA

NA Not applicable.

The expected return on plan assets for 2012 was determined by evaluating historical returns, the current investment climate (yield on fixed income securities and other recent investment market indicators), rate of inflation and current prospects for economic growth.

The health care trend rate assumptions as of January 1 of each year used for OPEB plans measurement purposes are shown below:

Health Care Trend Rates	2012	2011
Initial	7.00 %	7.50 %
Ultimate	5.00 %	5.00 %
Year Ultimate Reached	2020	2016

Assumed health care cost trend rates have a significant effect on the amounts reported for the OPEB health care plans. A 1% change in assumed health care cost trend rates would have the following effects:

	<u>1% Increase</u>	<u>1% Decrease</u>
	(in thousands)	
Effect on Total Service and Interest Cost		
Components of Net Periodic Postretirement Health Care Benefit Cost	\$ 1,373	\$ (1,089)
Effect on the Health Care Component of the Accumulated Postretirement Benefit Obligation	6,267	(4,732)

Significant Concentrations of Risk within Plan Assets

In addition to establishing the target asset allocation of plan assets, the investment policy also places restrictions on securities to limit significant concentrations within plan assets. The investment policy establishes guidelines that govern maximum market exposure, security restrictions, prohibited asset classes, prohibited types of transactions, minimum credit quality, average portfolio credit quality, portfolio duration and concentration limits. The guidelines were established to mitigate the risk of loss due to significant concentrations in any investment. The plans are monitored to control security diversification and ensure compliance with the investment policy. As of December 31, 2012, the assets were invested in compliance with all investment limits. See "Investments Held in Trust for Future Liabilities" section of Note 1 for limit details.

Benefit Plan Obligations, Plan Assets and Funded Status as of December 31, 2012 and 2011

The following tables provide a reconciliation of the changes in the plans' benefit obligations, fair value of plan assets and funded status as of December 31. The benefit obligation for the defined benefit pension and OPEB plans are the projected benefit obligation and the accumulated benefit obligation, respectively.

	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>2012</u>	<u>2011</u>	<u>2012</u>	<u>2011</u>
	(in thousands)			
Change in Benefit Obligation				
Benefit Obligation as of January 1	\$ 347,273	\$ 333,234	\$ 139,929	\$ 131,786
Service Cost	5,199	5,000	2,459	2,218
Interest Cost	15,099	16,520	6,413	6,797
Actuarial Loss	5,430	13,744	7,731	19,122
Plan Amendment Prior Service Credit	-	-	(34,797)	(12,963)
Benefit Payments	(34,943)	(21,225)	(10,354)	(10,139)
Participant Contributions	-	-	2,493	2,342
Medicare Subsidy	-	-	800	766
Benefit Obligation as of December 31	<u>\$ 338,058</u>	<u>\$ 347,273</u>	<u>\$ 114,674</u>	<u>\$ 139,929</u>
Change in Fair Value of Plan Assets				
Fair Value of Plan Assets as of January 1	\$ 305,385	\$ 267,959	\$ 92,891	\$ 94,575
Actual Gain on Plan Assets	33,366	19,191	13,460	1,536
Company Contributions	13,223	39,460	5,647	4,577
Participant Contributions	-	-	2,493	2,342
Benefit Payments	(34,943)	(21,225)	(10,354)	(10,139)
Fair Value of Plan Assets as of December 31	<u>\$ 317,031</u>	<u>\$ 305,385</u>	<u>\$ 104,137</u>	<u>\$ 92,891</u>
Underfunded Status as of December 31	<u>\$ (21,027)</u>	<u>\$ (41,888)</u>	<u>\$ (10,537)</u>	<u>\$ (47,038)</u>

Amounts Recognized on the Balance Sheets as of December 31, 2012 and 2011

	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>2012</u>	<u>2011</u>	<u>December 31, 2012</u>	<u>2011</u>
	(in thousands)			
Other Current Liabilities - Accrued Short-term Benefit Liability	\$ (290)	\$ (284)	\$ -	\$ -
Deferred Credits and Other Noncurrent Liabilities - Accrued Long-term Benefit Liability	(20,737)	(41,604)	(10,537)	(47,038)
Underfunded Status	<u>\$ (21,027)</u>	<u>\$ (41,888)</u>	<u>\$ (10,537)</u>	<u>\$ (47,038)</u>

Amounts Included in Regulatory Assets as of December 31, 2012 and 2011

<u>Components</u>	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>2012</u>	<u>2011</u>	<u>December 31, 2012</u>	<u>2011</u>
	(in thousands)			
Net Actuarial Loss	\$ 171,954	\$ 187,753	\$ 57,782	\$ 60,668
Prior Service Cost (Credit)	1,195	(67)	(47,275)	(13,660)
Recorded as				
Regulatory Assets	\$ 173,149	\$ 187,686	\$ 10,507	\$ 47,008

Components of the change in amounts included in Regulatory Assets during the years ended December 31, 2012 and 2011 are as follows:

<u>Components</u>	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>2012</u>	<u>2011</u>	<u>Years Ended December 31, 2012</u>	<u>2011</u>
	(in thousands)			
Actuarial Loss (Gain) During the Year	\$ (5,649)	\$ 16,366	\$ 670	\$ 24,487
Prior Service Credit	-	-	(34,797)	(12,963)
Amortization of Actuarial Loss	(10,150)	(8,472)	(3,556)	(1,760)
Amortization of Prior Service Credit	1,262	1,270	1,182	62
Change for the Year	<u>\$ (14,537)</u>	<u>\$ 9,164</u>	<u>\$ (36,501)</u>	<u>\$ 9,826</u>

Pension and Other Postretirement Plans' Assets

The following table presents the classification of pension plan assets within the fair value hierarchy as of December 31, 2012:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in thousands)					
Equities:						
Domestic	\$ 88,314	\$ -	\$ -	\$ -	\$ 88,314	27.9 %
International	33,539	-	-	-	33,539	10.5 %
Real Estate Investment Trusts	6,114	-	-	-	6,114	1.9 %
Common Collective Trust - International	-	293	-	-	293	0.1 %
Subtotal - Equities	127,967	293	-	-	128,260	40.4 %
Fixed Income:						
Common Collective Trust - Debt	-	2,142	-	-	2,142	0.7 %
United States Government and Agency Securities	-	48,292	-	-	48,292	15.2 %
Corporate Debt	-	83,385	-	-	83,385	26.3 %
Foreign Debt	-	13,410	-	-	13,410	4.2 %
State and Local Government	-	2,969	-	-	2,969	0.9 %
Other - Asset Backed	-	2,405	-	-	2,405	0.8 %
Subtotal - Fixed Income	-	152,603	-	-	152,603	48.1 %
Real Estate	-	-	14,824	-	14,824	4.7 %
Alternative Investments	-	-	13,204	-	13,204	4.2 %
Securities Lending	-	5,423	-	-	5,423	1.7 %
Securities Lending Collateral (a)	-	-	-	(6,133)	(6,133)	(1.9)%
Cash and Cash Equivalents	-	8,490	-	-	8,490	2.7 %
Other - Pending Transactions and Accrued Income (b)	-	-	-	360	360	0.1 %
Total	\$ 127,967	\$ 166,809	\$ 28,028	\$ (5,773)	\$ 317,031	100.0 %

(a) Amounts in "Other" column primarily represent an obligation to repay cash collateral received as part of the Securities Lending Program.

(b) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.

The following table sets forth a reconciliation of changes in the fair value of assets classified as Level 3 in the fair value hierarchy for TCC's pension assets:

	Corporate Debt	Real Estate	Alternative Investments	Total Level 3
	(in thousands)			
Balance as of January 1, 2012	\$ 452	\$ 11,592	\$ 11,380	\$ 23,424
Actual Return on Plan Assets				
Relating to Assets Still Held as of the Reporting Date	-	1,710	521	2,231
Relating to Assets Sold During the Period	(159)	-	253	94
Purchases and Sales	(293)	1,522	1,050	2,279
Transfers into Level 3	-	-	-	-
Transfers out of Level 3	-	-	-	-
Balance as of December 31, 2012	\$ -	\$ 14,824	\$ 13,204	\$ 28,028

The following table presents the classification of OPEB plan assets within the fair value hierarchy as of December 31, 2012:

<u>Asset Class</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>	<u>Year End Allocation</u>
	(in thousands)					
Equities:						
Domestic	\$ 28,027	\$ -	\$ -	\$ -	\$ 28,027	26.9 %
International	33,509	-	-	-	33,509	32.2 %
Subtotal - Equities	<u>61,536</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>61,536</u>	<u>59.1 %</u>
Fixed Income:						
Common Collective Trust - Debt	-	4,818	-	-	4,818	4.6 %
United States Government and Agency Securities	-	5,459	-	-	5,459	5.2 %
Corporate Debt	-	10,282	-	-	10,282	9.9 %
Foreign Debt	-	1,738	-	-	1,738	1.7 %
State and Local Government	-	483	-	-	483	0.5 %
Other - Asset Backed	-	653	-	-	653	0.6 %
Subtotal - Fixed Income	<u>-</u>	<u>23,433</u>	<u>-</u>	<u>-</u>	<u>23,433</u>	<u>22.5 %</u>
Trust Owned Life Insurance:						
International Equities	-	3,422	-	-	3,422	3.3 %
United States Bonds	-	10,797	-	-	10,797	10.3 %
Cash and Cash Equivalents	4,122	757	-	-	4,879	4.7 %
Other - Pending Transactions and Accrued Income (a)	<u>-</u>	<u>-</u>	<u>-</u>	<u>70</u>	<u>70</u>	<u>0.1 %</u>
Total	<u><u>\$ 65,658</u></u>	<u><u>\$ 38,409</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 70</u></u>	<u><u>\$ 104,137</u></u>	<u><u>100.0 %</u></u>

(a) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.

The following table presents the classification of pension plan assets within the fair value hierarchy as of December 31, 2011:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in thousands)					
Equities:						
Domestic	\$ 103,245	\$ -	\$ -	\$ -	\$ 103,245	33.8 %
International	28,306	-	-	-	28,306	9.3 %
Real Estate Investment Trusts	7,381	-	-	-	7,381	2.4 %
Common Collective Trust - International	-	9,116	-	-	9,116	3.0 %
Subtotal - Equities	138,932	9,116	-	-	148,048	48.5 %
Fixed Income:						
Common Collective Trust - Debt United States Government and Agency Securities	-	1,863	-	-	1,863	0.6 %
Corporate Debt	-	40,151	-	-	40,151	13.2 %
Foreign Debt	-	69,881	452	-	70,333	23.0 %
State and Local Government	-	13,531	-	-	13,531	4.4 %
Other - Asset Backed	-	3,410	-	-	3,410	1.1 %
	-	1,845	-	-	1,845	0.6 %
Subtotal - Fixed Income	-	130,681	452	-	131,133	42.9 %
Real Estate	-	-	11,592	-	11,592	3.8 %
Alternative Investments	-	-	11,380	-	11,380	3.7 %
Securities Lending	-	15,243	-	-	15,243	5.0 %
Securities Lending Collateral (a)	-	-	-	(16,734)	(16,734)	(5.5)%
Cash and Cash Equivalents	-	6,584	-	-	6,584	2.2 %
Other - Pending Transactions and Accrued Income (b)	-	-	-	(1,861)	(1,861)	(0.6)%
Total	\$ 138,932	\$ 161,624	\$ 23,424	\$ (18,595)	\$ 305,385	100.0 %

(a) Amounts in "Other" column primarily represent an obligation to repay cash collateral received as part of the Securities Lending Program.

(b) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.

The following table sets forth a reconciliation of changes in the fair value of assets classified as Level 3 in the fair value hierarchy for the pension assets:

	Corporate Debt	Real Estate	Alternative Investments	Total Level 3
	(in thousands)			
Balance as of January 1, 2011	\$ -	\$ 5,779	\$ 9,029	\$ 14,808
Actual Return on Plan Assets				
Relating to Assets Still Held as of the Reporting Date	-	1,618	673	2,291
Relating to Assets Sold During the Period	-	-	231	231
Purchases and Sales	-	4,195	1,447	5,642
Transfers into Level 3	452	-	-	452
Transfers out of Level 3	-	-	-	-
Balance as of December 31, 2011	\$ 452	\$ 11,592	\$ 11,380	\$ 23,424

The following table presents the classification of OPEB plan assets within the fair value hierarchy as of December 31, 2011:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in thousands)					
Equities:						
Domestic	\$ 22,914	\$ -	\$ -	\$ -	\$ 22,914	24.7 %
International	25,062	-	-	-	25,062	27.0 %
Common Collective Trust - Global	-	6,534	-	-	6,534	7.0 %
Subtotal - Equities	47,976	6,534	-	-	54,510	58.7 %
Fixed Income:						
Common Collective Trust - Debt	-	4,561	-	-	4,561	4.9 %
United States Government and Agency Securities	-	5,323	-	-	5,323	5.7 %
Corporate Debt	-	10,024	-	-	10,024	10.8 %
Foreign Debt	-	2,125	-	-	2,125	2.3 %
State and Local Government	-	554	-	-	554	0.6 %
Other - Asset Backed	-	126	-	-	126	0.1 %
Subtotal - Fixed Income	-	22,713	-	-	22,713	24.4 %
Trust Owned Life Insurance:						
International Equities	-	3,046	-	-	3,046	3.3 %
United States Bonds	-	10,399	-	-	10,399	11.2 %
Cash and Cash Equivalents	1,108	1,543	-	-	2,651	2.9 %
Other - Pending Transactions and Accrued Income (a)	-	-	-	(428)	(428)	(0.5)%
Total	\$ 49,084	\$ 44,235	\$ -	\$ (428)	\$ 92,891	100.0 %

(a) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.

Determination of Pension Expense

The determination of pension expense or income is based on a market-related valuation of assets which reduces year-to-year volatility. This market-related valuation recognizes investment gains or losses over a five-year period from the year in which they occur. Investment gains or losses for this purpose are the difference between the expected return calculated using the market-related value of assets and the actual return.

Accumulated Benefit Obligation	December 31,	
	2012	2011
	(in thousands)	
Qualified Pension Plan	\$ 327,665	\$ 337,865
Nonqualified Pension Plan	3,181	3,491
Total	\$ 330,846	\$ 341,356

For the underfunded pension plans that had an accumulated benefit obligation in excess of plan assets, the projected benefit obligation, accumulated benefit obligation and fair value of plan assets of these plans as of December 31, 2012 and 2011 were as follows:

	Underfunded Pension Plans	
	2012	2011
	(in thousands)	
Projected Benefit Obligation	\$ 338,058	\$ 347,273
Accumulated Benefit Obligation	\$ 330,846	\$ 341,356
Fair Value of Plan Assets	317,031	305,385
Underfunded Accumulated Benefit Obligation	\$ (13,815)	\$ (35,971)

Estimated Future Benefit Payments and Contributions

TCC expects contributions and payments for the pension plans of \$8.7 million during 2013. The estimated contributions to the pension trust are at least the minimum amount required by the Employee Retirement Income Security Act and additional discretionary contributions may also be made to maintain the funded status of the plan.

The table below reflects the total benefits expected to be paid from the plan or from TCC's assets. The payments include the participants' contributions to the plan for their share of the cost. In November 2012, changes to the retiree medical coverage were announced. Effective for retirements after December 2012, contributions to retiree medical coverage will be capped reducing exposure to future medical cost inflation. Effective for employees hired after December 2013, retiree medical coverage will not be provided. In December 2011, the prescription drug plan was amended for certain participants. The impact of the changes is reflected in the Benefit Plan Obligation table as plan amendments. Future benefit payments are dependent on the number of employees retiring, whether the retiring employees elect to receive pension benefits as annuities or as lump sum distributions, future integration of the benefit plans with changes to Medicare and other legislation, future levels of interest rates and variances in actuarial results. The estimated payments for pension benefits and OPEB are as follows:

	Estimated Payments	
	Pension Plans	Other Postretirement Benefit Plans
	(in thousands)	
2013	\$ 24,092	\$ 9,555
2014	25,196	9,693
2015	25,947	10,029
2016	25,465	10,452
2017	27,035	10,894
Years 2018 to 2022, in Total	129,656	61,654

Components of Net Periodic Benefit Cost

The following table provides the components of net periodic benefit cost for the years ended December 31, 2012, 2011 and 2010:

	Pension Plans			Other Postretirement Benefit Plans		
	Years Ended December 31,					
	2012	2011	2010	2012	2011	2010
	(in thousands)					
Service Cost	\$ 5,199	\$ 5,000	\$ 5,555	\$ 2,459	\$ 2,218	\$ 2,462
Interest Cost	15,099	16,520	18,592	6,413	6,797	7,132
Expected Return on Plan Assets	(22,287)	(21,811)	(25,727)	(6,604)	(7,100)	(6,910)
Amortization of Transition Obligation	-	-	-	-	-	3,468
Amortization of Prior Service Credit	(1,262)	(1,270)	(1,271)	(1,182)	(62)	-
Amortization of Net Actuarial Loss	10,150	8,472	6,522	3,556	1,760	1,779
Net Periodic Benefit Cost	6,899	6,911	3,671	4,642	3,613	7,931
Capitalized Portion	(2,835)	(2,744)	(1,520)	(1,908)	(1,434)	(3,283)
Net Periodic Benefit Cost Recognized as Expense	\$ 4,064	\$ 4,167	\$ 2,151	\$ 2,734	\$ 2,179	\$ 4,648

Estimated amounts expected to be amortized to net periodic benefit costs (credits) and the impact on the balance sheet during 2013 are shown in the following table:

Components	Pension Plans	Other Postretirement Benefit Plans
	(in thousands)	
Net Actuarial Loss	\$ 11,442	\$ 4,003
Prior Service Cost (Credit)	320	(4,288)
Total Estimated 2013 Amortization	\$ 11,762	\$ (285)
Expected to be Recorded as		
Regulatory Asset	\$ 11,762	\$ (285)
Total	\$ 11,762	\$ (285)

American Electric Power System Retirement Savings Plan

TCC participates in an AEP sponsored defined contribution retirement savings plan, the American Electric Power System Retirement Savings Plan, for substantially all employees. This qualified plan offers participants an opportunity to contribute a portion of their pay, includes features under Section 401(k) of the Internal Revenue Code and provides for matching contributions. The matching contributions to the plan are 100% of the first 1% of eligible employee contributions and 70% of the next 5% of contributions. The cost for matching contributions totaled \$3.1 million in 2012, \$3 million in 2011 and \$2.8 million in 2010.

7. BUSINESS SEGMENTS

TCC has one reportable segment, an integrated electricity transmission and distribution business. TCC's other activities are insignificant.

8. DERIVATIVES AND HEDGING

Cash Flow Hedging Strategies

TCC's vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEPSC, on behalf of TCC, enters into financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. Not all fuel price risk exposure is hedged. The gross notional volumes of TCC's outstanding derivative contracts for heating oil and gasoline as of December 31, 2012 and 2011 were 801 thousand gallons and 812 thousand gallons, respectively.

According to the accounting guidance for "Derivatives and Hedging," TCC reflects the fair values of derivative instruments subject to netting agreements with the same counterparty net of related cash collateral. For certain risk management contracts, TCC is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the December 31, 2012 balance sheet, TCC had no netting of cash collateral paid to third parties against short-term and long-term risk management liabilities.

The following tables represent the gross fair value impact of TCC's derivative activity on the balance sheets as of December 31, 2012 and 2011:

**Fair Value of Derivative Instruments
December 31, 2012**

<u>Balance Sheet Location</u>	<u>Hedging Contracts (a)</u>	<u>Gross Amounts Offset in the Statement of Financial Position (b)</u>	<u>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</u>
	(in thousands)		
Prepayments and Other Current Assets	\$ 62	\$ (28)	\$ 34
Deferred Charges and Other Noncurrent Assets	-	-	-
Total Assets	<u>62</u>	<u>(28)</u>	<u>34</u>
Other Current Liabilities	28	(28)	-
Deferred Credits and Other Noncurrent Liabilities	-	-	-
Total Liabilities	<u>28</u>	<u>(28)</u>	<u>-</u>
Total MTM Derivative Contract Net Assets (Liabilities)	<u>\$ 34</u>	<u>\$ -</u>	<u>\$ 34</u>

**Fair Value of Derivative Instruments
December 31, 2011**

<u>Balance Sheet Location</u>	<u>Hedging Contracts (a)</u>	<u>Gross Amounts Offset in the Statement of Financial Position (b)</u>	<u>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</u>
	(in thousands)		
Prepayments and Other Current Assets	\$ -	\$ -	\$ -
Deferred Charges and Other Noncurrent Assets	-	-	-
Total Assets	<u>-</u>	<u>-</u>	<u>-</u>
Other Current Liabilities	129	(129)	-
Deferred Credits and Other Noncurrent Liabilities	-	-	-
Total Liabilities	<u>129</u>	<u>(129)</u>	<u>-</u>
Total MTM Derivative Contract Net Assets (Liabilities)	<u>\$ (129)</u>	<u>\$ 129</u>	<u>\$ -</u>

- (a) Derivative instruments within these categories are reported gross. These instruments are subject to master netting agreements and are presented on the balance sheets on a net basis in accordance with the accounting guidance for "Derivatives and Hedging."
- (b) Amounts include counterparty netting of risk management and hedging contracts and associated cash collateral in accordance with the accounting guidance for "Derivatives and Hedging."
- (c) There are no derivative contracts subject to a master netting arrangement or similar agreement which are not offset in the statement of financial position.

Accounting for Cash Flow Hedging Strategies

For cash flow hedges (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), TCC initially reports the effective portion of the gain or loss on the derivative instrument as a component of Accumulated Other Comprehensive Income (Loss) on its balance sheets until the period the hedged item affects Net Income. TCC records hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains).

TCC reclassifies gains and losses on heating oil and gasoline derivative contracts designated as cash flow hedges from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Other Operation expense, Maintenance expense or Depreciation and Amortization expense, as it relates to capital projects, on its statements of income. During 2012, 2011 and 2010, TCC designated heating oil and gasoline derivatives as cash flow hedges. Hedge ineffectiveness was immaterial for this hedge strategy.

The following table provides details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TCC's balance sheets and the reasons for changes in cash flow hedges for the years ended December 31, 2012, 2011 and 2010. All amounts in the following tables are presented net of related income taxes.

Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges Years Ended December 31, 2012, 2011 and 2010

	Years Ended December 31,		
	2012	2011	2010
		(in thousands)	
Balance in AOCI as of January 1,	\$ (83)	\$ 115	\$ 163
Changes in Fair Value Recognized in AOCI	155	190	105
Amount of (Gain) or Loss Reclassified from AOCI to Statement of Income/within Balance Sheet:			
Other Operation Expense	(17)	(137)	(65)
Maintenance Expense	(10)	(101)	(36)
Property, Plant and Equipment	(16)	(150)	(52)
Balance in AOCI as of December 31,	<u>\$ 29</u>	<u>\$ (83)</u>	<u>\$ 115</u>

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TCC's balance sheets as of December 31, 2012 and 2011 were:

Impact of Cash Flow Hedges on the Balance Sheet December 31, 2012 and 2011

	December 31,	
	2012	2011
		(in thousands)
Hedging Assets	\$ 34	\$ -
Hedging Liabilities	-	129
AOCI Gain (Loss) Net of Tax	29	(83)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	29	(83)

The actual amounts that TCC reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ from the estimate above due to market price changes. As of December 31, 2012, the maximum length of time that TCC is hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions is 12 months.

9. FAIR VALUE MEASUREMENTS

Fair Value Measurements of Long-term Debt

The fair values of Long-term Debt are based on quoted market prices, without credit enhancements, for the same or similar issues and the current interest rates offered for instruments with similar maturities classified as Level 2 measurement inputs. These instruments are not marked-to-market. The estimates presented are not necessarily indicative of the amounts that could be realized in a current market exchange.

The book values and fair values of TCC's Long-term Debt as of December 31, 2012 and 2011 are summarized in the following table:

	December 31,			
	2012		2011	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 2,924,566	\$ 3,328,785	\$ 2,390,716	\$ 2,742,800

Fair Value Measurements of Financial Assets and Liabilities

For a discussion of fair value accounting and the classification of assets and liabilities within the fair value hierarchy, see the “Fair Value Measurements of Assets and Liabilities” section of Note 1.

The following tables set forth, by level within the fair value hierarchy, TCC’s financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2012 and 2011. As required by the accounting guidance for “Fair Value Measurements and Disclosures,” financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Management’s assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. There have not been any significant changes in management’s valuation techniques.

Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2012

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Assets:					
Restricted Cash for Securitized Transition Funding (a)	\$ 215,218	\$ -	\$ -	\$ 14	\$ 215,232
<u>Risk Management Assets</u>					
Cash Flow Hedges:					
Commodity Hedges (b)	-	62	-	(28)	34
Total Assets	<u>\$ 215,218</u>	<u>\$ 62</u>	<u>\$ -</u>	<u>\$ (14)</u>	<u>\$ 215,266</u>
Liabilities:					
<u>Risk Management Liabilities</u>					
Cash Flow Hedges:					
Commodity Hedges (b)	\$ -	\$ 28	\$ -	\$ (28)	\$ -

Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2011

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Assets:					
Other Cash Deposits (a)	\$ 190,995	\$ -	\$ -	\$ 14	\$ 191,009
Liabilities:					
<u>Risk Management Liabilities</u>					
Cash Flow Hedges:					
Commodity Hedges (b)	-	129	-	(129)	-

- (a) Amounts in “Other” column primarily represent cash deposits with third parties. Level 1 amounts primarily represent investments in money market funds.
- (b) Amounts in “Other” column primarily represent counterparty netting of risk management and hedging contracts and associated cash collateral under the accounting guidance for “Derivatives and Hedging.”

There have been no transfers between Level 1 and Level 2 during the years ended December 31, 2012, 2011 and 2010.

10. INCOME TAXES

The details of TCC's income taxes before extraordinary item as reported are as follows:

	Years Ended December 31,		
	2012	2011	2010
	(in thousands)		
Income Tax Expense (Credit):			
Current	\$ 80,128	\$ 39,471	\$ 26,383
Deferred	(27,328)	127,155	4,572
Deferred Investment Tax Credits	(804)	(805)	(808)
Income Tax Expense	<u>\$ 51,996</u>	<u>\$ 165,821</u>	<u>\$ 30,147</u>

The following is a reconciliation of the difference between the amount of federal income taxes computed by multiplying book income before income taxes by the federal statutory rate and the amount of income taxes reported:

	Years Ended December 31,		
	2012	2011	2010
	(in thousands)		
Net Income	\$ 109,466	\$ 680,353	\$ 68,267
Extraordinary Item, Net of Tax of \$112,095 in 2011	-	(373,093)	-
Income Tax Expense	51,996	165,821	30,147
Pretax Income	<u>\$ 161,462</u>	<u>\$ 473,081</u>	<u>\$ 98,414</u>
Income Taxes on Pretax Income at Statutory Rate (35%)	\$ 56,512	\$ 165,578	\$ 34,445
Increase (Decrease) in Income Taxes resulting from the following items:			
Depreciation	922	1,227	1,291
Investment Tax Credits, Net	(804)	(805)	(808)
State and Local Income Taxes, Net	2,440	1,244	2,483
Parent Company Loss Benefit	(8,317)	(2,620)	(3,097)
Other	1,243	1,197	(4,167)
Income Tax Expense	<u>\$ 51,996</u>	<u>\$ 165,821</u>	<u>\$ 30,147</u>
Effective Income Tax Rate	32.2 %	35.1 %	30.6 %

The following table shows elements of TCC's net deferred tax liability and significant temporary differences:

	December 31,	
	2012	2011
	(in thousands)	
Deferred Tax Assets	\$ 138,876	\$ 121,789
Deferred Tax Liabilities	(1,454,218)	(1,464,073)
Net Deferred Tax Liabilities	<u>\$ (1,315,342)</u>	<u>\$ (1,342,284)</u>
Property Related Temporary Differences	\$ (532,790)	\$ (487,044)
Amounts Due from Customers for Future Federal Income Taxes	(4,515)	(4,789)
Accrued Pensions	10,883	17,792
Regulatory Assets	(19,535)	(271,165)
Securitized Transition Assets	(780,009)	(621,384)
All Other, Net	10,624	24,306
Net Deferred Tax Liabilities	<u>\$ (1,315,342)</u>	<u>\$ (1,342,284)</u>

AEP System Tax Allocation Agreement

TCC joins in the filing of a consolidated federal income tax return with its affiliates in the AEP System. The allocation of the AEP System's current consolidated federal income tax to the AEP System companies allocates the benefit of current tax losses to the AEP System companies giving rise to such losses in determining their current tax expense. The tax benefit of the Parent is allocated to its subsidiaries with taxable income. With the exception of the loss of the Parent, the method of allocation reflects a separate return result for each company in the consolidated group.

Federal and State Income Tax Audit Status

TCC and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2009. TCC and other AEP subsidiaries completed the examination of the years 2007 and 2008 in April 2011 and settled all outstanding issues on appeal for the years 2001 through 2006 in October 2011. The settlements did not materially impact TCC's and other AEP subsidiaries' net income, cash flows or financial condition. The IRS examination of years 2009 and 2010 started in October 2011. Although the outcome of tax audits is uncertain, in management's opinion, adequate provisions for federal income taxes have been made for potential liabilities resulting from such matters. In addition, TCC accrues interest on these uncertain tax positions. Management is not aware of any issues for open tax years that upon final resolution are expected to materially impact net income.

TCC and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns and TCC and other AEP subsidiaries are currently under examination in several state and local jurisdictions. Management believes that previously filed tax returns have positions that may be challenged by these tax authorities. However, management believes that adequate provisions for income taxes have been made for potential liabilities resulting from such challenges and that the ultimate resolution of these audits will not materially impact net income. With few exceptions, TCC is no longer subject to state or local income tax examinations by tax authorities for years before 2008.

Tax Credit Carryforward

As of December 31, 2012, TCC had unused federal income tax credits of \$649 thousand, not all of which have an expiration date. Included in the credit carryforward are federal general business tax credits of \$135 thousand. If these credits are not utilized, the federal general business tax credits will expire in the years 2028 through 2031.

TCC anticipates future federal taxable income will be sufficient to realize the tax benefits of the federal tax credits before they expire unused.

Uncertain Tax Positions

TCC recognizes interest accruals related to uncertain tax positions in interest income or expense as applicable, and penalties in Other Operation expense in accordance with the accounting guidance for "Income Taxes."

The following table shows the amounts reported for interest expense, interest income and reversal of prior period interest expense:

	Years Ended December 31,		
	2012	2011	2010
	(in thousands)		
Interest Expense	\$ 91	\$ 238	\$ 648
Interest Income	-	(3,655)	-
Reversal of Prior Period Interest Expense	16	1,785	-

The following table shows balances for amounts accrued for the receipt of interest and the payment of interest and penalties:

	December 31,	
	2012	2011
	(in thousands)	
Accrual for Receipt of Interest	\$ -	\$ 122
Accrual for Payment of Interest Penalties	749	259

The reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	2012	2011	2010
	(in thousands)		
Balance as of January 1,	\$ 2,923	\$ 14,991	\$ 15,526
Increase - Tax Positions Taken During a Prior Period	589	1,948	849
Decrease - Tax Positions Taken During a Prior Period	(80)	(2,300)	(1,028)
Increase - Tax Positions Taken During the Current Year	-	-	-
Decrease - Tax Positions Taken During the Current Year	-	-	(356)
Decrease - Settlements with Taxing Authorities	(595)	(7,659)	-
Decrease - Lapse of the Applicable Statute of Limitations	(87)	(4,057)	-
Balance as of December 31,	<u>\$ 2,750</u>	<u>\$ 2,923</u>	<u>\$ 14,991</u>

The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate is \$1.1 million, \$800 thousand and \$1.3 million for 2012, 2011 and 2010, respectively. Management believes there will be no significant net increase or decrease in unrecognized tax benefits within 12 months of the reporting date.

Federal Tax Legislation

The Patient Protection and Affordable Care Act and the related Health Care and Education Reconciliation Act (Health Care Acts) were enacted in March 2010. The Health Care Acts amend tax rules so that the portion of employer health care costs that are reimbursed by the Medicare Part D prescription drug subsidy will no longer be deductible by the employer for federal income tax purposes effective for years beginning after December 31, 2012. Because of the loss of the future tax deduction, a reduction in the deferred tax asset related to the nondeductible OPEB liabilities accrued to date was recorded by TCC in March 2010. This reduction, which was offset by recording net tax regulatory assets, did not materially affect TCC's net income, cash flows or financial condition for the year ended December 31, 2010.

The Small Business Jobs Act (the 2010 Act) was enacted in September 2010. Included in the 2010 Act was a one-year extension of the 50% bonus depreciation provision. The Tax Relief, Unemployment Insurance Reauthorization and the Job Creation Act of 2010 extended the life of research and development, employment and several energy tax credits originally scheduled to expire at the end of 2010. In addition, the 2010 Act extended the time for claiming bonus depreciation and increased the deduction to 100% for part of 2011 and 2010. The enacted provisions did not materially impact TCC's net income or financial condition but had a favorable impact on cash flows of approximately \$43 million in 2010.

In December 2011, the U.S. Treasury Department issued guidance regarding the deduction and capitalization of expenditures related to tangible property. The guidance was in the form of proposed and temporary regulations and generally is effective for tax years beginning in 2012. In November 2012, the effective date was moved to tax years beginning in 2014. Further, the notice stated that the U. S. Treasury Department anticipates that the final regulations will contain changes from the temporary regulations. Management will evaluate the impact of these regulations once they are issued.

The American Taxpayer Relief Act of 2012 (the 2012 Act) was enacted in January 2013. Included in the 2012 Act was a one-year extension of the 50% bonus depreciation. The 2012 Act also retroactively extended the life of research and development, employment and several energy tax credits, which expired at the end of 2011. The enacted provisions will not materially impact TCC's net income or financial condition but are expected to have a favorable impact on cash flows in 2013.

11. LEASES

Leases of property, plant and equipment are for periods up to 10 years and require payments of related property taxes, maintenance and operating costs. The majority of the leases have purchase or renewal options and will be renewed or replaced by other leases.

Lease rentals for both operating and capital leases are generally charged to Other Operation and Maintenance expense in accordance with rate-making treatment for regulated operations. The components of rental costs are as follows:

Lease Rental Costs	Years Ended December 31,		
	2012	2011	2010
	(in thousands)		
Net Lease Expense on Operating Leases	\$ 3,820	\$ 4,952	\$ 4,656
Amortization of Capital Leases	1,928	1,738	1,543
Interest on Capital Leases	213	253	177
Total Lease Rental Costs	\$ 5,961	\$ 6,943	\$ 6,376

The following table shows the property, plant and equipment under capital leases and related obligations recorded on TCC's balance sheets. Capital lease obligations are included in Other Current Liabilities and Deferred Credits and Other Noncurrent Liabilities on TCC's balance sheets.

	December 31,	
	2012	2011
	(in thousands)	
Property, Plant and Equipment Under Capital Leases		
Total Property, Plant and Equipment Under Capital Leases – Other	\$ 6,164	\$ 4,503
Accumulated Amortization	1,923	1,558
Net Property, Plant and Equipment Under Capital Leases	\$ 4,241	\$ 2,945
Obligations Under Capital Leases		
Noncurrent Liability	\$ 2,735	\$ 1,758
Liability Due Within One Year	1,506	1,187
Total Obligations Under Capital Leases	\$ 4,241	\$ 2,945

Future minimum lease payments consisted of the following as of December 31, 2012:

Future Minimum Lease Payments	Noncancelable	
	Capital Leases	Operating Leases
	(in thousands)	
2013	\$ 1,659	\$ 3,125
2014	808	2,485
2015	660	2,213
2016	502	1,957
2017	397	1,430
Later Years	725	2,471
Total Future Minimum Lease Payments	4,751	\$ 13,681
Less Estimated Interest Element	510	
Estimated Present Value of Future Minimum Lease Payments	\$ 4,241	

Master Lease Agreements

TCC leases certain equipment under master lease agreements. Under the lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, TCC is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of December 31, 2012, the maximum potential loss for these lease agreements was approximately \$2.6 million assuming the fair value of the equipment is zero at the end of the lease term.

12. FINANCING ACTIVITIES

Preferred Stock

In December 2011, TCC redeemed all of its outstanding preferred stock with a par value of \$5.3 million at a premium, resulting in a \$269 thousand loss, which is included in Preferred Stock Dividend Requirements Including Capital Stock Expense on TCC's statement of income.

Series	Number of Shares Redeemed	
	Years Ended December 31, 2011	2010
4.00%	41,736	11
4.20%	15,301	2,000

Long-term Debt

There are certain limitations on establishing liens against TCC's assets under its indentures. None of the long-term debt obligations of TCC have been guaranteed or secured by AEP or any of its affiliates.

The following details long-term debt outstanding as of December 31, 2012 and 2011:

Type of Debt	Maturity	Weighted	Interest Rate Ranges as of		Outstanding as of	
		Average	December 31,		December 31,	
		Interest Rate as of	2012	2011	2012	2011
		December 31,	2012	2011	(in thousands)	
Senior Unsecured Notes	2033	6.65%	6.65%	6.65%	\$ 275,000	\$ 275,000
Pollution Control Bonds (a)	2012-2030	5.20%	4.40%-6.30%	1.125%-6.30%	369,555	429,555
Securitization Bonds	2013-2024 (b)	4.21%	0.88%-6.25%	4.98%-6.25%	2,281,437	1,687,746
Unamortized Discount, Net					(1,426)	(1,585)
Total Long-term Debt Outstanding					<u>2,924,566</u>	<u>2,390,716</u>
Long-term Debt Due Within One Year					<u>243,378</u>	<u>231,574</u>
Long-term Debt					<u>\$ 2,681,188</u>	<u>\$ 2,159,142</u>

- (a) Standby bond purchase agreements and insurance policies support certain series.
 (b) Dates represent the scheduled final payment dates for TCC's securitization bonds. The maturity date is one to two years later. These bonds have been classified for maturity and repayment purposes based on the scheduled final payment date.

Long-term debt outstanding as of December 31, 2012 is payable as follows:

	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>After 2017</u>	<u>Total</u>
	(in thousands)						
Principal Amount	\$ 243,378	\$ 258,099	\$ 273,690	\$ 253,709	\$ 263,060	\$ 1,634,056	\$ 2,925,992
Unamortized Discount, Net							(1,426)
Total Long-term Debt Outstanding							<u>\$ 2,924,566</u>

In January 2013, TCC retired \$105 million of its outstanding Securitization Bonds.

As of December 31, 2012, trustees held, on TCC's behalf, \$120 million of its reacquired Pollution Control Bonds.

Dividend Restrictions

Federal Power Act

The Federal Power Act prohibits TCC from participating “in the making or paying of any dividends of such public utility from any funds properly included in capital account.” The term “capital account” is not defined in the Federal Power Act or its regulations. Management understands “capital account” to mean the book value of the common stock. This restriction does not limit the ability of TCC to pay dividends out of retained earnings.

Utility Money Pool – AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of the subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP’s utility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions approved in a regulatory order. The amount of outstanding borrowings from the Utility Money Pool as of December 31, 2012 and 2011 is included in Advances from Affiliates on TCC’s balance sheets. TCC’s Utility Money Pool activity and corresponding authorized borrowing limits for the years ended December 31, 2012 and 2011 are described in the following table:

<u>Year</u>	<u>Maximum Borrowings from Utility Money Pool</u>	<u>Maximum Loans to Utility Money Pool</u>	<u>Average Borrowings from Utility Money Pool</u>	<u>Average Loans to Utility Money Pool</u>	<u>Borrowings from Utility Money Pool as of December 31,</u>	<u>Authorized Short-Term Borrowing Limit</u>
	(in thousands)					
2012	\$ 103,335	\$ 720,746	\$ 54,849	\$ 53,036	\$ 103,335	\$ 250,000
2011	36,043	141,586	19,326	53,569	36,043	250,000

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the years ended December 31, 2012, 2011 and 2010 are summarized in the following table:

<u>Years Ended December 31,</u>	<u>Maximum Interest Rates for Funds Borrowed from Utility Money Pool</u>	<u>Minimum Interest Rates for Funds Borrowed from Utility Money Pool</u>	<u>Maximum Interest Rates for Funds Loaned to Utility Money Pool</u>	<u>Minimum Interest Rates for Funds Loaned to Utility Money Pool</u>	<u>Average Interest Rates for Funds Borrowed from Utility Money Pool</u>	<u>Average Interest Rates for Funds Loaned to Utility Money Pool</u>
2012	0.56 %	0.39 %	0.48 %	0.46 %	0.46 %	0.47 %
2011	0.51 %	0.39 %	0.56 %	0.06 %	0.46 %	0.29 %
2010	-	-	0.55 %	0.09 %	-	0.27 %

Interest expense and interest income related to the Utility Money Pool are included in Interest Expense and Interest Income, respectively, on TCC's statements of income. For amounts borrowed from and advanced to the Utility Money Pool, TCC incurred the following amounts of interest expense and earned the following amounts of interest income for the years ended December 31, 2012, 2011 and 2010:

	Years Ended December 31,		
	2012	2011	2010
	(in thousands)		
Interest Expense	\$ 201	\$ 13	\$ -
Interest Income	55	138	351

13. RELATED PARTY TRANSACTIONS

For other related party transactions, also see "Texas Transmission Facilities" sections of Note 5, "AEP System Tax Allocation Agreement" section of Note 10 and "Utility Money Pool – AEP System" section of Note 12.

Affiliated Revenues

TCC's other revenues derived from sales to affiliates for the years ended December 31, 2012, 2011 and 2010 were \$3.7 million, \$3.7 million and \$4.2 million, respectively. These related party revenues are reported in Sales to AEP Affiliates on TCC's statements of income.

ERCOT Transmission Cost of Service

TCC's net expenses allocated pursuant to the PUCT-approved ERCOT protocols for the years ended December 31, 2012, 2011 and 2010 were \$2.1 million, \$2.1 million and \$2.1 million, respectively. The net expenses are recorded in Other Operation expenses on TCC's statements of income.

ERCOT Transmission Service Charges

Pursuant to an order from the PUCT, ETT bills TCC for its ERCOT wholesale transmission services. ETT billed TCC \$6.5 million, \$4.4 million and \$2.7 million for transmission services in 2012, 2011 and 2010, respectively. The billings are recorded in Other Operation expenses on TCC's statements of income.

Sales and Purchases of Property

TCC had affiliated sales and purchases of electric property individually amounting to \$100 thousand or more and sales and purchases of meters and transformers for the years ended December 31, 2012, 2011 and 2010 as shown in the following table:

	Years Ended December 31,		
	2012	2011	2010
	(in thousands)		
Sales	\$ 7,517	\$ 4,915	\$ 1,681
Purchases	3,844	2,880	883

The amounts above are recorded in Property, Plant and Equipment on the balance sheets.

Intercompany Billings

TCC performs certain utility services for other AEP subsidiaries when necessary or practical. The costs of these services are billed on a direct-charge basis, whenever possible, or on reasonable basis of proration for services that benefit multiple companies. The billings for services are made at cost and include no compensation for the use of equity capital.

14. VARIABLE INTEREST ENTITIES

The accounting guidance for “Variable Interest Entities” is a consolidation model that considers if a company has a controlling financial interest in a VIE. A controlling financial interest will have both (a) the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Entities are required to consolidate a VIE when it is determined that they have a controlling financial interest in a VIE and therefore, are the primary beneficiary of that VIE, as defined by the accounting guidance for “Variable Interest Entities.” In determining whether TCC is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE’s variability TCC absorbs, guarantees of indebtedness, voting rights including kick-out rights, the power to direct the VIE, variable interests held by related parties and other factors. Management believes that significant assumptions and judgments were applied consistently.

AEP Texas Central Transition Funding I LLC, AEP Texas Central Transition Funding II LLC and AEP Texas Central Transition Funding III LLC, wholly-owned subsidiaries of TCC, (collectively Transition Funding) were formed for the sole purpose of issuing and servicing securitization bonds related to Texas Restructuring Legislation. Management has concluded that TCC is the primary beneficiary of Transition Funding because TCC has the power to direct the most significant activities of the VIE and TCC’s equity interest could potentially be significant. Therefore, TCC is required to consolidate Transition Funding. The securitized bonds totaled \$2.3 billion and \$1.7 billion as of December 31, 2012 and 2011, respectively, and are included in current and long-term debt on the balance sheets. Transition Funding has securitized transition assets of \$2.1 billion and \$1.6 billion as of December 31, 2012 and 2011, respectively, which are presented separately on the face of the balance sheets. The securitized transition assets represent the right to impose and collect Texas true-up costs from customers receiving electric transmission or distribution service from TCC under recovery mechanisms approved by the PUCT. The securitization bonds are payable only from and secured by the securitized transition assets. The bondholders have no recourse to TCC or any other AEP entity. TCC acts as the servicer for Transition Funding’s securitized transition asset and remits all related amounts collected from customers to Transition Funding for interest and principal payments on the securitization bonds and related costs.

The balances below represent the assets and liabilities of the Transition Funding that are consolidated. These balances include intercompany transactions that are eliminated upon consolidation.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
VARIABLE INTEREST ENTITIES
December 31, 2012 and 2011
(in millions)

<u>ASSETS</u>	<u>Transition Funding</u>	
	<u>2012</u>	<u>2011</u>
Current Assets	\$ 249,286	\$ 219,708
Other Noncurrent Assets	2,167,217 (a)	1,580,149
Total Assets	\$ 2,416,503	\$ 1,799,857
 <u>LIABILITIES AND EQUITY</u>		
Current Liabilities	\$ 303,775	\$ 229,374
Noncurrent Liabilities	2,094,678	1,556,446
Equity	18,050	14,037
Total Liabilities and Equity	\$ 2,416,503	\$ 1,799,857

(a) Includes an intercompany item eliminated in consolidation of \$89 million.

AEPSC provides certain managerial and professional services to AEP’s subsidiaries. AEP is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC’s cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to

regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC's cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. TCC's total billings from AEPSC for the years ended December 31, 2012, 2011 and 2010 were \$65 million, \$63 million and \$76 million, respectively. The carrying amount of liabilities associated with AEPSC as of December 31, 2012 and 2011 was \$10 million and \$7 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

15. PROPERTY, PLANT AND EQUIPMENT

Depreciation

TCC provides for depreciation of Property, Plant and Equipment on a straight-line basis over the estimated useful lives of property, generally using composite rates by functional class. The following table provides the annual composite depreciation rates by functional class:

2012		Regulated			Nonregulated			
Functional Class of Property	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite	Depreciable Life Ranges	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite	Depreciable Life Ranges
			Depreciation Rate				Depreciation Rate	
		(in thousands)			(in years)			
Transmission	\$ 1,194,582	\$ 239,141	1.5%	50-81	\$ -	\$ -	NA	NA
Distribution	2,120,155	431,152	3.6%	22-64	-	-	NA	NA
CWIP	104,788	(9,344)	NM	NM	-	-	NA	NA
Other	261,788	110,231	7.3%	15-40	2,540	674	NM	NM
Total	\$ 3,681,313	\$ 771,180			\$ 2,540	\$ 674		

2011		Regulated			Nonregulated			
Functional Class of Property	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite	Depreciable Life Ranges	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite	Depreciable Life Ranges
			Depreciation Rate				Depreciation Rate	
		(in thousands)			(in years)			
Transmission	\$ 1,135,982	\$ 217,177	1.5%	50-81	\$ -	\$ -	NA	NA
Distribution	2,002,508	402,267	3.6%	22-64	-	-	NA	NA
CWIP	58,906	6,634	NM	NM	-	-	NA	NA
Other	256,064	110,317	7.3%	NM	3,346	1,127	NM	NM
Total	\$ 3,453,460	\$ 736,395			\$ 3,346	\$ 1,127		

2010		Regulated		Nonregulated	
Functional Class of Property		Annual Composite	Depreciable Life Ranges	Annual Composite	Depreciable Life Ranges
		Depreciation Rate		Depreciation Rate	
		(in years)		(in years)	
Transmission		1.6%	50-81	NA	NA
Distribution		3.5%	22-64	NA	NA
CWIP		NM	NM	NA	NA
Other		6.5%	NM	NM	NM

NA Not applicable.
 NM Not meaningful.

The composite depreciation rate generally includes a component for nonasset retirement obligation (non-ARO) removal costs, which is credited to Accumulated Depreciation and Amortization. Actual removal costs incurred are charged to Accumulated Depreciation and Amortization. Any excess of accrued non-ARO removal costs over actual removal costs incurred is reclassified from Accumulated Depreciation and Amortization and reflected as a regulatory liability.

Asset Retirement Obligations (ARO)

TCC records ARO in accordance with the accounting guidance for “Asset Retirement and Environmental Obligations” for asbestos removal. TCC has identified, but not recognized, ARO liabilities related to electric transmission and distribution assets, as a result of certain easements on property on which assets are owned. Generally, such easements are perpetual and require only the retirement and removal of assets upon the cessation of the property’s use. The retirement obligation is not estimable for such easements since TCC plans to use its facilities indefinitely. The retirement obligation would only be recognized if and when TCC abandons or ceases the use of specific easements, which is not expected.

The following is a reconciliation of the 2012 and 2011 aggregate carrying amounts of ARO for TCC:

Year	ARO as of January 1,	Accretion Expense	Liabilities Incurred	Liabilities Settled	Revisions in		ARO as of December 31,
					Cash Flow Estimates		
(in thousands)							
2012	\$ 1,869	\$ 117	\$ 15	\$ (45)	19	\$	1,975
2011	1,550	99	220	-	-		1,869

Allowance for Funds Used During Construction (AFUDC)

TCC’s amounts of allowance for borrowed and equity funds used during construction are summarized in the following table:

	Years Ended December 31,		
	2012	2011	2010
(in thousands)			
Allowance for Equity Funds Used During Construction	\$ 1,967	\$ 2,642	\$ 4,653
Allowance for Borrowed Funds Used During Construction	1,309	1,402	3,637

16. COST REDUCTION PROGRAMS

2012 Sustainable Cost Reductions

In April 2012, management initiated a process to identify strategic repositioning opportunities and efficiencies that will result in sustainable cost savings. Management selected a consulting firm to conduct an organizational and process evaluation and a second firm to evaluate current employee benefit programs. The process resulted in involuntary severances and is expected to be completed by the end of the first quarter of 2013. The severance program provides two weeks of base pay for every year of service along with other severance benefits.

TCC recorded a charge to expense during 2012 related to the sustainable cost reductions initiative.

Expense Allocation from AEPSC	Incurred	Settled	Remaining Balance as of December 31, 2012
(in thousands)			
\$ 2,453	\$ 702	\$ (2,456)	\$ 699

These expenses relate primarily to severance benefits. They are included primarily in Other Operation expense on the statement of income and Other Current Liabilities on the balance sheet.

2010 Cost Reduction Initiatives

In April 2010, management began initiatives to decrease both labor and non-labor expenses with a goal of achieving significant reductions in operation and maintenance expenses. A total of 2,461 positions was eliminated across the AEP System as a result of process improvements, streamlined organizational designs and other efficiencies. Many of these eliminated positions resulted from employees that elected retirement through voluntary severance. Most of the affected employees terminated employment as of May 31, 2010. The severance program provided two weeks of base pay for every year of service along with other severance benefits.

TCC recorded a charge to Other Operation expense during 2010 primarily related to severance benefits as the result of headcount reduction initiatives. The total amount incurred in 2010 by TCC was \$24.9 million.

17. UNAUDITED QUARTERLY FINANCIAL INFORMATION

In management's opinion, the unaudited quarterly information reflects all normal and recurring accruals and adjustments necessary for a fair presentation of the results of operations for interim periods. Quarterly results are not necessarily indicative of a full year's operations because of various factors. TCC's unaudited quarterly financial information is as follows:

	<u>March 31</u>	<u>2012 Quarterly Periods Ended</u>		<u>December 31</u>
		<u>June 30</u>	<u>September 30</u>	
		<u>(in thousands)</u>		
Total Revenues	\$ 210,995	\$ 260,448	\$ 287,667	\$ 229,748
Operating Income	69,464	77,177	87,445	56,268
Net Income	30,275	27,299	33,630	18,262

	<u>March 31</u>	<u>2011 Quarterly Periods Ended</u>		<u>December 31</u>
		<u>June 30</u>	<u>September 30</u>	
		<u>(in thousands)</u>		
Total Revenues	\$ 209,100	\$ 238,135	\$ 264,954	\$ 210,643
Operating Income	63,518	77,728	83,270	58,306
Income Before Extraordinary Item (a)	-	-	201,933	61,129
Extraordinary Item, Net of Tax (a)	-	-	273,452	99,641
Net Income	18,332	25,866	475,385 (b)	160,770 (b)

(a) See Note 2 for discussion of extraordinary item related to Texas Restructuring appeals recorded in the third and fourth quarters of 2011.

(b) Includes carrying costs income related to Texas Restructuring appeals recorded in the third and fourth quarters of 2011.