AEP Texas and Subsidiaries

2016 Annual Report

Audited Consolidated Financial Statements

AEP TEXAS

An AEP Company

BOUNDLESS ENERGY

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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	American Electric Power Company, Inc., an investor-owned electric public utility holding company which includes American Electric Power Company, Inc. (Parent) and majority owned consolidated subsidiaries and consolidated affiliates.
AEP System	American Electric Power System, an electric system, owned and operated by AEP subsidiaries.
AEP Texas	AEP Texas, an AEP electric utility subsidiary.
AEP Utilities, Inc.	A former subsidiary of AEP and holding company for TCC, TNC and CSW Energy, Inc. Effective December 31, 2016, TCC and TNC were merged into AEP Utilities, Inc. Subsequently following this merger, the assets and liabilities of CSW Energy, Inc. were transferred to an affiliated company and AEP Utilities, Inc. was renamed AEP Texas Inc.
AEPEP	AEP Energy Partners, Inc., a subsidiary of AEP dedicated to wholesale marketing and trading, asset management and commercial and industrial sales in the deregulated Texas market.
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.
ASU	Accounting Standards Update.
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 Parent and Berkshire Hathaway Energy Company formed to own and operate electric transmission facilities in ERCOT.
FASB	Financial Accounting Standards Board.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FGD	Flue Gas Desulfurization or scrubbers.
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.
GAAP	Accounting Principles Generally Accepted in the United States of America.
IRS	Internal Revenue Service.
MTM	Mark-to-Market.
Nonutility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain nonutility subsidiaries.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
Parent	American Electric Power Company, Inc., the equity owner of AEP subsidiaries within the AEP consolidation.
PPA	Purchase Power and Sale Agreement.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
PUCT	Public Utility Commission of Texas.
REP	Texas Retail Electric Provider.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.

Term	Meaning
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
Texas Restructuring Legislation	Legislation enacted in 1999 to restructure the electric utility industry in Texas.
TNC	AEP Texas North 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 Legislation.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.
Wind Farms	Desert Sky and Trent Wind Farms, previously owned by a subsidiary of AEP Utilities, Inc., were transferred to an affiliated company on December 31, 2016.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholder of
AEP Texas Inc.:

We have audited the accompanying consolidated financial statements of AEP Texas Inc. and its subsidiaries (the "Company"), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, 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, 2016, 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 audits 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 Inc. and its subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2016 in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Columbus, Ohio
April 26, 2017

AEP TEXAS AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
For the Years Ended December 31, 2016, 2015 and 2014
(in millions)

	Years Ended December 31,		
	2016	**2015**	**2014**
REVENUES			
Electric Transmission and Distribution	$ 1,383.2	$ 1,374.1	$ 1,331.6
Sales to AEP Affiliates	75.7	78.5	92.8
Other Revenues	2.5	5.4	4.2
TOTAL REVENUES	1,461.4	1,458.0	1,428.6
EXPENSES			
Fuel and Other Consumables Used for Electric Generation	32.1	32.1	45.0
Other Operation	454.5	439.9	406.7
Maintenance	73.7	91.0	80.3
Depreciation and Amortization	413.9	468.9	444.1
Taxes Other Than Income Taxes	107.6	105.3	100.0
TOTAL EXPENSES	1,081.8	1,137.2	1,076.1
OPERATING INCOME	379.6	320.8	352.5
Other Income (Expense):			
Interest Income	10.9	0.8	0.2
Allowance for Equity Funds Used During Construction	9.2	6.7	4.8
Interest Expense	(144.4)	(148.4)	(152.0)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAX EXPENSE	255.3	179.9	205.5
Income Tax Expense	59.9	58.2	78.4
INCOME FROM CONTINUING OPERATIONS	195.4	121.7	127.1
INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF TAX	(48.8)	(1.4)	0.8
NET INCOME	$ 146.6	$ 120.3	$ 127.9

The common stock of AEP Texas is wholly-owned by Parent.

See Notes to Consolidated Financial Statements beginning on page 10.

AEP TEXAS AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Years Ended December 31, 2016, 2015 and 2014
(in millions)

	Years Ended December 31, 2016	2015	2014
Net Income	$ 146.6	$ 120.3	$ 127.9
OTHER COMPREHENSIVE INCOME, NET OF TAXES			
Cash Flow Hedges, Net of Tax of $0.6, $0.6 and $0.7 in 2016, 2015 and 2014, Respectively	1.1	1.2	1.2
Amortization of Pension and OPEB Deferred Costs, Net of Tax of $0.2, $0.2 and $0.3 in 2016, 2015 and 2014, Respectively	0.3	0.3	0.6
Pension and OPEB Funded Status, Net of Tax of $0.5, $0.1 and $0.9 in 2016, 2015 and 2014, Respectively	0.9	0.2	1.8
TOTAL OTHER COMPREHENSIVE INCOME	2.3	1.7	3.6
TOTAL COMPREHENSIVE INCOME	$ 148.9	$ 122.0	$ 131.5

See Notes to Consolidated Financial Statements beginning on page 10.

AEP TEXAS AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY
For the Years Ended December 31, 2016, 2015 and 2014
(in millions)

	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2013	$ 532.6	$ 702.8	$ (22.5)	$ 1,212.9
Common Stock Dividends		(35.0)		(35.0)
Net Income		127.9		127.9
Other Comprehensive Income			3.6	3.6
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2014	532.6	795.7	(18.9)	1,309.4
Capital Contribution from Parent	272.3			272.3
Common Stock Dividends		(29.0)		(29.0)
Net Income		120.3		120.3
Other Comprehensive Income			1.7	1.7
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2015	804.9	887.0	(17.2)	1,674.7
Capital Contribution from Parent	53.0			53.0
Common Stock Dividends		(34.0)		(34.0)
Net Income		146.6		146.6
Other Comprehensive Income			2.3	2.3
Distribution of CSW Energy, Inc. to Parent		(185.5)		(185.5)
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2016	$ 857.9	$ 814.1	$ (14.9)	$ 1,657.1

See Notes to Consolidated Financial Statements beginning on page 10.

AEP TEXAS AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
ASSETS
December 31, 2016 and 2015
(in millions)

	December 31, 2016	December 31, 2015
CURRENT ASSETS		
Cash and Cash Equivalents	$ 0.6	$ 0.5
Restricted Cash for Securitized Transition Funding	146.3	203.4
Advances to Affiliates	8.6	147.6
Accounts Receivable:		
Customers	94.4	94.7
Affiliated Companies	11.8	8.4
Accrued Unbilled Revenues	64.8	45.6
Miscellaneous	0.1	0.9
Allowance for Uncollectible Accounts	(0.6)	(1.7)
Total Accounts Receivable	170.5	147.9
Fuel	9.8	10.2
Materials and Supplies	49.0	54.5
Risk Management Assets	0.2	—
Assets From Discontinued Operations	—	83.7
Prepayments and Other Current Assets	4.2	3.7
TOTAL CURRENT ASSETS	389.2	651.5
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	349.6	342.5
Transmission	2,623.6	2,352.9
Distribution	3,527.2	3,343.6
Other Property, Plant and Equipment	436.4	407.7
Construction Work in Progress	385.9	293.5
Total Property, Plant and Equipment	7,322.7	6,740.2
Accumulated Depreciation and Amortization	1,542.0	1,480.4
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	5,780.7	5,259.8
OTHER NONCURRENT ASSETS		
Regulatory Assets	347.2	299.8
Securitized Transition Assets (December 31, 2016 and 2015 Amounts Include $1,088.3 and $1,297.5, Respectively, Related to Transition Funding)	1,118.7	1,335.9
Assets From Discontinued Operations	—	128.3
Deferred Charges and Other Noncurrent Assets	73.3	207.2
TOTAL OTHER NONCURRENT ASSETS	1,539.2	1,971.2
TOTAL ASSETS	$ 7,709.1	$ 7,882.5

See Notes to Consolidated Financial Statements beginning on page 10.

AEP TEXAS AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
December 31, 2016 and 2015
(dollars in millions)

	December 31,	
	2016	**2015**
CURRENT LIABILITIES		
Advances from Affiliates	$ 169.5	$ 52.5
Accounts Payable:		
General	129.5	102.5
Affiliated Companies	30.5	31.1
Long-term Debt Due Within One Year – Nonaffiliated (December 31, 2016 and 2015 Amounts Include $222.2 and $253.7, Respectively, Related to Transition Funding)	263.1	428.7
Risk Management Liabilities	—	0.3
Accrued Taxes	68.2	90.8
Accrued Interest (December 31, 2016 and 2015 Amounts Include $20.2 and $25.3, Respectively, Related to Transition Funding)	41.5	46.6
Liabilities From Discontinued Operations	—	72.4
Other Current Liabilities	94.8	88.1
TOTAL CURRENT LIABILITIES	797.1	913.0
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated (December 31, 2016 and 2015 Amounts Include $1,023.6 and $1,243.5, Respectively, Related to Transition Funding)	2,954.6	3,015.0
Deferred Income Taxes	1,531.7	1,477.4
Regulatory Liabilities and Deferred Investment Tax Credits	660.8	635.5
Oklaunion Purchase Power Agreement	51.5	50.2
Liabilities From Discontinued Operations	—	19.0
Deferred Credits and Other Noncurrent Liabilities	56.3	97.7
TOTAL NONCURRENT LIABILITIES	5,254.9	5,294.8
TOTAL LIABILITIES	6,052.0	6,207.8
Rate Matters (Note 4)		
Commitments and Contingencies (Note 6)		
COMMON SHAREHOLDER'S EQUITY		
Paid-in Capital	857.9	804.9
Retained Earnings	814.1	887.0
Accumulated Other Comprehensive Income (Loss)	(14.9)	(17.2)
TOTAL COMMON SHAREHOLDER'S EQUITY	1,657.1	1,674.7
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	$ 7,709.1	$ 7,882.5

See Notes to Consolidated Financial Statements beginning on page 10.

AEP TEXAS AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2016, 2015 and 2014
(in millions)

	Years Ended December 31, 2016	2015	2014
OPERATING ACTIVITIES			
Net Income	$ 146.6	$ 120.3	$ 127.9
Income (Loss) from Discontinued Operations	(48.8)	(1.4)	0.8
Income from Continuing Operations	195.4	121.7	127.1
Adjustments to Reconcile Income from Continuing Operations to Net Cash Flows from Continuing Operating Activities:			
Depreciation and Amortization	413.9	468.9	444.1
Deferred Income Taxes	29.5	(7.1)	2.6
Allowance for Equity Funds Used During Construction	(9.2)	(6.7)	(4.8)
Mark-to-Market of Risk Management Contracts	(0.5)	(0.7)	1.0
Pension Contributions to Qualified Plan Trust	(8.2)	(8.5)	(7.4)
Change in Other Noncurrent Assets	(45.0)	(72.4)	(34.0)
Change in Other Noncurrent Liabilities	(10.3)	(43.1)	23.9
Changes in Certain Components of Working Capital:			
Accounts Receivable, Net	(22.6)	9.9	(4.3)
Fuel, Materials and Supplies	5.9	(4.4)	(0.8)
Accounts Payable	(3.0)	(12.3)	2.5
Accrued Taxes, Net	(22.6)	46.9	11.0
Other Current Assets	(0.2)	(0.1)	0.1
Other Current Liabilities	(6.5)	3.1	(3.0)
Net Cash Flows from Continuing Operating Activities	516.6	495.2	558.0
INVESTING ACTIVITIES			
Construction Expenditures	(640.9)	(593.4)	(579.0)
Change in Restricted Cash for Securitized Transition Funding	57.1	2.3	(8.8)
Change in Advances to Affiliates, Net	139.0	(138.0)	0.6
Other Investing Activities	10.4	29.1	21.3
Net Cash Flows Used for Continuing Investing Activities	(434.4)	(700.0)	(565.9)
FINANCING ACTIVITIES			
Capital Contribution from Parent	53.0	272.3	—
Issuance of Long-term Debt – Nonaffiliated	199.2	370.1	298.6
Change in Advances from Affiliates, Net	117.0	(142.0)	3.8
Retirement of Long-term Debt – Nonaffiliated	(428.7)	(273.7)	(258.1)
Principal Payments for Capital Lease Obligations	(3.4)	(2.9)	(2.9)
Dividends Paid on Common Stock	(34.0)	(29.0)	(35.0)
Other Financing Activities	0.8	0.3	1.2
Net Cash Flows from (Used for) Continuing Financing Activities	(96.1)	195.1	7.6
Net Cash Flows from Discontinued Operating Activities	42.4	0.6	14.3
Net Cash Flows from (Used for) Discontinued Investing Activities	11.7	18.8	(14.5)
Net Cash Flows from (Used for) Discontinued Financing Activities	(44.6)	(15.9)	0.2
Net Decrease in Cash and Cash Equivalents	(4.4)	(6.2)	(0.3)
Cash and Cash Equivalents at Beginning of Period	5.0	11.2	11.5
Cash and Cash Equivalents at End of Period	$ 0.6	$ 5.0	$ 11.2
SUPPLEMENTARY INFORMATION			
Cash Paid for Interest, Net of Capitalized Amounts	$ 145.6	$ 144.0	$ 147.7
Net Cash Paid for Income Taxes	38.2	8.1	80.1
Noncash Acquisitions Under Capital Leases	7.1	6.1	3.9
Construction Expenditures Included in Current Liabilities as of December 31,	100.1	72.8	45.6
Noncash Distribution of CSW Energy, Inc. to Parent	185.5	—	—

See Notes to Consolidated Financial Statements beginning on page 10.

INDEX OF NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

Effective December 31, 2016, TCC and TNC merged into AEP Utilities, Inc., as approved by the FERC and the PUCT. Upon merger, AEP Utilities, Inc. changed its name to AEP Texas Inc. As a public utility, AEP Texas engages in the transmission and distribution of electric power to 1,024,000 retail customers through REPs in its service territory in southern, western and central Texas. AEP Texas consolidates AEP Texas North Generation Company, LLC, 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.

Under the Texas Restructuring Legislation, TCC and TNC exited the generation business and ceased serving retail load. However, AEP Texas continues as part owner in the Oklaunion Plant operated by PSO but has leased its entire portion of the output of the plant through 2027 to a non-utility affiliate.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Rates and Service Regulation

AEP Texas' transmission and distribution operations and related rates are regulated by the PUCT. The FERC regulates AEP Texas' 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 a nonregulated affiliate to bill an affiliated public utility company at 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 AEP Texas' wholesale transmission operations and rates. The FERC claims jurisdiction over retail transmission rates when retail rates are unbundled in connection with restructuring. AEP Texas' retail transmission rates in Texas are unbundled. Although AEP Texas' retail transmission rates in Texas are unbundled, retail transmission rates are regulated, on a cost basis, by the PUCT.

Principles of Consolidation

AEP Texas' financial statements include AEP Texas and its wholly-owned subsidiaries. Intercompany items are eliminated in consolidation. AEP Texas also has a generating unit that is jointly-owned with an affiliated company and nonaffiliated companies. AEP Texas' proportionate share of the operating costs associated with that facility is included in the financial statements and the assets and liabilities are reflected on the balance sheets. See "Oklaunion PPA between AEP Texas and AEP Energy Partners" section within Note 14 for detail of AEP Texas' agreement to sell its portion of the Oklaunion generation to AEPEP. See Note 15 - Variable Interest Entities.

Accounting for the Effects of Cost-Based Regulation

As a rate-regulated electric public utility company, AEP Texas' 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," AEP Texas 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

Fossil fuel inventories are carried at the lower of average cost or market. 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, AEP Texas 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

AEP Texas 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

AEP Texas 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 AEP Texas: Centrica, Just Energy and Reliant Energy	**2016**	**2015**	**2014**
Percentage of Operating Revenues	46%	53%	55%
Percentage of Accounts Receivable – Customers	42%	43%	44%

Management monitors credit levels and the financial condition of AEP Texas' 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

Regulated

Electric utility property, plant and equipment for AEP Texas' rate-regulated transmission and distribution operations 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 original cost retirements, 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 removal cost incurred and salvage received. These rates and the related lives are subject to periodic review. Removal costs accrued are typically recorded as regulatory liabilities when removal costs accrued exceed actual removal costs incurred. The asset removal costs liability is relieved as removal costs are incurred. A regulatory asset balance will occur if actual removal costs incurred exceed accumulated removal costs accrued.

The costs of labor, materials and overhead incurred to operate and maintain plant and equipment 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 is the amount at which that asset 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 in active markets, fair value is estimated using various internal and external valuation methods including cash flow analysis and appraisals.

Nonregulated

The generation operations of AEP Texas generally follow the policies of its rate-regulated operations listed above but with the following exceptions. Property, plant and equipment are stated at fair value at acquisition (or as adjusted for any applicable impairments) plus the original cost of property acquired or constructed since the acquisition, less disposals. Normal and routine retirements from the plant accounts, net of salvage, are charged to accumulated depreciation under the group composite method of depreciation. A gain or loss would be recorded if the retirement is not considered an interim routine replacement. Removal costs are charged to expense.

Allowance for Funds Used During Construction

For AEP Texas' regulated operations, 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. AEP Texas 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. For AEP Texas' nonregulated operations, interest is capitalized during construction in accordance with the accounting guidance for "Capitalization of Interest."

Valuation of Nonderivative Financial Instruments

The book values of Cash and Cash Equivalents, Advances to/from Affiliates, Accounts Receivable 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 amount of risk taken is determined by the Commercial Operations and Finance groups in accordance with established risk management policies as approved by the Finance Committee of AEP's Board of Directors. AEPSC's market risk oversight staff independently monitors risk policies, procedures and risk levels and provides members of the Commercial Operations Risk Committee (Regulated Risk Committee) various reports regarding compliance with policies, limits and procedures. The Regulated Risk Committee consists of AEPSC's Vice Chairman, Chief Financial Officer, Executive Vice President of Generation, 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. 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 portion of the Level 3 instruments have been economically hedged which 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 equivalent funds. Fixed income securities generally do not trade on exchanges 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, infrastructure and private equity investments that are valued using methods requiring judgment including appraisals. The fair value of real estate and infrastructure investments is measured using market capitalization rates, recent sales of comparable investments and independent third-party appraisals. The fair value of private equity investments is measured using cost and purchase multiples, operating results, discounted future cash flows and market based comparable data. Depending on the specific situation, one or multiple approaches are used to determine the valuation of a real estate, infrastructure or private equity investment.

Revenue Recognition

Regulatory Accounting

AEP Texas' 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, AEP Texas records them as assets on its balance sheets. AEP Texas 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, AEP Texas writes off that regulatory asset as a charge against income.

Electricity Supply and Delivery Activities

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

Power Purchase and Sale Agreement

AEP Texas recognizes revenue from an affiliate, AEPEP, for a 20-year PPA. AEP Texas recognizes revenues for the fuel, operations and maintenance and all other taxes on a billed basis. Revenue is recognized for the capacity and depreciation billed to AEPEP on a straight-line basis over the term of the PPA as these amounts represent the minimum amount due.

Maintenance

Maintenance costs are expensed as incurred. If it becomes probable that AEP Texas 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

AEP Texas 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 (ITC) were historically accounted for under the flow-through method, except where regulatory commissions reflected ITC in the rate-making process. In the third quarter of 2016, AEP Texas and other AEP subsidiaries changed accounting for the recognition of ITC and elected to apply the preferred deferral methodology. This change had no financial impact to AEP Texas.

Deferred ITC is amortized to income tax expense over the life of the asset. Amortization of deferred ITC begins when the asset is placed into service, except where regulatory commissions reflect ITC in the rate-making process, then amortization begins when the cash tax benefit is recognized.

AEP Texas accounts for uncertain tax positions in accordance with the accounting guidance for "Income Taxes." AEP Texas 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, AEP Texas collects from customers certain excise taxes levied by those state or local governments on customers. AEP Texas 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 on the statements of income.

Pension and OPEB Plans

AEP Texas participates in an AEP sponsored qualified pension plan and two unfunded nonqualified pension plans. Substantially all of AEP Texas' employees are covered by the qualified plan or both the qualified and a nonqualified pension plan. AEP Texas also participates in OPEB plans sponsored by AEP to provide health and life insurance benefits for retired employees. AEP Texas is allocated a proportionate share of benefit costs and accounts for its participation in these plans as multiple-employer plans. See Note 8 - Benefit Plans for additional information including significant accounting policies associated with the plans.

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 the trust funds is to use a diversified portfolio of investments to achieve an acceptable rate of return while managing the investment risk 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 objective of the investment policy for the pension fund is to maintain the funded status of the plan while providing for growth in the plan assets to offset the growth in the plan liabilities. The current target asset allocations are as follows:

Pension Plan Assets	Target
Equity	25%
Fixed Income	59%
Other Investments	15%
Cash and Cash Equivalents	1%

OPEB Plans Assets	Target
Equity	65%
Fixed Income	33%
Cash and Cash Equivalents	2%

The investment policy for each benefit plan contains various investment limitations. The investment policies establish concentration limits for securities and prohibit the purchase of 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.

For equity investments, the concentration 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% and 7% for pension and OPEB investments, respectively, 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, each investment manager's portfolio is compared to investment grade, diversified long and intermediate benchmark indices.

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, which are publicly traded real estate securities.

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 collateral. All loans are collateralized by at least 102% of the loaned asset's market value and the collateral is invested. The difference between the rebate owed to the borrower and the 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 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).

Earnings Per Share (EPS)

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

Supplementary Income Statement Information

The following table provides the components of Depreciation and Amortization:

Depreciation and Amortization	Years Ended December 31, 2016	2015	2014
		(in millions)	
Depreciation and Amortization of Property, Plant and Equipment	$ 204.0	$ 193.3	$ 177.4
Amortization of Securitized Transition Assets	210.3	275.5	266.9
Amortization of Regulatory Assets and Liabilities	(0.4)	0.1	(0.2)
Total Depreciation and Amortization	$ 413.9	$ 468.9	$ 444.1

Subsequent Events

Management reviewed subsequent events through April 26, 2017, the date that AEP Texas' 2016 annual report was issued.

2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of final pronouncements, management reviews the new accounting literature to determine its relevance, if any, to AEP Texas' business. The following final pronouncements will impact the financial statements.

ASU 2014-09 "Revenue from Contracts with Customers" (ASU 2014-09)

In May 2014, the FASB issued ASU 2014-09 clarifying the method used to determine the timing and requirements for revenue recognition on the statements of income. Under the new standard, an entity must identify the performance obligations in a contract, determine the transaction price and allocate the price to specific performance obligations to recognize the revenue when the obligation is completed. The amendments in this update also require disclosure of sufficient information to allow users to understand the nature, amount, timing and uncertainty of revenue and cash flow arising from contracts.

The FASB deferred implementation of ASU 2014-09 under the terms in ASU 2015-14, "Revenue from Contracts with Customers (Topic: 606): Deferral of the Effective Date." The new accounting guidance is effective for interim and annual periods beginning after December 15, 2017 with early adoption permitted.

Management continues to analyze the impact of the new revenue standard and related ASUs. During 2016, initial revenue contract assessments were completed. Material revenue streams were identified within the AEP System and representative contract/transaction types were sampled. Performance obligations identified within each material revenue stream were evaluated to determine whether the obligations were satisfied at a point in time or over time. Contracts determined to be satisfied over time generally qualified for the invoicing practical expedient since the invoiced amounts reasonably represented the value to customers of performance obligations fulfilled to date. Based upon the completed assessments, management does not expect a material impact to the timing of revenue recognized or net income and plans to elect the modified retrospective transition approach upon adoption. Management also continues to monitor unresolved industry implementation issues, including items related to collectability and alternative revenue programs, and will analyze the related impacts to revenue recognition. Management plans to adopt ASU 2014-09 effective January 1, 2018.

ASU 2015-11 "Simplifying the Measurement of Inventory" (ASU 2015-11)

In July 2015, the FASB issued ASU 2015-11 simplifying the guidance on the subsequent measurement of inventory, excluding inventory measured using last-in, first-out or the retail inventory method. Under the new standard, inventory should be at the lower of cost and net realizable value. The new accounting guidance is effective for interim and annual periods beginning after December 15, 2016 with early adoption permitted. Management adopted ASU 2015-11 prospectively, effective January 1, 2017. There was no impact on results of operations, financial position or cash flows at adoption.

ASU 2016-01 "Recognition and Measurement of Financial Assets and Financial Liabilities" (ASU 2016-01)

In January 2016, the FASB issued ASU 2016-01 enhancing the reporting model for financial instruments. Under the new standard, equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) are required to be measured at fair value with changes in fair value recognized in net income. The new standard also amends disclosure requirements and requires separate presentation of financial assets and liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. The amendments also clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2017 with early adoption permitted. The amendments will be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption on net income. Management plans to adopt ASU 2016-01 effective January 1, 2018.

ASU 2016-02 "Accounting for Leases" (ASU 2016-02)

In February 2016, the FASB issued ASU 2016-02 increasing the transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Under the new standard, an entity must recognize an asset and liability for operating leases on the balance sheets. Additionally, a capital lease will be known as a finance lease going forward. Leases with lease terms of 12 months or longer will be subject to the new requirements. Fundamentally, the criteria used to determine lease classification will remain the same, but will be more subjective under the new standard.

The new accounting guidance is effective for annual periods beginning after December 15, 2018 with early adoption permitted. The guidance will be applied by means of a modified retrospective approach. The modified retrospective approach will require lessees and lessors to recognize and measure leases at the beginning of the earliest period presented.

Management continues to analyze the impact of the new lease standard. During 2016, initial lease contract assessments were completed. The AEP System lease population was identified and representative lease contracts were sampled. Based upon the completed assessments, management prepared a system gap analysis to outline new disclosure compliance requirements compared to current system capabilities. Lease system options are currently being evaluated. Management plans to elect certain of the following practical expedients upon adoption:

Practical Expedient	Description
Overall Expedients (for leases commenced prior to adoption date and must be adopted as a package)	Do not need to reassess whether any expired or existing contracts are/or contain leases, do not need to reassess the lease classification for any expired or existing leases and do not need to reassess initial direct costs for any existing leases.
Lease and Non-lease Components (elect by class of underlying asset)	Elect as an accounting policy to not separate non-lease components from lease components and instead account for each lease and associated non-lease component as a single lease component.
Short-term Lease (elect by class of underlying asset)	Elect as an accounting policy to not apply the recognition requirements to short-term leases.
Lease term	Elect to use hindsight to determine the lease term.

Management expects the new standard to impact financial position, but not results of operations or cash flows. Management also continues to monitor unresolved industry implementation issues, including items related to renewables and Purchase Power and Sale Agreements, pole attachments, easements and right-of-ways, and will analyze the related impacts to lease accounting. Management plans to adopt ASU 2016-02 effective January 1, 2019.

ASU 2016-09 "Compensation – Stock Compensation" (ASU 2016-09)

In March 2016, the FASB issued ASU 2016-09 simplifying the accounting for share-based payment transactions including the income tax consequences, classification of awards as either equity or liabilities and classification on the statements of cash flows. Under the new standard, all excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) should be recognized as income tax expense or benefit on the statements of income. Under current GAAP, excess tax benefits are recognized in additional paid-in capital while tax deficiencies are recognized either as an offset to accumulated excess tax benefits, if any, or on the statements of income.

The new accounting guidance is effective for annual periods beginning after December 15, 2016. Early adoption is permitted in any interim or annual period. Certain provisions require retrospective/modified retrospective transition while others are to be applied prospectively. Management adopted ASU 2016-09 effective January 1, 2017. There was no impact on results of operations, financial position or cash flows at adoption.

ASU 2016-13 “Measurement of Credit Losses on Financial Instruments” (ASU 2016-13)

In June 2016, the FASB issued ASU 2016-13 requiring an allowance to be recorded for all expected credit losses for financial assets. The allowance for credit losses is based on historical information, current conditions and reasonable and supportable forecasts. The new standard also makes revisions to the other than temporary impairment model for available-for-sale debt securities. Disclosures of credit quality indicators in relation to the amortized cost of financing receivables are further disaggregated by year of origination.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2019 with early adoption permitted for interim and annual periods beginning after December 15, 2018. The amendments will be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption on net income. Management plans to adopt ASU 2016-13 effective January 1, 2020.

ASU 2016-18 “Restricted Cash” (ASU 2016-18)

In November 2016, the FASB issued ASU 2016-18 clarifying the treatment of restricted cash on the statements of cash flows. Under the new standard, amounts considered restricted cash will be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts on the statements of cash flows.

The new accounting guidance is effective for annual periods beginning after December 15, 2017. Early adoption is permitted in any interim or annual period. The guidance will be applied by means of a retrospective approach. Management is analyzing the impact of the new standard. Management plans to adopt ASU 2016-18 effective for the 2017 Annual Report.

ASU 2017-07 “Compensation - Retirement Benefits” (ASU 2017-07)

In March 2017, the FASB issued ASU 2017-07 requiring that an employer report the service cost component of pension and postretirement benefits in the same line item or items as other compensation costs. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations. In addition, only the service cost component will be eligible for capitalization as applicable following labor.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2017. Early adoption is permitted as of the beginning of an annual period for which financial statements have not been issued or made available for issuance. Management is analyzing the impact of the new standard. Management plans to adopt ASU 2017-07 effective January 1, 2018.

3. COMPREHENSIVE INCOME

Presentation of Comprehensive Income

The following tables provide the components of changes in AOCI and details of reclassifications from AOCI for the years ended December 31, 2016, 2015 and 2014. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 8 for additional details.

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Year Ended December 31, 2016

	Cash Flow Hedges		Pension and OPEB		
	Commodity	Interest Rate	Amortization of Deferred Costs	Changes in Funded Status	Total
			(in millions)		
Balance in AOCI as of December 31, 2015	$ —	$ (6.5)	$ 3.9	$ (14.6)	$ (17.2)
Change in Fair Value Recognized in AOCI	—	(0.1)	—	0.9	0.8
Amount of (Gain) Loss Reclassified from AOCI					
Interest Expense	—	1.8	—	—	1.8
Amortization of Prior Service Cost (Credit)	—	—	(0.1)	—	(0.1)
Amortization of Actuarial (Gains)/Losses	—	—	0.5	—	0.5
Reclassifications from AOCI, before Income Tax (Expense) Credit	—	1.8	0.4	—	2.2
Income Tax (Expense) Credit	—	0.6	0.1	—	0.7
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	—	1.2	0.3	—	1.5
Net Current Period Other Comprehensive Income	—	1.1	0.3	0.9	2.3
Balance in AOCI as of December 31, 2016	$ —	$ (5.4)	$ 4.2	$ (13.7)	$ (14.9)

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Year Ended December 31, 2015

	Cash Flow Hedges		Pension and OPEB		
	Commodity	Interest Rate	Amortization of Deferred Costs	Changes in Funded Status	Total
			(in millions)		
Balance in AOCI as of December 31, 2014	$ —	$ (7.7)	$ 3.6	$ (14.8)	$ (18.9)
Change in Fair Value Recognized in AOCI	—	(0.1)	—	0.2	0.1
Amount of (Gain) Loss Reclassified from AOCI					
Interest Expense	—	1.9	—	—	1.9
Amortization of Prior Service Cost (Credit)	—	—	(0.1)	—	(0.1)
Amortization of Actuarial (Gains)/Losses	—	—	0.6	—	0.6
Reclassifications from AOCI, before Income Tax (Expense) Credit	—	1.9	0.5	—	2.4
Income Tax (Expense) Credit	—	0.6	0.2	—	0.8
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	—	1.3	0.3	—	1.6
Net Current Period Other Comprehensive Income	—	1.2	0.3	0.2	1.7
Balance in AOCI as of December 31, 2015	$ —	$ (6.5)	$ 3.9	$ (14.6)	$ (17.2)

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Year Ended December 31, 2014

	Cash Flow Hedges		Pension and OPEB		
	Commodity	Interest Rate	Amortization of Deferred Costs	Changes in Funded Status	Total
			(in millions)		
Balance in AOCI as of December 31, 2013	$ 0.1	$ (9.0)	$ 3.0	$ (16.6)	$ (22.5)
Change in Fair Value Recognized in AOCI	—	(0.1)	—	1.8	1.7
Amount of (Gain) Loss Reclassified from AOCI					
Regulatory Assets/(Liabilities), Net (a)	(0.1)	—	—	—	(0.1)
Interest Expense	—	2.1	—	—	2.1
Amortization of Prior Service Cost (Credit)	—	—	(0.1)	—	(0.1)
Amortization of Actuarial (Gains)/Losses	—	—	1.0	—	1.0
Reclassifications from AOCI, before Income Tax (Expense) Credit	(0.1)	2.1	0.9	—	2.9
Income Tax (Expense) Credit	—	0.7	0.3	—	1.0
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	(0.1)	1.4	0.6	—	1.9
Net Current Period Other Comprehensive Income (Loss)	(0.1)	1.3	0.6	1.8	3.6
Balance in AOCI as of December 31, 2014	$ —	$ (7.7)	$ 3.6	$ (14.8)	$ (18.9)

(a) Represents realized gains and losses subject to regulatory accounting treatment recorded as either current or noncurrent on the balance sheets.

4. RATE MATTERS

AEP Texas is involved in rate and regulatory proceedings at the PUCT and the FERC. Rate matters can have a material impact on net income, cash flows and possibly financial condition. AEP Texas' recent significant rate orders and pending rate filings are addressed in this note.

TCC and TNC Merger

Effective December 31, 2016, TCC and TNC merged into AEP Utilities, Inc., as approved by the FERC and the PUCT in September 2016 and December 2016, respectively. Upon merger, AEP Utilities, Inc. changed its name to AEP Texas Inc., but maintained TCC's and TNC's respective customer rates. The PUCT ordered certain post-merger conditions which included a) the sharing of certain interest rate savings with customers and b) an annual credit to customers of approximately $630 thousand for savings resulting from an expected reduction in post-merger debt issuance costs, effective until the next base rate case.

AEP Texas Distribution Cost Recovery Factor (DCRF)

In July 2016, the PUCT approved settlement agreements between TCC, TNC and intervenors related to requests for DCRF riders to allow recovery of eligible net distribution investments. The settlement agreement included an annual revenue requirement of $56 million ($45 million for the TCC division and $11 million for the TNC division), effective September 2016. Amounts approved are subject to refund based upon a prudence review of the investments in AEP Texas' next base rate case.

AEP Texas Base Rates

As of December 31, 2016, AEP's share of AEP Texas' cumulative revenues from interim base rate increases from 2009 through 2016, subject to review, is estimated to be $528 million. A base rate review could produce a refund if AEP Texas incurs a disallowance of the transmission or distribution investment on which an interim increase was based. Management is unable to determine a range of potential losses, if any, that are reasonably possible of occurring. A revenue decrease, including a refund of interim transmission and distribution rates, could reduce future net income and cash flows and impact financial condition.

5. EFFECTS OF REGULATION

Regulatory assets and liabilities are comprised of the following items:

Regulatory Assets:	December 31, 2016	December 31, 2015	Remaining Recovery Period
	(in millions)		
Noncurrent Regulatory Assets			
Regulatory assets pending final regulatory approval:			
Regulatory Assets Currently Earning a Return			
Storm Related Costs	$ 25.1	$ 24.2	
Regulatory Assets Currently Not Earning a Return			
Rate Case Expense	0.1	0.1	
Total Regulatory Assets Pending Final Regulatory Approval	25.2	24.3	
Regulatory assets approved for recovery:			
Regulatory Assets Currently Earning a Return			
Meter Replacement Costs	49.8	54.6	11 years
Advanced Metering System	21.3	3.6	4 years
Regulatory Assets Currently Not Earning a Return			
Pension and OPEB Funded Status	188.2	177.1	12 years
Income Taxes, Net	40.3	11.8	28 years
Unamortized Loss on Reacquired Debt	7.3	9.6	21 years
Medicare Subsidy	5.6	6.3	8 years
Transmission Cost Recovery Factor	5.3	9.9	1 year
Peak Demand Reduction/Energy Efficiency	4.2	1.9	2 years
Other Regulatory Assets Approved for Recovery	—	0.7	
Total Regulatory Assets Approved for Recovery	322.0	275.5	
Total Noncurrent Regulatory Assets	$ 347.2	$ 299.8	

Regulatory Liabilities:	December 31, 2016	December 31, 2015	Remaining Refund Period
	(in millions)		
Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits			
Regulatory liabilities approved for payment:			
Regulatory Liabilities Currently Paying a Return			
Asset Removal Costs	$ 581.7	$ 544.4	(a)
Advanced Metering Infrastructure Surcharge	17.0	21.3	4 years
Excess Earnings	7.3	7.8	15 years
Regulatory Liabilities Currently Not Paying a Return			
Transition Charges	40.5	46.5	11 years
Deferred Investment Tax Credits	13.9	15.5	46 years
Other Regulatory Liabilities Approved for Payment	0.4	—	various
Total Regulatory Liabilities Approved for Payment	660.8	635.5	
Total Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits	$ 660.8	$ 635.5	

(a) Relieved as removal costs are incurred

6. COMMITMENTS, GUARANTEES AND CONTINGENCIES

AEP Texas is subject to certain claims and legal actions arising in its ordinary course of business. In addition, AEP Texas' business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation against AEP Texas cannot be predicted. Management accrues contingent liabilities only when management concludes that it is both probable that a liability has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. When management determines that it is not probable, but rather reasonably possible that a liability has been incurred at the date of the financial statements, management discloses such contingencies and the possible loss or range of loss if such estimate can be made. Any estimated range is based on currently available information and involves elements of judgment and significant uncertainties. Any estimated range of possible loss may not represent the maximum possible loss exposure. Circumstances change over time and actual results may vary significantly from estimates.

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

AEP Texas has substantial construction commitments to support its operations and environmental investments. In managing the overall construction program and in the normal course of business, AEP Texas contractually commits to third-party construction vendors for certain material purchases and other construction services. AEP Texas also purchases fuel, 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.

In accordance with the accounting guidance for "Commitments", AEP Texas had no actual contractual commitments as of December 31, 2016.

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.

Letters of Credit

An uncommitted facility gives the issuer of the facility the right to accept or decline each request made under the facility. AEP issues letters of credit on behalf of subsidiaries under four uncommitted facilities totaling $300 million. As of December 31, 2016, AEP Texas's maximum future payment for letters of credit issued under the uncommitted credit facilities was $3 million with a maturity of January 2018.

Indemnifications and Other Guarantees

Contracts

AEP Texas 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. As of December 31, 2016, there were no material liabilities recorded for any indemnifications.

Lease Obligations

AEP Texas leases certain equipment under master lease agreements. See "Master Lease Agreements" section of Note 12 for disclosure of lease residual value guarantees.

CONTINGENCIES

Insurance and Potential Losses

AEP Texas maintains insurance coverage normal and customary for an electric utility, subject to various deductibles. AEP Texas also maintains property and casualty insurance that may cover certain physical damage or third-party injuries caused by cyber security incidents. Insurance coverage includes all risks of physical loss or damage to assets, subject to insurance policy conditions and exclusions. Covered property generally includes power plants, 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 AEP Texas' 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, including, but not limited to, liabilities relating to a cyber security incident. 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.

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

By-products from the generation of electricity include materials such as ash, slag and sludge. Coal combustion by-products, which constitute the overwhelming percentage of these materials, are typically treated and deposited in captive disposal facilities or are beneficially utilized. In addition, the generation plants and transmission and distribution facilities have used asbestos, polychlorinated biphenyls and other hazardous and nonhazardous materials. AEP Texas currently incurs costs to dispose of these substances safely.

Superfund addresses clean-up of hazardous substances that are released to the environment. The Federal EPA administers the clean-up programs. Several states enacted similar laws. Superfund does not recognize compliance as a defense, but imposes strict liability on parties who fall within its broad statutory categories. Present estimates do not anticipate material cleanup costs.

7. IMPAIRMENT AND DISPOSITION

IMPAIRMENT

2016

Wind Farms

In September 2016, due to AEP's ongoing evaluation of strategic alternatives for its merchant generation assets and declining forecasts of future energy and capacity prices, AEP performed an impairment analysis at the unit level on its merchant generation assets in accordance with accounting guidance for impairments of long-lived assets. The Wind Farms were included in this analysis. For the Wind Farms, AEP performed step one of the impairment analysis using undiscounted cash flows for the estimated useful lives of the assets based upon energy and capacity price curves, as applicable, which were developed internally with both observable Level 2 third party quotations and unobservable Level 3 inputs, as well as management's forecasts of operating expenses and capital expenditures. The step one analysis concluded the book value of the Wind Farms would not be recovered.

AEP performed step two of the impairment analysis on the Wind Farms using a ten-year discounted cash flow model utilizing forecasted energy price curves, which were developed internally using both observable Level 2 third party quotations and unobservable Level 3 inputs, as well as management's forecasts of operating expenses and capital expenditures. The results concluded the Wind Farms were impaired.

Based on the impairment analysis performed, in the third quarter of 2016, AEP Texas recorded a pretax impairment of $73 million, which was subsequently classified into Income (Loss) from Discontinued Operations, Net of Tax on AEP Texas' statement of income for the year ended December 31, 2016. See "DISPOSITION" section of this note. See the table below for additional information.

Impaired Assets	Book Value	Fair Value	Impairment
		(in millions)	
Trent and Desert Sky Wind Farms	$ 118.7	$ 46.0	$ 72.7

DISPOSITION

2016

Wind Farms

In December 2016, TCC and TNC merged into AEP Utilities, Inc. Upon merger, AEP Utilities, Inc. changed its name to AEP Texas. Subsequent to the merger, AEP Texas exited the merchant generation business by transferring all of the common stock of the Wind Farms to a competitive AEP affiliate. No gain or loss was recognized and no cash was exchanged related to the disposition of the Wind Farms.

In the fourth quarter of 2016, the Wind Farms were determined to be discontinued operations. The assets and liabilities were classified as Assets from Discontinued Operations and Liabilities from Discontinued Operations, respectively, on AEP Texas' balance sheet as of December 31, 2015 and as shown in the following table:

	December 31, 2015
	(in millions)
Assets:	
Advances to Affiliates	$ 59.1
Property, Plant and Equipment, Net	128.2
Other Classes of Assets That Are Not Major	24.7
Total Assets from Discontinued Operations on the Balance Sheet	$ 212.0
Liabilities:	
Advances from Affiliates	$ 64.5
Long-term Debt	10.3
Other Classes of Liabilities That Are Not Major	16.6
Total Liabilities from Discontinued Operations on the Balance Sheet	$ 91.4

Results of operations of the Wind Farms have been classified as discontinued operations on AEP Texas' statements of income for the years ended December 31, 2016, 2015 and 2014 as shown in the following table:

	Years Ended December 31,		
	2016	2015	2014
	(in millions)		
Revenue	$ 18.2	$ 22.4	$ 25.5
Other Operation Expense	6.5	6.5	5.5
Maintenance Expense	3.4	4.9	4.5
Asset Impairment and Other Related Charges	72.7	—	—
Depreciation and Amortization Expense	9.8	11.5	11.1
Taxes Other Than Income Taxes	1.3	1.3	1.4
Total Expenses	93.7	24.2	22.5
Other Income (Expense)	(0.8)	(1.3)	(1.5)
Pretax Income of Discontinued Operations	(76.3)	(3.1)	1.5
Income Tax Expense	(27.5)	(1.7)	0.7
Total Income on Discontinued Operations as Presented on the Statements of Income	$ (48.8)	$ (1.4)	$ 0.8

8. BENEFIT PLANS

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

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

AEP Texas 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. AEP Texas 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. AEP Texas 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 an AOCI equity reduction or regulatory asset and deferred gains result in an AOCI equity addition or regulatory liability.

Actuarial Assumptions for Benefit Obligations

The weighted-average assumptions used in the measurement of benefit obligations are shown in the following table:

	Pension Plans		Other Postretirement Benefit Plans	
	December 31,			
Assumptions	2016	2015	2016	2015
Discount Rate	4.05%	4.30%	4.10%	4.30%
Rate of Compensation Increase	4.85% (a)	4.70% (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 2016, the rate of compensation increase assumed varies with the age of the employee, ranging from 3.5% per year to 12% per year, with an average increase of 4.85%.

Actuarial Assumptions for Net Periodic Benefit Costs

The weighted-average assumptions used in the measurement of benefit costs are shown in the following table:

	Pension Plans			Other Postretirement Benefit Plans		
			January 1,			
Assumptions	**2016**	**2015**	**2014**	**2016**	**2015**	**2014**
Discount Rate	4.30%	4.00%	4.70%	4.30%	4.00%	4.70%
Expected Return on Plan Assets	6.00%	6.00%	6.00%	7.00%	6.75%	6.75%
Rate of Compensation Increase	4.85% (a)	4.50% (a)	4.65% (a)	NA	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.

The expected return on plan assets 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 used for OPEB plans measurement purposes are shown below:

	January 1,	
Health Care Trend Rates	**2016**	**2015**
Initial	7.00%	6.25%
Ultimate	5.00%	5.00%
Year Ultimate Reached	2024	2020

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:

	1% Increase	1% Decrease
	(in millions)	
Effect on Total Service and Interest Cost Components of Net Periodic Postretirement Health Care Benefit Cost	$ 0.2	$ (0.1)
Effect on the Health Care Component of the Accumulated Postretirement Benefit Obligation	4.0	(3.5)

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, 2016, 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

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

Upon completion of the merger, CSW Energy, Inc. was transferred to an affiliate. The transfer occurred on December 31, 2016. CSW Energy, Inc.'s benefit obligation and portion of plan assets were transferred to the affiliate and the impact of the transfer can be seen in the table below.

	Pension Plans		Other Postretirement Benefit Plans	
	2016	2015	2016	2015
Change in Benefit Obligation	(in millions)			
Benefit Obligation as of January 1,	$ 420.3	$ 455.1	$ 122.0	$ 122.0
Transfer of CSW Energy, Inc. Benefit Obligation	(2.8)	—	(0.4)	—
Service Cost	7.5	7.6	0.7	0.8
Interest Cost	17.8	17.2	5.1	4.8
Actuarial (Gain) Loss	11.1	(27.8)	0.8	2.6
Benefit Payments	(32.2)	(31.8)	(11.4)	(11.4)
Participant Contributions	—	—	3.5	3.1
Medicare Subsidy	—	—	0.1	0.1
Benefit Obligation as of December 31,	$ 421.7	$ 420.3	$ 120.4	$ 122.0
Change in Fair Value of Plan Assets				
Fair Value of Plan Assets as of January 1,	$ 415.4	$ 438.9	$ 138.6	$ 152.8
Transfer of CSW Energy, Inc. Plan Assets	(2.5)	—	(0.4)	—
Actual Gain (Loss) on Plan Assets	27.4	(0.6)	3.8	(5.9)
Company Contributions	8.5	8.9	—	—
Participant Contributions	—	—	3.5	3.1
Benefit Payments	(32.2)	(31.8)	(11.4)	(11.4)
Fair Value of Plan Assets as of December 31,	$ 416.6	$ 415.4	$ 134.1	$ 138.6
Funded (Underfunded) Status as of December 31,	$ (5.1)	$ (4.9)	$ 13.7	$ 16.6

Amounts Recognized on the Balance Sheets

	Pension Plans		Other Postretirement Benefit Plans	
	December 31,			
	2016	2015	2016	2015
	(in millions)			
Deferred Charges and Other Noncurrent Assets – Prepaid Benefit Costs	$ —	$ —	$ 13.7	$ 16.6
Other Current Liabilities – Accrued Short-term Benefit Liability	(0.4)	(0.4)	—	—
Deferred Credits and Other Noncurrent Liabilities – Accrued Long-term Benefit Liability	(4.7)	(4.5)	—	—
Funded (Underfunded) Status	$ (5.1)	$ (4.9)	$ 13.7	$ 16.6

Amounts Included in AOCI and Regulatory Assets

	Pension Plans		Other Postretirement Benefit Plans	
	December 31,			
	2016	2015	2016	2015
Components	(in millions)			
Net Actuarial Loss	$ 193.3	$ 193.3	$ 50.7	$ 47.1
Prior Service Cost (Credit)	—	0.4	(41.2)	(47.2)
Recorded as				
Regulatory Assets	$ 178.5	$ 176.6	$ 9.7	$ 0.5
Deferred Income Taxes	5.2	6.0	(0.1)	(0.2)
Net of Tax AOCI	9.6	11.1	(0.1)	(0.4)

Components of the change in amounts included in AOCI and Regulatory Assets are as follows:

	Pension Plans		Other Postretirement Benefit Plans	
	2016	2015	2016	2015
Components	(in millions)			
Actuarial (Gain) Loss During the Year	$ 7.1	$ (3.1)	$ 6.4	$ 17.9
Amortization of Actuarial Loss	(7.1)	(9.0)	(2.8)	(1.5)
Amortization of Prior Service Credit (Cost)	(0.4)	(0.3)	6.0	5.9
Change for the Year Ended December 31,	$ (0.4)	$ (12.4)	$ 9.6	$ 22.3

Pension and Other Postretirement Benefits Plans' Assets

The fair value tables within Pension and Other Postretirement Benefits Plans' Assets present the classification of assets for AEP within the fair value hierarchy. All Level 1, 2, 3 and Other amounts can be allocated to AEP Texas using the percentages in the table below:

Pension Plan		Other Postretirement Benefit Plans	
December 31,			
2016	2015	2016	2015
8.6%	8.7%	8.7%	8.8%

The following table presents the classification of pension plan assets for AEP within the fair value hierarchy as of December 31, 2016:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	$ 354.7	$ —	$ —	$ —	$ 354.7	7.3 %
International	439.2	—	—	—	439.2	9.1 %
Options	—	20.0	—	—	20.0	0.4 %
Real Estate Investment Trusts	3.1	—	—	—	3.1	0.1 %
Common Collective Trusts (c)	—	14.0	—	400.5	414.5	8.6 %
Subtotal – Equities	797.0	34.0	—	400.5	1,231.5	25.5 %
Fixed Income:						
Common Collective Trust – Debt (c)	—	—	—	32.3	32.3	0.7 %
United States Government and Agency Securities (c)	—	423.3	—	17.7	441.0	9.1 %
Corporate Debt (c)	—	1,932.2	—	10.0	1,942.2	40.2 %
Foreign Debt (c)	—	373.7	—	12.1	385.8	8.0 %
State and Local Government	—	11.5	—	—	11.5	0.2 %
Other – Asset Backed (c)	—	5.4	—	7.4	12.8	0.3 %
Subtotal – Fixed Income	—	2,746.1	—	79.5	2,825.6	58.5 %
Infrastructure	—	—	57.6	—	57.6	1.2 %
Real Estate	—	—	254.9	—	254.9	5.3 %
Alternative Investments	—	—	411.1	—	411.1	8.5 %
Securities Lending	—	161.6	—	—	161.6	3.4 %
Securities Lending Collateral (a)	—	—	—	(163.3)	(163.3)	(3.4)%
Cash and Cash Equivalents (c)	—	—	—	29.7	29.7	0.6 %
Other – Pending Transactions and Accrued Income (b)	—	—	—	18.6	18.6	0.4 %
Total	$ 797.0	$ 2,941.7	$ 723.6	$ 365.0	$ 4,827.3	100.0 %

(a) Amounts in "Other" column primarily represent an obligation to repay collateral received as part of the Securities Lending Program.
(b) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.
(c) Amounts in "Other" column represent investments for which fair value is measured using net asset value per share in accordance with ASU 2015-07, Disclosure for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), which was retrospectively applied to prior periods.

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

	Foreign Debt	Infrastructure	Real Estate	Alternative Investments	Total Level 3
			(in millions)		
Balance as of January 1, 2016	$ 0.1	$ 42.0	$ 253.7	$ 378.7	$ 674.5
Actual Return on Plan Assets					
Relating to Assets Still Held as of the Reporting Date	—	5.9	5.3	13.7	24.9
Relating to Assets Sold During the Period	—	0.9	23.2	21.1	45.2
Purchases and Sales	(0.1)	8.8	(27.3)	(2.4)	(21.0)
Transfers into Level 3	—	—	—	—	—
Transfers out of Level 3	—	—	—	—	—
Balance as of December 31, 2016	$ —	$ 57.6	$ 254.9	$ 411.1	$ 723.6

The following table presents the classification of OPEB plan assets for AEP within the fair value hierarchy as of December 31, 2016:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	$ 517.1	$ —	$ —	$ —	$ 517.1	33.5 %
International	435.5	—	—	—	435.5	28.2 %
Options	—	15.2	—	—	15.2	1.0 %
Common Collective Trusts (b)	—	10.9	—	20.5	31.4	2.0 %
Subtotal – Equities	952.6	26.1	—	20.5	999.2	64.7 %
Fixed Income:						
Common Collective Trust – Debt (b)	—	—	—	93.7	93.7	6.0 %
United States Government and Agency Securities	—	64.7	—	—	64.7	4.2 %
Corporate Debt	—	121.6	—	—	121.6	7.9 %
Foreign Debt	—	18.6	—	—	18.6	1.2 %
State and Local Government	—	3.0	—	—	3.0	0.2 %
Other – Asset Backed	—	5.9	—	—	5.9	0.4 %
Subtotal – Fixed Income	—	213.8	—	93.7	307.5	19.9 %
Trust Owned Life Insurance:						
International Equities (b)	—	—	—	110.1	110.1	7.1 %
United States Bonds (b)	—	—	—	97.4	97.4	6.3 %
Subtotal – Trust Owned Life Insurance	—	—	—	207.5	207.5	13.4 %
Cash and Cash Equivalents	24.0	10.5	—	—	34.5	2.2 %
Other – Pending Transactions and Accrued Income (a)	—	—	—	(2.8)	(2.8)	(0.2)%
Total	$ 976.6	$ 250.4	$ —	$ 318.9	$ 1,545.9	100.0 %

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

(b) Amounts in “Other” column represent investments for which fair value is measured using net asset value per share in accordance with ASU 2015-07, Disclosure for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), which was retrospectively applied to prior periods.

The following table presents the classification of pension plan assets for AEP within the fair value hierarchy as of December 31, 2015:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	$ 315.7	$ —	$ —	$ —	$ 315.7	6.6 %
International	402.3	—	—	—	402.3	8.4 %
Options	—	15.6	—	—	15.6	0.3 %
Real Estate Investment Trusts	4.0	—	—	—	4.0	0.1 %
Common Collective Trusts (c)	—	16.1	—	369.7	385.8	8.1 %
Subtotal – Equities	722.0	31.7	—	369.7	1,123.4	23.5 %
Fixed Income:						
Common Collective Trust – Debt (c)	—	—	—	34.2	34.2	0.7 %
United States Government and Agency Securities (c)	—	397.8	—	24.1	421.9	8.9 %
Corporate Debt (c)	—	1,964.2	—	19.0	1,983.2	41.6 %
Foreign Debt (c)	—	405.4	0.1	16.0	421.5	8.8 %
State and Local Government	—	12.8	—	—	12.8	0.3 %
Other – Asset Backed (c)	—	15.8	—	7.6	23.4	0.5 %
Subtotal – Fixed Income	—	2,796.0	0.1	100.9	2,897.0	60.8 %
Infrastructure	—	—	42.0	—	42.0	0.9 %
Real Estate	—	—	253.7	—	253.7	5.3 %
Alternative Investments	—	—	378.7	—	378.7	8.0 %
Securities Lending	—	263.0	—	—	263.0	5.5 %
Securities Lending Collateral (a)	—	—	—	(264.7)	(264.7)	(5.5)%
Cash and Cash Equivalents (c)	—	1.2	—	47.4	48.6	1.0 %
Other – Pending Transactions and Accrued Income (b)	—	—	—	25.9	25.9	0.5 %
Total	$ 722.0	$ 3,091.9	$ 674.5	$ 279.2	$ 4,767.6	100.0 %

(a) Amounts in "Other" column primarily represent an obligation to repay collateral received as part of the Securities Lending Program.
(b) Amounts in "Other" column primarily represent accrued interest, dividend receivables and transactions pending settlement.
(c) Amounts in "Other" column represent investments for which fair value is measured using net asset value per share in accordance with ASU 2015-07, Disclosure for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), which was retrospectively applied to prior periods.

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

	Foreign Debt	Infrastructure	Real Estate	Alternative Investments	Total Level 3
			(in millions)		
Balance as of January 1, 2015	$ 0.1	$ 12.5	$ 235.8	$ 378.9	$ 627.3
Actual Return on Plan Assets					
Relating to Assets Still Held as of the Reporting Date	—	(3.6)	12.5	(25.9)	(17.0)
Relating to Assets Sold During the Period	—	0.3	23.8	37.6	61.7
Purchases and Sales	—	32.8	(18.4)	(11.9)	2.5
Transfers into Level 3	—	—	—	—	—
Transfers out of Level 3	—	—	—	—	—
Balance as of December 31, 2015	$ 0.1	$ 42.0	$ 253.7	$ 378.7	$ 674.5

The following table presents the classification of OPEB plan assets for AEP within the fair value hierarchy as of December 31, 2015:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	$ 465.1	$ —	$ —	$ —	$ 465.1	29.5%
International	484.3	—	—	—	484.3	30.7%
Options	—	15.6	—	—	15.6	1.0%
Common Collective Trusts (b)	—	12.6	—	19.0	31.6	2.0%
Subtotal – Equities	949.4	28.2	—	19.0	996.6	63.2%
Fixed Income:						
Common Collective Trust – Debt (b)	—	—	—	100.9	100.9	6.4%
United States Government and Agency Securities	—	58.4	—	—	58.4	3.7%
Corporate Debt	—	117.7	—	—	117.7	7.4%
Foreign Debt	—	20.7	—	—	20.7	1.3%
State and Local Government	—	4.2	—	—	4.2	0.3%
Other – Asset Backed	—	8.4	—	—	8.4	0.5%
Subtotal – Fixed Income	—	209.4	—	100.9	310.3	19.6%
Trust Owned Life Insurance:						
International Equities (b)	—	—	—	28.3	28.3	1.8%
United States Bonds (b)	—	—	—	184.3	184.3	11.7%
Subtotal – Trust Owned Life Insurance	—	—	—	212.6	212.6	13.5%
Cash and Cash Equivalents	44.9	7.2	—	—	52.1	3.3%
Other – Pending Transactions and Accrued Income (a)	—	—	—	5.8	5.8	0.4%
Total	$ 994.3	$ 244.8	$ —	$ 338.3	$ 1,577.4	100.0%

(a) Amounts in “Other” column primarily represent accrued interest, dividend receivables and transactions pending settlement.
(b) Amounts in “Other” column represent investments for which fair value is measured using net asset value per share in accordance with ASU 2015-07, Disclosure for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), which was retrospectively applied to prior periods.

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.

The accumulated benefit obligation for the pension plans is as follows:

	December 31, 2016	December 31, 2015
	(in millions)	
Qualified Pension Plan	$ 404.7	$ 404.5
Nonqualified Pension Plan	3.8	4.0
Total Accumulated Benefit Obligation	$ 408.5	$ 408.5

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 were as follows:

	Underfunded Pension Plans December 31, 2016	Underfunded Pension Plans December 31, 2015
	(in millions)	
Projected Benefit Obligation	$ 3.8	$ 4.0
Accumulated Benefit Obligation	$ 3.8	$ 4.0
Fair Value of Plan Assets	—	—
Underfunded Accumulated Benefit Obligation	$ (3.8)	$ (4.0)

Estimated Future Benefit Payments and Contributions

AEP Texas expects contributions and payments for the pension plans of $9 million during 2017. 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 AEP Texas' assets. The payments include the participants' contributions to the plan for their share of the cost. 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	Estimated Payments: Other Postretirement Benefit Plans
	(in millions)	
2017	$ 32.1	$ 12.1
2018	31.4	12.1
2019	31.7	12.1
2020	33.9	12.3
2021	34.8	12.4
Years 2022 to 2026, in Total	166.6	63.2

Components of Net Periodic Benefit Cost

The following table provides the components of net periodic benefit cost (credit):

	Pension Plans			Other Postretirement Benefit Plans		
	Years Ended December 31,					
	2016	2015	2014	2016	2015	2014
	(in millions)					
Service Cost	$ 7.5	$ 7.6	$ 6.5	$ 0.7	$ 0.8	$ 1.0
Interest Cost	17.8	17.2	19.6	5.1	4.8	5.6
Expected Return on Plan Assets	(24.5)	(24.1)	(23.6)	(9.3)	(9.9)	(10.0)
Amortization of Prior Service Cost (Credit)	0.4	0.3	0.4	(6.0)	(5.9)	(5.9)
Amortization of Net Actuarial Loss	7.1	9.0	11.1	2.8	1.5	1.8
Net Periodic Benefit Cost (Credit)	8.3	10.0	14.0	(6.7)	(8.7)	(7.5)
Capitalized Portion	(3.6)	(4.7)	(6.0)	3.4	4.1	3.2
Net Periodic Benefit Cost (Credit) Recognized in Expense	$ 4.7	$ 5.3	$ 8.0	$ (3.3)	$ (4.6)	$ (4.3)

Estimated amounts expected to be amortized to net periodic benefit costs (credits) and the impact on the balance sheet during 2017 are shown in the following table:

	Pension Plans	Other Postretirement Benefit Plans
Components	(in millions)	
Net Actuarial Loss	$ 7.0	$ 3.0
Prior Service Credit	—	(5.9)
Total Estimated 2017 Amortization	$ 7.0	$ (2.9)
Expected to be Recorded as		
Regulatory Asset	$ 6.7	$ (3.0)
Deferred Income Taxes	0.1	—
Net of Tax AOCI	0.2	0.1
Total	$ 7.0	$ (2.9)

American Electric Power System Retirement Savings Plan

AEP Texas 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 $5 million in 2016, $5 million in 2015 and $5 million in 2014.

9. DERIVATIVES AND HEDGING

AEPSC is agent for and transacts on behalf of AEP Texas.

Risk Management Strategies

AEP Texas' vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEP Texas utilizes financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. AEP Texas does not hedge all fuel price risk. The gross notional volumes of AEP Texas' outstanding derivative contracts for heating oil and gasoline were 2 million gallons as of December 31, 2016 and 2015.

Cash Flow Hedging Strategies

AEP Texas utilizes a variety of interest rate derivative transactions in order to manage interest rate risk exposure. AEP Texas also utilizes interest rate derivative contracts to manage interest rate exposure related to future borrowings of fixed-rate debt. AEP Texas does not hedge all interest rate exposure.

ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND THE IMPACT ON THE FINANCIAL STATEMENTS

According to the accounting guidance for "Derivatives and Hedging," AEP Texas 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, AEP Texas is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the December 31, 2016 and 2015 balance sheets, AEP Texas netted $185 thousand and $0, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and $0 and $412 thousand, respectively, 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 AEP Texas' derivative activity on the balance sheets:

Fair Value of Derivative Instruments
December 31, 2016

Balance Sheet Location	Risk Management Contracts Commodity (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
		(in millions)	
Current Risk Management Assets	$ 0.4	$ (0.2)	$ 0.2
Long-term Risk Management Assets	—	—	—
Total Assets	0.4	(0.2)	0.2
Current Risk Management Liabilities	—	—	—
Long-term Risk Management Liabilities	—	—	—
Total Liabilities	—	—	—
Total MTM Derivative Contract Net Assets (Liabilities)	$ 0.4	$ (0.2)	$ 0.2

Fair Value of Derivative Instruments
December 31, 2015

Balance Sheet Location	Risk Management Contracts Commodity (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
		(in millions)	
Current Risk Management Assets	$ —	$ —	$ —
Long-term Risk Management Assets	—	—	—
Total Assets	—	—	—
Current Risk Management Liabilities	0.7	(0.4)	0.3
Long-term Risk Management Liabilities	—	—	—
Total Liabilities	0.7	(0.4)	0.3
Total MTM Derivative Contract Net Assets (Liabilities)	$ (0.7)	$ 0.4	$ (0.3)

(a) Derivative instruments within this category 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.

The table below presents AEP Texas' activity of derivative risk management contracts:

Amount of Gain (Loss) Recognized on
Risk Management Contracts

Location of Gain (Loss)	Years Ended December 31, 2016	2015	2014
		(in millions)	
Electric Generation, Transmission and Distribution Revenues	$ —	$ —	$ 0.1
Other Operation Expense	(0.4)	(0.8)	—
Maintenance Expense	(0.4)	(0.7)	—
Regulatory Assets (a)	0.8	0.4	(1.2)
Regulatory Liabilities (a)	0.4	—	—
Total Gain (Loss) on Risk Management Contracts	$ 0.4	$ (1.1)	$ (1.1)

(a) Represents realized and unrealized gains and losses subject to regulatory accounting treatment recorded as either current or noncurrent on the balance sheets.

Certain qualifying derivative instruments have been designated as normal purchase or normal sale contracts, as provided in the accounting guidance for "Derivatives and Hedging." Derivative contracts that have been designated as normal purchases or normal sales under that accounting guidance are not subject to MTM accounting treatment and are recognized on the statements of income on an accrual basis.

The accounting for the changes in the fair value of a derivative instrument depends on whether it qualifies for and has been designated as part of a hedging relationship and further, on the type of hedging relationship. Depending on the exposure, management designates a hedging instrument as a fair value hedge or a cash flow hedge.

For contracts that have not been designated as part of a hedging relationship, the accounting for changes in fair value depends on whether the derivative instrument is held for trading purposes. Unrealized and realized gains and losses on derivative instruments held for trading purposes are included in revenues on a net basis on AEP Texas's statements of income. Unrealized and realized gains and losses on derivative instruments not held for trading purposes are included in revenues or expenses on AEP Texas's statements of income depending on the relevant facts and circumstances. Certain derivatives that economically hedge future commodity risk are recorded in the same expense line item on the statements of income as that of the associated risk. However, unrealized and some realized gains and losses for both trading and non-trading derivative instruments are recorded as regulatory assets (for losses) or regulatory liabilities (for gains), in accordance with the accounting guidance for "Regulated Operations."

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), AEP Texas 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. AEP Texas would record hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains) if applicable.

AEP Texas reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Interest Expense on its statements of income in those periods in which hedged interest payments occur. During 2016, 2015 and 2014, AEP Texas did not apply cash flow hedging to outstanding interest rate derivatives.

During 2016, 2015 and 2014, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies discussed above.

For details on effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on AEP Texas' balance sheets and the reasons for changes in cash flow hedges, see Note 3.

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on AEP Texas' balance sheets were:

Impact of Cash Flow Hedges on the Balance Sheet

	Interest Rate	
	December 31,	
	2016	2015
	(in millions)	
Hedging Liabilities (a)	$ —	$ 0.4
AOCI Loss Net of Tax	(5.4)	(6.5) (b)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(0.9)	(0.9) (c)

(a) Hedging Assets and Liabilities are included in Risk Management Assets and Liabilities AEP Texas's balance sheets.
(b) AOCI Loss Net of Tax includes $(0.3) million related to the Wind Farms. See Note 7 for additional information.
(c) Portion Expected to be reclassified to Net Income During the Next Twelve Months excludes $(0.2) related to the Wind Farms. See Note 7 for additional information.

The actual amounts that AEP Texas 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, 2016, AEP Texas is not hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions.

10. 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 AEP Texas' Long-term Debt are summarized in the following table:

	December 31,			
	2016		2015	
	Book Value	Fair Value	Book Value (a)	Fair Value (a)
	(in millions)			
Long-term Debt	$ 3,217.7	$ 3,463.2	$ 3,454.0	$ 3,679.8

(a) Amount includes debt related to Desert Sky Wind Farm that has been classified as Liabilities From Discontinued Operations on the balance sheet and has a fair value of $12 million. See Note 7 for additional information.

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, AEP Texas' financial assets and liabilities that were accounted for at fair value on a recurring basis. 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, 2016

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in millions)		
Restricted Cash for Securitized Transition Funding	$ 146.3	$ —	$ —	$ —	$ 146.3
Risk Management Assets					
Risk Management Commodity Contracts (a)	—	0.4	—	(0.2)	0.2
Total Assets	$ 146.3	$ 0.4	$ —	$ (0.2)	$ 146.5

Assets and Liabilities Measured at Fair Value on a Recurring Basis
December 31, 2015

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in millions)		
Restricted Cash for Securitized Transition Funding	$ 203.4	$ —	$ —	$ —	$ 203.4
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a)	$ —	$ 0.7	$ —	$ (0.4)	$ 0.3

(a) 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."

As of December 31, 2016, AEP Texas had no liabilities measured at fair value on a recurring basis.

There were no transfers between Level 1 and Level 2 during the years ended December 31, 2016, 2015 and 2014.

11. INCOME TAXES

The details of AEP Texas' income tax expense before discontinued operations as reported are as follows:

	Years Ended December 31,		
	2016	2015	2014
		(in millions)	
Federal:			
Current	$ 40.9	$ 61.4	$ 67.1
Deferred	29.9	(7.1)	2.7
Deferred Investment Tax Credits	(1.7)	(1.7)	(1.7)
Total Federal	69.1	52.6	68.1
State and Local:			
Current	(8.8)	5.6	10.4
Deferred	(0.4)	—	(0.1)
Deferred Investment Tax Credits	—	—	—
Total State and Local:	(9.2)	5.6	10.3
Income Tax Expense Before Discontinued Operations	$ 59.9	$ 58.2	$ 78.4

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 tax rate and the amount of income taxes reported:

	Years Ended December 31,		
	2016	2015	2014
		(in millions)	
Net Income	$ 146.6	$ 120.3	$ 127.9
Discontinued Operations (Net of Income Tax of $27.6, $1.8 and ($0.6) in 2016, 2015 and 2014, Respectively)	48.8	1.4	(0.8)
Income Tax Expense Before Discontinued Operations	59.9	58.2	78.4
Pretax Income	$ 255.3	$ 179.9	$ 205.5
Income Taxes on Pretax Income at Statutory Rate (35%)	$ 89.4	$ 63.0	$ 71.9
Increase (Decrease) in Income Taxes Resulting from the Following Items:			
Depreciation	0.5	0.5	0.3
Investment Tax Credits, Net	(1.7)	(1.7)	(1.7)
State and Local Income Taxes, Net	(6.0)	3.6	6.7
Parent Company Loss Benefit	(2.5)	(3.1)	(2.1)
Tax Adjustments	(4.9)	(1.6)	1.5
U.K. Windfall Tax	(12.9)	—	—
Other	(2.0)	(2.5)	1.8
Income Tax Expense Before Discontinued Operations	$ 59.9	$ 58.2	$ 78.4
Effective Income Tax Rate	23.5 %	32.4 %	38.2 %

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

		December 31,		
		2016		2015
		(in millions)		
Deferred Tax Assets	$	135.8	$	142.6
Deferred Tax Liabilities		(1,667.5)		(1,620.0)
Net Deferred Tax Liabilities	$	(1,531.7)	$	(1,477.4)
Property Related Temporary Differences	$	(1,056.1)	$	(960.8)
Amounts Due from Customers for Future Federal Income Taxes		(5.7)		(4.1)
Deferred State Income Taxes		(24.2)		(0.8)
Deferred Income Taxes on Other Comprehensive Loss		8.0		8.8
Regulatory Assets		(61.3)		(45.8)
Deferred Revenues		18.0		17.6
Securitized Transition Assets		(407.0)		(488.4)
All Other, Net		(3.4)		(3.9)
Net Deferred Tax Liabilities	$	(1,531.7)	$	(1,477.4)

AEP System Tax Allocation Agreement

AEP Texas 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 consolidated net operating loss of the AEP System is allocated to each company in the consolidated group with taxable losses. The tax benefit of the Parent is allocated to its subsidiaries with taxable income. With the exception of the allocation of the consolidated AEP System net operating loss and 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

AEP Texas and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011, 2012 and 2013 started in April 2014. AEP and subsidiaries received a Revenue Agents Report in April 2016, completing the 2011 through 2013 audit cycle indicating an agreed upon audit. The 2011 through 2013 audit was submitted to the Congressional Joint Committee on Taxation for approval. The Joint Committee referred the audit back to the IRS exam team for further consideration. 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, AEP Texas 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.

AEP Texas and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns. AEP Texas and other AEP subsidiaries are currently under examination in several state and local jurisdictions. However, it is possible that previously filed tax returns have positions that may be challenged by these tax authorities. 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. AEP Texas is no longer subject to state or local income tax examinations by tax authorities for years before 2009.

Tax Credit Carryforward

As of December 31, 2016 and 2015, AEP Texas had unused federal income tax credits of $249 thousand and $450 thousand, respectively, not all of which have an expiration date. Included in the credit carryforward are federal general business tax credits of $0 and $131 thousand as of December 31, 2016 and 2015, respectively. The federal general business tax credits were fully utilized in 2016.

AEP Texas 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

AEP Texas 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,		
	2016	2015	2014
		(in millions)	
Interest Expense	$ —	$ 0.2	$ 0.1
Interest Income	0.2	0.2	1.2
Reversal of Prior Period Interest Expense	0.8	—	0.2

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

	December 31,	
	2016	2015
	(in millions)	
Accrual for Receipt of Interest	$ 2.1	$ 1.7
Accrual for Payment of Interest and Penalties	0.3	1.0

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

	2016	2015	2014
		(in millions)	
Balance as of January 1,	$ 27.8	$ 22.6	$ 21.1
Increase – Tax Positions Taken During a Prior Period	6.5	5.2	3.0
Decrease – Tax Positions Taken During a Prior Period	(15.0)	—	(0.3)
Increase – Tax Positions Taken During the Current Year	—	—	—
Decrease – Tax Positions Taken During the Current Year	—	—	—
Decrease – Settlements with Taxing Authorities	(12.8)	—	—
Decrease – Lapse of the Applicable Statute of Limitations	—	—	(1.2)
Balance as of December 31,	$ 6.5	$ 27.8	$ 22.6

The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate is $4 million, $26 million and $22 million for 2016, 2015 and 2014, 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 Tax Increase Prevention Act of 2014 (the 2014 Act) was enacted in December 2014. Included in the 2014 Act was a one-year extension of the 50% bonus depreciation. The 2014 Act also retroactively extended the life of research and development, employment and several energy tax credits, which expired at the end of 2013. The enacted provisions did not materially impact AEP Texas' net income or financial condition but did have a favorable impact on cash flows in 2015.

The Protecting Americans from Tax Hikes Act of 2015 (PATH) included an extension of the 50% bonus depreciation for three years through 2017, phasing down to 40% in 2018 and 30% in 2019. PATH also provided for the extension of research and development, employment and several energy tax credits for 2015. PATH also includes provisions to extend the wind energy production tax credit through 2016 with a three-year phase-out (2017-2019), and to extend the 30% temporary solar investment tax credit for three years through 2019 and with a two-year phase-out (2020-2021). PATH also provided for a permanent extension of the Research and Development tax credit. The enacted provisions did not materially impact AEP Texas' net income or financial condition but will have a favorable impact on future cash flows.

Federal Tax Regulations

In 2013, the U.S. Treasury Department issued final and re-proposed regulations regarding the deduction and capitalization of expenditures related to tangible property, effective for the tax years beginning in 2014. In addition, the IRS issued Revenue Procedures under the Industry Issue Resolutions program that provides specific guidance for the implementation of the regulations for the electric utility industry. These final regulations did not materially impact AEP Texas' net income, cash flows or financial condition.

State Tax Regulations

House Bill 32 was passed by the state of Texas in June 2015, permanently reducing the Texas income/franchise tax rate from 0.95% to 0.75% effective January 1, 2016, applicable to reports originally due on or after the effective date. The Texas income/franchise tax rate had been scheduled to return to 1% in 2016. The enacted provision did not materially impact AEP Texas' net income, cash flows or financial condition.

In March 2016, the Texas Comptroller of Public Accounts issued clarifying guidance regarding the treatment of transmission and distribution expenses included in the computation of taxable income for purposes of calculating the Texas income/franchise tax. The guidance clarified which specific transmission and distribution expenses are included in the computation of the cost of goods sold deduction. This guidance resulted in a net favorable adjustment to net income of $7 million in 2016 for AEP Texas.

12. LEASES

Leases of property, plant and equipment are for remaining 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. For capital leases, a capital lease asset and offsetting liability are recorded at the present value of the remaining lease payments for each reporting period. The components of rental costs are as follows:

	Years Ended December 31,		
Lease Rental Costs	**2016**	**2015**	**2014**
		(in millions)	
Net Lease Expense on Operating Leases (a)	$ 9.8	$ 8.1	$ 6.6
Amortization of Capital Leases	3.4	2.9	2.9
Interest on Capital Leases	0.6	0.4	0.4
Total Lease Rental Costs	$ 13.8	$ 11.4	$ 9.9

(a) Amounts include lease expenses related to Wind Farms that have been classified as Other Operation Expense from Discontinued Operations on the statements of income in the amount of $1 million for each of the years Ended December 31, 2016, 2015 and 2014, respectively. See Note 7 for additional information.

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

	December 31,	
	2016	**2015**
	(in millions)	
Property, Plant and Equipment Under Capital Leases		
Total Property, Plant and Equipment Under Capital Leases – Other	$ 26.1	$ 21.0
Accumulated Amortization	7.7	6.2
Net Property, Plant and Equipment Under Capital Leases	$ 18.4	$ 14.8
Obligations Under Capital Leases		
Noncurrent Liability	$ 14.8	$ 11.7
Liability Due Within One Year	3.6	3.1
Total Obligations Under Capital Leases	$ 18.4	$ 14.8

Future minimum lease payments consisted of the following as of December 31, 2016:

Future Minimum Lease Payments	**Capital Leases**	**Noncancelable Operating Leases**
	(in millions)	
2017	$ 4.2	$ 9.6
2018	3.7	8.8
2019	2.6	8.0
2020	2.3	7.3
2021	2.0	6.4
Later Years	6.3	17.9
Total Future Minimum Lease Payments	21.1	$ 58.0
Less Estimated Interest Element	2.7	
Estimated Present Value of Future Minimum Lease Payments	$ 18.4	

Master Lease Agreements

AEP Texas 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, AEP Texas 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, 2016, the maximum potential loss for these lease agreements was $9 million assuming the fair value of the equipment is zero at the end of the lease term.

13. FINANCING ACTIVITIES

Long-term Debt

The following details long-term debt outstanding:

Type of Debt	Maturity	Weighted Average Interest Rate as of December 31, 2016	Interest Rate Ranges as of December 31, 2016	2015	Outstanding as of December 31, 2016	2015
					(in millions)	
Senior Unsecured Notes	2018-2044	4.75%	2.61%-6.76%	2.61%-6.76%	$ 1,241.3	$ 1,240.6
Pollution Control Bonds (a)	2017-2030	4.87%	4.00%-6.30%	4.00%-6.30%	530.3	530.2
Notes Payable - Nonaffiliated (b) (d)	2017			6.60%	—	10.3
Securitization Bonds	2016-2024 (c)	4.07%	0.88%-5.31%	0.88%-6.25%	1,245.8	1,497.2
Other Long-term Debt	2016-2059	2.45%	2.438%-4.5%	1.823%-4.50%	200.3	175.7
Total Long-term Debt Outstanding					$ 3,217.7	$ 3,454.0

(a) Insurance policies support certain series.

(b) Notes Payable represents an outstanding financing agreement issued with a number of banks and other financial institutions. As of December 31, 2015 the maturity date for this Note Payable was 2017. During 2016, this Note Payable was retired.

(c) Dates represent the scheduled final payment dates for AEP Texas' securitization bonds. The legal 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.

(d) Amount includes debt related to Desert Sky Wind Farm that has been classified as Liabilities From Discontinued Operations on the balance sheet. See Note 7 for additional information.

Long-term debt outstanding as of December 31, 2016 is payable as follows:

	2017	2018	2019	2020	2021	After 2021	Total
				(in millions)			
Principal Amount	$ 263.1	$ 266.1	$ 501.1	$ 317.7	$ 66.2	$ 1,823.5	$ 3,237.7
Unamortized Discount, Net and Debt Issuance Costs							(20.0)
Total Long-term Debt Outstanding							$ 3,217.7

In January 2017, AEP Texas retired $90 million of Securitization Bonds.

In February 2017, AEP Texas received an equity contribution of $200 million from Parent.

Dividend Restrictions

Parent depends on AEP Texas and other AEP subsidiaries to pay dividends to shareholders. AEP Texas pays dividends to Parent provided funds are legally available. Various financing arrangements and regulatory requirements may impose certain restrictions on the ability of AEP Texas to transfer funds to Parent in the form of dividends.

All of the dividends declared by AEP Texas are subject to a Federal Power Act restriction that prohibits the payment of dividends out of capital accounts without regulatory approval; payment of dividends is allowed out of retained earnings only.

AEP Texas also has credit agreements that contain covenants that limit their debt to capitalization ratio to 67.5%. The payment of cash dividends indirectly results in an increase in the percentage of debt to total capitalization of AEP Texas. The method for calculating outstanding debt and capitalization is contractually defined in the credit agreements.

As of December 31, 2016, the maximum amount of restricted net assets of AEP Texas that may not be distributed to the Parent in the form of a loan, advance or dividend was $1 billion.

As of December 31, 2016, the Federal Power Act restriction does not limit the ability of AEP Texas to pay dividends out of retained earnings. However, the credit agreement covenant restrictions can limit the ability of AEP Texas to pay dividends out of retained earnings. As of December 31, 2016, the amount of any such restrictions was $508 million.

Corporate Borrowing Program – AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of AEP's subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP's utility subsidiaries, a Nonutility Money Pool, which funds a majority of AEP's nonutility subsidiaries, and direct borrowing from AEP. The AEP System Utility Money Pool operates in accordance with the terms and conditions of the AEP System Utility Money Pool agreement filed with the FERC. The amounts of outstanding loans to (borrowings from) the Utility Money Pool are included in Advances to Affiliates and Advances from Affiliates, respectively, on AEP Texas' balance sheets. AEP Texas' Utility Money Pool activity and corresponding authorized borrowing limits are described in the following table:

Year	Maximum Borrowings from the Utility Money Pool	Maximum Loans to the Utility Money Pool	Average Borrowings from the Utility Money Pool	Average Loans to the Utility Money Pool	Net Loans to (Borrowings from) the Utility Money Pool as of December 31,	Authorized Short-Term Borrowing Limit
			(in millions)			
2016	$ 176.9	$ 138.9	$ 87.5	$ 79.8	$ (174.5)	$ 400.0
2015	269.8	159.6	184.5	121.1	138.9	500.0

The activity in the above table does not include short-term lending activity of AEP Texas' wholly-owned subsidiary, AEP Texas North Generation Company LLC (TNGC), which is a participant in the Nonutility Money Pool. The amount of outstanding loans to (borrowings from) the Nonutility Money Pool are included in Advances to Affiliates and Advances from Affiliates, respectively, on AEP Texas' balance sheets. TNGC had the following activity in the Nonutility Money Pool:

Year	Maximum Borrowings from the Nonutility Money Pool	Maximum Loans to the Nonutility Money Pool	Average Borrowings from the Nonutility Money Pool	Average Loans to the Nonutility Money Pool	Net Loans to (Borrowings from) the Nonutility Money Pool as of December 31,
			(in millions)		
2016 (a)	$ 12.5	$ 27.0	$ 12.0	$ 12.3	$ 8.6
2015 (b)	31.3	—	16.0	—	(10.6)

(a) Amounts include short-term loans and (borrowings) related to Wind Farms that have been classified as Assets and Liabilities From Discontinued Operation, which were transferred to a competitive AEP Affiliate in December 2016. See Note 7 for additional information.

(b) Amounts include short-term loans and (borrowings) related to Wind Farms that have been classified as Assets and Liabilities From Discontinued Operations, respectively, on AEP Texas' balance sheet. See Note 7 for additional information.

The amounts of outstanding loans to (borrowings from) AEP are included in Advances to Affiliates and Advances from Affiliates, respectively, on AEP Texas' balance sheets. AEP Texas' direct borrowing activity with AEP is described in the following table:

Year	Maximum Borrowings from AEP	Maximum Loans to AEP	Average Borrowings from AEP	Average Loans to AEP	Net Loans to (Borrowings from) AEP as of December 31,
			(in millions)		
2016 (a)	$ 55.0	$ 5.0	$ 42.5	$ 5.0	$ 5.0
2015 (b)	44.5	—	36.5	—	(38.6)

(a) Amounts include short-term loans and (borrowings) related to Wind Farms that have been classified as Assets and Liabilities From Discontinued Operation, which were transferred to a competitive AEP Affiliate in December 2016. See Note 7 for additional information.

(b) Amounts include short-term loans and (borrowings) related to Wind Farms that have been classified as Assets and Liabilities From Discontinued Operations, respectively, on AEP Texas' balance sheet. See Note 7 for additional information.

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool are summarized in the following table:

Years Ended December 31,	Maximum Interest Rate for Funds Borrowed from the Utility Money Pool	Minimum Interest Rate for Funds Borrowed from the Utility Money Pool	Maximum Interest Rate for Funds Loaned to the Utility Money Pool	Minimum Interest Rate for Funds Loaned to the Utility Money Pool	Average Interest Rate for Funds Borrowed from the Utility Money Pool	Average Interest Rate for Funds Loaned to the Utility Money Pool
2016	1.02%	0.75%	0.83%	0.69%	0.88%	0.72%
2015	0.59%	0.39%	0.87%	0.37%	0.46%	0.52%
2014	0.59%	0.24%	—%	—%	0.29%	—%

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Nonutility Money Pool are summarized in the following table:

Years Ended December 31,	Maximum Interest Rate for Funds Borrowed from the Nonutility Money Pool	Minimum Interest Rate for Funds Borrowed from the Nonutility Money Pool	Maximum Interest Rate for Funds Loaned to the Nonutility Money Pool	Minimum Interest Rate for Funds Loaned to the Nonutility Money Pool	Average Interest Rate for Funds Borrowed from the Nonutility Money Pool	Average Interest Rate for Funds Loaned to the Nonutility Money Pool
2016	1.11%	0.97%	1.02%	0.75%	1.00%	0.86%
2015	1.14%	0.64%	—%	—%	0.76%	—%
2014	0.85%	0.53%	0.50%	—%	0.61%	0.29%

Maximum, minimum and average interest rates for funds either borrowed from or loaned to AEP are summarized in the following table:

Years Ended December 31,	Maximum Interest Rate for Funds Borrowed from AEP	Minimum Interest Rate for Funds Borrowed from AEP	Maximum Interest Rate for Funds Loaned to AEP	Minimum Interest Rate for Funds Loaned to AEP	Average Interest Rate for Funds Borrowed from AEP	Average Interest Rate for Funds Loaned to AEP
2016	0.98%	0.69%	1.02%	0.99%	0.83%	1.00%
2015	0.87%	0.37%	—%	—%	0.48%	—%
2014	0.59%	0.24%	—%	—%	0.29%	—%

Interest expense and interest income related to the Utility Money Pool are included in Interest Expense and Interest Income, respectively, on AEP Texas' statements of income. For amounts borrowed from and advanced to the Utility Money Pool, AEP Texas incurred the following amounts of interest expense and earned the following amounts of interest income:

	Years Ended December 31,		
	2016	2015	2014
		(in millions)	
Interest Expense	$ 0.6	$ 0.7	$ 0.4
Interest Income	0.2	0.2	—

Interest expense and interest income related to the Nonutility Money Pool are included in Interest Expense and Interest Income, respectively, on AEP Texas' statements of income. For amounts borrowed from and advanced to the Nonutility Money Pool, AEP Texas incurred the following amounts of interest expense and earned the following amounts of interest income:

	Years Ended December 31,		
	2016	2015	2014
		(in millions)	
Interest Expense	$ 0.6	$ 0.7	$ 0.5
Interest Income	0.5	0.3	0.2

Interest expense and interest income related to the direct borrowing from AEP are included in Interest Expense and Interest Income, respectively, on AEP Texas' statements of income. For amounts borrowed from and advanced to AEP, AEP Texas incurred the following amounts of interest expense and earned the following amounts of interest income:

	Years Ended December 31,		
	2016	2015	2014
		(in millions)	
Interest Expense	$ 0.4	$ 0.2	$ 0.2
Interest Income	—	—	—

Credit Facilities

For a discussion of credit facilities, see "Letters of Credit" section of Note 6.

14. RELATED PARTY TRANSACTIONS

For other related party transactions, also see "AEP System Tax Allocation Agreement" section of Note 11 and "Corporate Borrowing Program – AEP System" section of Note 13.

Affiliated Revenues

The following table shows the revenues derived from direct sales to affiliates and other revenues for the years ended December 31, 2016, 2015 and 2014:

Related Party Revenues	Years Ended December 31, 2016	2015	2014
		(in millions)	
Direct Sales to AEPEP Affiliate	$ 73.9	$ 76.9	$ 91.2
Other Revenues	1.8	1.6	1.6
Total Affiliated Revenues	$ 75.7	$ 78.5	$ 92.8

The above summarized related party revenues are reported in Sales to AEP Affiliates on AEP Texas' statements of income.

ERCOT Transmission Service Charges

Pursuant to an order from the PUCT, ETT bills AEP Texas for its ERCOT wholesale transmission services. ETT billed AEP Texas $29 million, $27 million and $25 million for transmission services in 2016, 2015 and 2014, respectively. The billings are recorded in Other Operation expenses on AEP Texas' statements of income.

Oklaunion PPA between AEP Texas and AEPEP

On January 1, 2007, AEP Texas began a PPA with an affiliate, AEPEP, whereby AEP Texas agrees to sell AEPEP 100% of AEP Texas' capacity and associated energy from its undivided interest (54.69%) in the Oklaunion Plant. This PPA is effective through December 2027. AEPEP is to pay AEP Texas for the capacity and associated energy delivered to the delivery point, the sum of fuel, operation and maintenance, depreciation, capacity and all taxes other than federal income taxes applicable. A portion of the payment is fixed and is payable regardless of the level of output. There are no penalties if AEP Texas fails to maintain a minimum availability level or exceeds a maximum heat rate level. The PPA was approved by the FERC. AEP Texas recognizes revenues for the fuel, operations and maintenance and all other taxes as-billed. Revenue is recognized for the capacity and depreciation billed to AEPEP, on a straight-line basis over the term of the PPA as these represent the minimum payments due.

AEP Texas recorded revenue of $74 million, $77 million and $91 million from AEPEP for the years ended December 31, 2016, 2015 and 2014, respectively. These amounts are included in Sales to AEP Affiliates on AEP Texas' statements of income.

Sales and Purchases of Property

AEP Texas had affiliated sales and purchases of electric property individually amounting to $100 thousand or more and sales and purchases of meters and transformers. There were no gains or losses recorded on the transactions. The following table shows the sales and purchases, recorded at net book value, for the years ended December 31, 2016, 2015 and 2014:

	Years Ended December 31,		
	2016	**2015**	**2014**
		(in millions)	
Sales	$ 0.3	$ 0.6	$ 5.6
Purchases	0.7	0.9	1.1

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

Intercompany Billings

AEP Texas 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.

15. VARIABLE INTEREST ENTITIES

The accounting guidance for "Variable Interest Entities" is a consolidation model that considers if a company has a variable interest in a VIE. A VIE is a legal entity that possesses any of the following conditions: the entity's equity at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support, equity owners are unable to direct the activities that most significantly impact the legal entity's economic performance (or they possess disproportionate voting rights in relation to the economic interest in the legal entity), or the equity owners lack the obligation to absorb the legal entity's expected losses or the right to receive the legal entity's expected residual returns. 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 AEP Texas is the primary beneficiary of a VIE, management considers whether AEP Texas has the power to direct the most significant activities of the VIE and is obligated to absorb losses or receive the expected residual returns that are significant to the VIE. Management believes that significant assumptions and judgments were applied consistently.

Transition Funding was formed for the sole purpose of issuing and servicing securitization bonds related to Texas Restructuring Legislation. Management has concluded that AEP Texas is the primary beneficiary of Transition Funding because AEP Texas has the power to direct the most significant activities of the VIE and AEP Texas' equity interest could potentially be significant. Therefore, AEP Texas is required to consolidate Transition Funding. The securitized bonds totaled $1.2 billion and $1.5 billion as of December 31, 2016 and 2015, respectively, and are included in Long-term Debt Due Within One Year - Nonaffiliated and Long-term Debt - Nonaffiliated on the balance sheets. Transition Funding has securitized transition assets of $1.1 billion and $1.3 billion as of December 31, 2016 and 2015, 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 AEP Texas 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 AEP Texas or any other AEP entity. AEP Texas 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 Transition Funding that are consolidated. These balances include intercompany transactions that are eliminated upon consolidation.

AEP TEXAS AND SUBSIDIARIES
VARIABLE INTEREST ENTITIES
December 31, 2016 and 2015
(in millions)

	Transition Funding	
ASSETS	**2016**	**2015**
Current Assets	$ 184.8	$ 234.1
Other Noncurrent Assets (a)	1,149.4	1,365.7
Total Assets	$ 1,334.2	$ 1,599.8
LIABILITIES AND EQUITY		
Current Liabilities	$ 251.9	$ 291.7
Noncurrent Liabilities	1,064.2	1,290.0
Equity	18.1	18.1
Total Liabilities and Equity	$ 1,334.2	$ 1,599.8

(a) Includes an intercompany item eliminated in consolidation as of December 31, 2016 and 2015 of $61.1 million and $68.2 million, respectively.

AEPSC provides certain managerial and professional services to AEP's subsidiaries. Parent 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. AEP Texas' total billings from AEPSC for the years ended December 31, 2016, 2015 and 2014 were $142 million, $133 million and $122 million, respectively. The carrying amount of liabilities associated with AEPSC as of December 31, 2016 and 2015 was $23 million and $17 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

16. PROPERTY, PLANT AND EQUIPMENT

Property, Plant and Equipment is shown functionally on the face of AEP Texas' balance sheets. The following table includes AEP Texas' total plant balances as of December 31, 2016 and 2015:

	December 31, 2016	December 31, 2015
	(in millions)	
Regulated Property, Plant and Equipment		
Transmission	$ 2,623.6	$ 2,352.9
Distribution	3,527.2	3,343.6
Other	432.1	403.5
CWIP	385.0	288.1
Less: Accumulated Depreciation	1,354.4	1,301.3
Total Regulated Property, Plant and Equipment - Net	5,613.5	5,086.8
Nonregulated Property, Plant and Equipment - Net	167.2	173.0 (a)
Total Property, Plant and Equipment - Net	$ 5,780.7	$ 5,259.8 (a)

(a) Amount excludes $128 million of Property, Plant and Equipment - Net classified as Assets from Discontinued Operations on the balance sheet. See Note 7 for additional information.

Depreciation

AEP Texas 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 total annual composite depreciation rates and depreciable lives for AEP Texas.

Functional Class of Property	2016 Annual Composite Depreciation Rate	2016 Depreciable Life Ranges (in years)	2015 Annual Composite Depreciation Rate	2015 Depreciable Life Ranges (in years)	2014 Annual Composite Depreciation Rate	2014 Depreciable Life Ranges (in years)
Regulated						
Transmission	1.8%	45 - 81	1.8%	45 - 81	1.8%	45 - 81
Distribution	3.3%	7 - 70	3.3%	7 - 70	3.3%	22 - 70
Other	8.3%	5 - 50	9.7%	5 - 50	8.3%	10 - 50
Nonregulated						
Generation	2.8%	60	2.5%	60	2.6%	60

For regulated operations, the composite depreciation rate generally includes a component for non-asset retirement obligation (non-ARO) removal costs, which is credited to Accumulated Depreciation and Amortization on the balance sheets. 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. For nonregulated operations, non-ARO removal cost is expensed as incurred.

Asset Retirement Obligations (ARO)

AEP Texas records ARO in accordance with the accounting guidance for "Asset Retirement and Environmental Obligations" for the retirement of ash disposal facilities and asbestos removal. AEP Texas 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 AEP Texas plans to use its facilities indefinitely. The retirement obligation would only be recognized if and when AEP Texas abandons or ceases the use of specific easements, which is not expected.

AEP Texas recorded an increase in Asset Retirement Obligations in the second quarter of 2015, primarily related to the final Coal Combustion Residual Rule which, was published in the Federal Register in April 2015. The Federal EPA now regulates the disposal and beneficial re-use of coal combustion residuals (CCR), including fly ash and bottom ash generated at coal-fired electric generating units and also FGD gypsum generated at some coal-fired plants. The Federal EPA regulates CCR as a non-hazardous solid waste and established minimum federal solid waste management standards. Noncash increases related to the CCR Rule are recorded as Property, Plant and Equipment.

The following is a reconciliation of the 2016 and 2015 aggregate carrying amounts of ARO for AEP Texas:

Year	ARO as of January 1,	Accretion Expense	Liabilities Incurred	Liabilities Settled	Revisions in Cash Flow Estimates	ARO as of December 31,
			(in millions)			
2016	$ 24.0	$ 1.1	$ —	$ (0.1)	$ 0.5	$ 25.5
2015	3.5	0.6	19.9	—	—	24.0

AFUDC and Interest Capitalization

AEP Texas' amounts of allowance for equity and borrowed funds used during construction are summarized in the following table:

	Years Ended December 31, 2016	2015	2014
		(in millions)	
Allowance for Equity Funds Used During Construction	$ 9.2	$ 6.7	$ 4.8
Allowance for Borrowed Funds Used During Construction	5.9	4.5	3.6

Jointly-owned Electric Facilities

AEP Texas has a 54.7% ownership share of Unit No. 1 at the Oklaunion Generating Station. In addition to AEP Texas, the Oklaunion Generating Station is jointly-owned by PSO and various non-affiliated companies. Using its own financing, each participating company is obligated to pay its share of the costs in the same proportion as its ownership interest. AEP Texas' proportionate share of the operating costs associated with this facility is included in its statements of income and the investment and accumulated depreciation are reflected in its balance sheets under Property, Plant and Equipment as follows:

	Fuel Type	Percent of Ownership	Utility Plant in Service	Construction Work in Progress	Accumulated Depreciation
				(in millions)	
AEP Texas' Share as of December 31, 2016					
Oklaunion Generating Station, Unit 1 (a)	Coal	54.7%	$ 349.6	$ 0.9	$ 186.5
AEP Texas' Share as of December 31, 2015					
Oklaunion Generating Station, Unit 1 (a)	Coal	54.7%	$ 342.5	$ 5.4	$ 178.0

(a) Operated by PSO.