

AEP Texas North Company and Subsidiary

2012 Third Quarter Report

Consolidated Financial Statements



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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 or Parent	American Electric Power Company, Inc., a utility holding company.
AEP System	American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AOCI	Accumulated Other Comprehensive Income.
CAA	Clean Air Act.
CO ₂	Carbon dioxide and other greenhouse gases.
FERC	Federal Energy Regulatory Commission.
FTR	Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices.
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.
PUCT	Public Utility Commission of Texas.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
TNC	AEP Texas North Company, an AEP electric utility subsidiary.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three and Nine Months Ended September 30, 2012 and 2011
(in thousands)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	2012	2011	2012	2011
REVENUES				
Electric Transmission and Distribution	\$ 53,753	\$ 56,871	\$ 153,985	\$ 152,838
Sales to AEP Affiliates	22,920	24,533	59,871	66,892
Other Revenues	72	116	392	443
TOTAL REVENUES	76,745	81,520	214,248	220,173
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	12,256	14,104	26,198	32,883
Other Operation	19,547	21,044	61,830	61,071
Maintenance	5,798	4,652	15,650	15,081
Depreciation and Amortization	13,524	13,701	40,217	40,736
Taxes Other Than Income Taxes	5,082	4,424	14,285	13,346
TOTAL EXPENSES	56,207	57,925	158,180	163,117
OPERATING INCOME	20,538	23,595	56,068	57,056
Other Income (Expense):				
Other Income	25	692	41	841
Interest Expense	(5,624)	(5,774)	(16,419)	(16,947)
INCOME BEFORE INCOME TAX EXPENSE	14,939	18,513	39,690	40,950
Income Tax Expense	4,941	6,801	12,666	14,802
NET INCOME	9,998	11,712	27,024	26,148
Preferred Stock Dividend Requirements	-	25	-	77
EARNINGS ATTRIBUTABLE TO COMMON STOCK	\$ 9,998	\$ 11,687	\$ 27,024	\$ 26,071

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

See Condensed Notes to Condensed Consolidated Financial Statements beginning on page 8.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Three and Nine Months Ended September 30, 2012 and 2011
(in thousands)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	2012	2011	2012	2011
Net Income	\$ 9,998	\$ 11,712	\$ 27,024	\$ 26,148
<u>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES</u>				
Cash Flow Hedges, Net of Tax of \$523 and \$2,515 for the Three Months Ended September 30, 2012 and 2011, Respectively, and \$2,176 and \$2,497 for the Nine Months Ended September 30, 2012 and 2011, Respectively	(972)	(4,672)	(4,042)	(4,639)
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$63 and \$51 for the Three Months Ended September 30, 2012 and 2011, Respectively, and \$188 and \$155 for the Nine Months Ended September 30, 2012 and 2011, Respectively	<u>117</u>	<u>95</u>	<u>350</u>	<u>288</u>
TOTAL OTHER COMPREHENSIVE LOSS	<u>(855)</u>	<u>(4,577)</u>	<u>(3,692)</u>	<u>(4,351)</u>
TOTAL COMPREHENSIVE INCOME	<u>\$ 9,143</u>	<u>\$ 7,135</u>	<u>\$ 23,332</u>	<u>\$ 21,797</u>

See Condensed Notes to Condensed Consolidated Financial Statements beginning on page 8.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN
COMMON SHAREHOLDER'S EQUITY
For the Nine Months Ended September 30, 2012 and 2011
(in thousands)
(Unaudited)

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2010	\$ 137,214	\$ 3,440	\$ 183,263	\$ (14,609)	\$ 309,308
Common Stock Dividends			(11,250)		(11,250)
Preferred Stock Dividends			(77)		(77)
Subtotal – Common Shareholder's Equity					<u>297,981</u>
Net Income			26,148		26,148
Other Comprehensive Loss				(4,351)	(4,351)
TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2011	<u>\$ 137,214</u>	<u>\$ 3,440</u>	<u>\$ 198,084</u>	<u>\$ (18,960)</u>	<u>\$ 319,778</u>
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2011	\$ 137,214	\$ 3,276	\$ 208,280	\$ (21,385)	\$ 327,385
Common Stock Dividends			(15,000)		(15,000)
Subtotal – Common Shareholder's Equity					<u>312,385</u>
Net Income			27,024		27,024
Other Comprehensive Loss				(3,692)	(3,692)
TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2012	<u>\$ 137,214</u>	<u>\$ 3,276</u>	<u>\$ 220,304</u>	<u>\$ (25,077)</u>	<u>\$ 335,717</u>

See Condensed Notes to Condensed Consolidated Financial Statements beginning on page 8.

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS**

ASSETS

September 30, 2012 and December 31, 2011

(in thousands)

(Unaudited)

	2012	2011
CURRENT ASSETS		
Cash and Cash Equivalents	\$ -	\$ 203
Advances to Affiliates	10,632	11,088
Accounts Receivable:		
Customers	14,603	11,686
Affiliated Companies	14,073	8,678
Accrued Unbilled Revenues	7,305	7,953
Miscellaneous	1,089	1,635
Allowance for Uncollectible Accounts	(320)	(20)
Total Accounts Receivable	36,750	29,932
Fuel	12,445	7,432
Materials and Supplies	14,330	12,959
Prepayments and Other Current Assets	1,739	1,518
TOTAL CURRENT ASSETS	75,896	63,132
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	309,607	308,475
Transmission	502,659	488,501
Distribution	652,338	624,122
Other Property, Plant and Equipment	104,722	96,762
Construction Work in Progress	24,810	19,623
Total Property, Plant and Equipment	1,594,136	1,537,483
Accumulated Depreciation and Amortization	527,777	502,735
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,066,359	1,034,748
OTHER NONCURRENT ASSETS		
Regulatory Assets	67,164	72,583
Deferred Charges and Other Noncurrent Assets	4,983	2,003
TOTAL OTHER NONCURRENT ASSETS	72,147	74,586
TOTAL ASSETS	\$ 1,214,402	\$ 1,172,466

See Condensed Notes to Condensed Consolidated Financial Statements beginning on page 8.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
September 30, 2012 and December 31, 2011
(Unaudited)

	2012	2011
	(in thousands)	
CURRENT LIABILITIES		
Advances from Affiliates	\$ 45,363	\$ 25,889
Accounts Payable:		
General	10,019	9,258
Affiliated Companies	11,805	11,052
Long-term Debt Due Within One Year – Nonaffiliated	225,006	6
Accrued Taxes	27,332	24,828
Accrued Interest	4,940	5,914
Other Current Liabilities	29,646	9,689
TOTAL CURRENT LIABILITIES	354,111	86,636
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	145,286	370,223
Deferred Income Taxes	135,160	138,170
Regulatory Liabilities and Deferred Investment Tax Credits	170,956	167,145
Employee Benefits and Pension Obligations	26,272	30,404
Deferred Credits and Other Noncurrent Liabilities	46,900	52,503
TOTAL NONCURRENT LIABILITIES	524,574	758,445
TOTAL LIABILITIES	878,685	845,081
Rate Matters (Note 2)		
Commitments and Contingencies (Note 3)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – \$25 Per Share:		
Authorized – 7,800,000 Shares		
Outstanding – 5,488,560 Shares	137,214	137,214
Paid-in Capital	3,276	3,276
Retained Earnings	220,304	208,280
Accumulated Other Comprehensive Income (Loss)	(25,077)	(21,385)
TOTAL COMMON SHAREHOLDER'S EQUITY	335,717	327,385
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	\$ 1,214,402	\$ 1,172,466

See Condensed Notes to Condensed Consolidated Financial Statements beginning on page 8.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2012 and 2011
(in thousands)
(Unaudited)

	2012	2011
OPERATING ACTIVITIES		
Net Income	\$ 27,024	\$ 26,148
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	40,217	40,736
Deferred Income Taxes	(1,841)	7,366
Change in Other Noncurrent Assets	(6,365)	(5,457)
Change in Other Noncurrent Liabilities	606	5,558
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	(6,816)	(7,039)
Fuel, Materials and Supplies	(6,384)	3,924
Accounts Payable	2,483	(27,617)
Accrued Taxes, Net	3,434	5,674
Other Current Assets	(516)	(148)
Other Current Liabilities	2,027	671
Net Cash Flows from Operating Activities	53,869	49,816
INVESTING ACTIVITIES		
Construction Expenditures	(64,502)	(55,816)
Change in Advances to Affiliates, Net	456	9,482
Proceeds from Sales of Assets	4,128	2,983
Other Investing Activities	1,454	36
Net Cash Flows Used for Investing Activities	(58,464)	(43,315)
FINANCING ACTIVITIES		
Change in Advances from Affiliates, Net	19,474	5,389
Retirement of Long-term Debt – Nonaffiliated	(4)	(4)
Principal Payments for Capital Lease Obligations	(504)	(613)
Dividends Paid on Common Stock	(15,000)	(11,250)
Dividends Paid on Cumulative Preferred Stock	-	(77)
Other Financing Activities	426	31
Net Cash Flows from (Used for) Financing Activities	4,392	(6,524)
Net Decrease in Cash and Cash Equivalents	(203)	(23)
Cash and Cash Equivalents at Beginning of Period	203	223
Cash and Cash Equivalents at End of Period	\$ -	\$ 200
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 16,969	\$ 17,305
Net Cash Paid for Income Taxes	14,774	3,588
Noncash Acquisitions Under Capital Leases	694	165
Construction Expenditures Included in Current Liabilities as of September 30,	3,585	2,785

See Condensed Notes to Condensed Consolidated Financial Statements beginning on page 8.

INDEX OF CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Significant Accounting Matters
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3. Commitments, Guarantees and Contingencies
4. Benefit Plans
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6. Derivatives and Hedging
7. Fair Value Measurements
8. Income Taxes
9. Financing Activities
10. Sustainable Cost Reductions

1. SIGNIFICANT ACCOUNTING MATTERS

General

The unaudited condensed consolidated financial statements and footnotes were prepared in accordance with GAAP for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete annual financial statements.

In the opinion of management, the unaudited condensed consolidated interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three and nine months ended September 30, 2012 is not necessarily indicative of results that may be expected for the year ending December 31, 2012. The condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2011 financial statements and notes thereto, which are included in TNC's 2011 Annual Report.

Management reviewed subsequent events through October 26, 2012, the date that the third quarter 2012 report was issued.

Variable Interest Entities

The accounting guidance for "Variable Interest Entities" is a consolidation model that considers if a company has a controlling financial interest in a VIE. A controlling financial interest will have both (a) the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Entities are required to consolidate a VIE when it is determined that they have a controlling financial interest in a VIE and therefore, are the primary beneficiary of that VIE, as defined by the accounting guidance for "Variable Interest Entities." In determining whether TNC is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE's variability TNC absorbs, guarantees of indebtedness, voting rights including kick-out rights, the power to direct the VIE, variable interests held by related parties and other factors. Management believes that significant assumptions and judgments were applied consistently. TNC is not the primary beneficiary of any VIE and has not provided financial or other support to any VIE that was not previously contractually required.

AEPSC provides certain managerial and professional services to AEP's subsidiaries. AEP is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC's cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC's cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. TNC's total billings from AEPSC for the three months ended September 30, 2012 and 2011 were \$7 million and \$6 million, respectively, and for the nine months ended September 30, 2012 and 2011 were both \$18 million. The carrying amount of liabilities associated with AEPSC as of September 30, 2012 and December 31, 2011 were both \$3 million. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

2. RATE MATTERS

As discussed in TNC's 2011 Annual Report, TNC is involved in rate and regulatory proceedings at the FERC and the PUCT. The Rate Matters note within TNC's 2011 Annual Report should be read in conjunction with this report to gain a complete understanding of material rate matters still pending that could impact net income, cash flows and possibly financial condition. The following discusses ratemaking developments in 2012 and updates TNC's 2011 Annual Report.

Regulatory Assets Not Yet Being Recovered

<u>Noncurrent Regulatory Assets (excluding fuel)</u>	<u>September 30,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
Regulatory assets not yet being recovered pending future proceedings to determine the recovery method and timing:		
<u>Regulatory Assets Currently Not Earning a Return</u>		
Rate Case Expenses	\$ 3	\$ 3
Total Regulatory Assets Not Yet Being Recovered	<u>\$ 3</u>	<u>\$ 3</u>

If these costs are ultimately determined not to be recoverable, it would reduce future net income and cash flows and impact financial condition.

3. COMMITMENTS, GUARANTEES AND CONTINGENCIES

TNC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, TNC's business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation cannot be predicted. For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material effect on the financial statements. The Commitments, Guarantees and Contingencies note within TNC's 2011 Annual Report should be read in conjunction with this report.

GUARANTEES

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

Indemnifications and Other Guarantees

Contracts

TNC enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. The status of certain sale agreements is discussed in TNC's 2011 Annual Report "Disposition" section of Note 6. As of September 30, 2012, there were no material liabilities recorded for any indemnifications.

Master Lease Agreements

TNC 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, TNC 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 September 30, 2012, the maximum potential loss for these lease agreements was approximately \$1.1 million assuming the fair value of the equipment is zero at the end of the lease term.

CONTINGENCIES

Carbon Dioxide Public Nuisance Claims

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

Alaskan Villages' Claims

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

4. BENEFIT PLANS

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

Components of Net Periodic Benefit Cost

The following tables provide the components of TNC's net periodic benefit cost for the plans for the three and nine months ended September 30, 2012 and 2011:

	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>Three Months Ended September 30, 2012</u>	<u>2011</u>	<u>Three Months Ended September 30, 2012</u>	<u>2011</u>
	(in thousands)			
Service Cost	\$ 440	\$ 423	\$ 209	\$ 191
Interest Cost	1,165	1,287	581	614
Expected Return on Plan Assets	(1,762)	(1,761)	(598)	(641)
Amortization of Prior Service Credit	(104)	(105)	(110)	(5)
Amortization of Net Actuarial Loss	782	660	323	159
Net Periodic Benefit Cost	\$ 521	\$ 504	\$ 405	\$ 318

	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>Nine Months Ended September 30, 2012</u>	<u>2011</u>	<u>Nine Months Ended September 30, 2012</u>	<u>2011</u>
	(in thousands)			
Service Cost	\$ 1,319	\$ 1,267	\$ 625	\$ 575
Interest Cost	3,493	3,861	1,743	1,842
Expected Return on Plan Assets	(5,286)	(5,282)	(1,793)	(1,923)
Amortization of Prior Service Credit	(312)	(315)	(328)	(16)
Amortization of Net Actuarial Loss	2,347	1,981	966	477
Net Periodic Benefit Cost	\$ 1,561	\$ 1,512	\$ 1,213	\$ 955

5. BUSINESS SEGMENTS

TNC has one reportable segment, a generation, transmission and distribution business. TNC's other activities are insignificant.

6. DERIVATIVES AND HEDGING

Cash Flow Hedging Strategies

TNC's vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEPSC, on behalf of TNC, enters into financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. Not all fuel price risk exposure is hedged. The gross notional volumes of TNC's outstanding derivative contracts for heating oil and gasoline as of September 30, 2012 and December 31, 2011 were 307 thousand gallons and 382 thousand gallons, respectively.

AEPSC, on behalf of TNC, enters into a variety of interest rate derivative transactions in order to manage interest rate risk exposure. Some interest rate derivative transactions effectively modify exposure to interest rate risk by converting a portion of floating-rate debt to a fixed rate. AEPSC, on behalf of TNC, also enters into interest rate derivative contracts to manage interest rate exposure related to future borrowings of fixed-rate debt. The forecasted fixed-rate debt offerings have a high probability of occurrence as the proceeds will be used to fund existing debt maturities and projected capital expenditures. TNC does not hedge all interest rate exposure. The gross notional volumes of TNC's outstanding derivative contracts for interest rate hedges as of September 30, 2012 and December 31, 2011 were \$125 million and \$125 million, respectively.

According to the accounting guidance for “Derivatives and Hedging,” TNC 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, TNC is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the September 30, 2012 balance sheet, TNC netted \$3 thousand 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 TNC’s derivative activity on the condensed balance sheets as of September 30, 2012 and December 31, 2011:

**Fair Value of Derivative Instruments
September 30, 2012**

<u>Balance Sheet Location</u>	<u>Hedging Contracts</u>			<u>Total</u>
	<u>Commodity (a)</u>	<u>Interest Rate (a)</u>	<u>Other (b)</u>	
	(in thousands)			
Prepayments and Other Current Assets	\$ 34	\$ -	\$ (7)	\$ 27
Deferred Charges and Other Noncurrent Assets	<u>2</u>	<u>-</u>	<u>-</u>	<u>2</u>
Total Assets	<u>36</u>	<u>-</u>	<u>(7)</u>	<u>29</u>
Other Current Liabilities	8	15,320	(6)	15,322
Deferred Credits and Other Noncurrent Liabilities	<u>4</u>	<u>-</u>	<u>(4)</u>	<u>-</u>
Total Liabilities	<u>12</u>	<u>15,320</u>	<u>(10)</u>	<u>15,322</u>
Total MTM Derivative Contract Net Assets (Liabilities)	<u>\$ 24</u>	<u>\$ (15,320)</u>	<u>\$ 3</u>	<u>\$ (15,293)</u>

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

<u>Balance Sheet Location</u>	<u>Hedging Contracts</u>			<u>Total</u>
	<u>Commodity (a)</u>	<u>Interest Rate (a)</u>	<u>Other (b)</u>	
	(in thousands)			
Prepayments and Other Current Assets	\$ -	\$ -	\$ -	\$ -
Deferred Charges and Other Noncurrent Assets	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total Assets	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Other Current Liabilities	64	-	(64)	-
Deferred Credits and Other Noncurrent Liabilities	<u>-</u>	<u>9,005</u>	<u>-</u>	<u>9,005</u>
Total Liabilities	<u>64</u>	<u>9,005</u>	<u>(64)</u>	<u>9,005</u>
Total MTM Derivative Contract Net Assets (Liabilities)	<u>\$ (64)</u>	<u>\$ (9,005)</u>	<u>\$ 64</u>	<u>\$ (9,005)</u>

- (a) Derivative instruments within these categories are reported gross. These instruments are subject to master netting agreements and are presented on the condensed 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.”

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), TNC 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 condensed balance sheets until the period the hedged item affects Net Income. TNC records hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains).

TNC reclassifies gains and losses on heating oil and gasoline derivative contracts designated as cash flow hedges from Accumulated Other Comprehensive Income (Loss) on its condensed balance sheets into Other Operation expense, Maintenance expense or Depreciation and Amortization expense, as it relates to capital projects, on its condensed statements of income. During the three and nine months ended September 30, 2012 and 2011, TNC designated heating oil and gasoline derivatives as cash flow hedges.

TNC reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its condensed balance sheets into Interest Expense on its condensed statements of income in those periods in which hedged interest payments occur. During the three and nine months ended September 30, 2012 and 2011, TNC designated interest rate derivatives as cash flow hedges.

During the three and nine months ended September 30, 2012 and 2011, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies discussed above.

The following tables provide details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TNC's condensed balance sheets and the reasons for changes in cash flow hedges for the three and nine months ended September 30, 2012 and 2011. All amounts in the following tables are presented net of related income taxes.

Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges For the Three Months Ended September 30, 2012

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
	(in thousands)		
Balance in AOCI as of July 1,	\$ (64)	\$ (8,901)	\$ (8,965)
Changes in Fair Value Recognized in AOCI	79	(1,057)	(978)
Amount of (Gain) or Loss Reclassified from AOCI to Statement of Income/within Balance Sheet:			
Other Operation Expense	2	-	2
Maintenance Expense	2	-	2
Interest Expense	-	-	-
Property, Plant and Equipment	2	-	2
Balance in AOCI as of September 30,	<u>\$ 21</u>	<u>\$ (9,958)</u>	<u>\$ (9,937)</u>

Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges For the Three Months Ended September 30, 2011

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
	(in thousands)		
Balance in AOCI as of July 1,	\$ 87	\$ -	\$ 87
Changes in Fair Value Recognized in AOCI	(106)	(4,523)	(4,629)
Amount of (Gain) or Loss Reclassified from AOCI to Statement of Income/within Balance Sheet:			
Other Operation Expense	(16)	-	(16)
Maintenance Expense	(10)	-	(10)
Interest Expense	-	-	-
Property, Plant and Equipment	(17)	-	(17)
Balance in AOCI as of September 30,	<u>\$ (62)</u>	<u>\$ (4,523)</u>	<u>\$ (4,585)</u>

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
For the Nine Months Ended September 30, 2012**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
		<u>(in thousands)</u>	
Balance in AOCI as of January 1,	\$ (42)	\$ (5,853)	\$ (5,895)
Changes in Fair Value Recognized in AOCI	69	(4,105)	(4,036)
Amount of (Gain) or Loss Reclassified from AOCI to Statement of Income/within Balance Sheet:			
Other Operation Expense	(2)	-	(2)
Maintenance Expense	-	-	-
Interest Expense	-	-	-
Property, Plant and Equipment	(4)	-	(4)
Balance in AOCI as of September 30,	<u>\$ 21</u>	<u>\$ (9,958)</u>	<u>\$ (9,937)</u>

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
For the Nine Months Ended September 30, 2011**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
		<u>(in thousands)</u>	
Balance in AOCI as of January 1,	\$ 54	\$ -	\$ 54
Changes in Fair Value Recognized in AOCI	(3)	(4,523)	(4,526)
Amount of (Gain) or Loss Reclassified from AOCI to Statement of Income/within Balance Sheet:			
Other Operation Expense	(43)	-	(43)
Maintenance Expense	(26)	-	(26)
Interest Expense	-	-	-
Property, Plant and Equipment	(44)	-	(44)
Balance in AOCI as of September 30,	<u>\$ (62)</u>	<u>\$ (4,523)</u>	<u>\$ (4,585)</u>

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TNC's condensed balance sheets as of September 30, 2012 and December 31, 2011 were:

**Impact of Cash Flow Hedges on the Condensed Balance Sheet
September 30, 2012**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
		<u>(in thousands)</u>	
Hedging Assets	\$ 28	\$ -	\$ 28
Hedging Liabilities	4	15,320	15,324
AOCI Gain (Loss) Net of Tax	21	(9,958)	(9,937)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	22	(705)	(683)

**Impact of Cash Flow Hedges on the Condensed Balance Sheet
December 31, 2011**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
		<u>(in thousands)</u>	
Hedging Assets	\$ -	\$ -	\$ -
Hedging Liabilities	64	9,005	9,069
AOCI Loss Net of Tax	(42)	(5,853)	(5,895)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(42)	-	(42)

The actual amounts that TNC reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ from the estimate above due to market price changes. As of September 30, 2012, the maximum length of time that TNC is hedging (with contracts subject to the accounting guidance for “Derivatives and Hedging”) exposure to variability in future cash flows related to forecasted transactions is 15 months.

TNC’s interest rate hedging liabilities have cross-default provisions that could be triggered if there was a non-performance event by Parent or the obligor under outstanding debt or a third party obligation in excess of \$50 million. As of September 30, 2012 and December 31, 2011, TNC had \$15 million and \$9 million, respectively, of liabilities for contracts with cross-default provisions prior to contractual netting arrangements.

7. FAIR VALUE MEASUREMENTS

Fair Value Hierarchy and Valuation Techniques

The accounting guidance for “Fair Value Measurements and Disclosures” establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). Where observable inputs are available for substantially the full term of the asset or liability, the instrument is categorized in Level 2. When quoted market prices are not available, pricing may be completed using comparable securities, dealer values, operating data and general market conditions to determine fair value. Valuation models utilize various inputs such as commodity, interest rate and, to a lesser degree, volatility and credit that include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets, market corroborated inputs (i.e. inputs derived principally from, or correlated to, observable market data) and other observable inputs for the asset or liability. The AEP System’s market risk oversight staff independently monitors its valuation policies and procedures and provides members of the Commercial Operations Risk Committee (CORC) various daily, weekly and monthly reports, regarding compliance with policies and procedures. The CORC consists of AEPSC’s Chief Operation Officer, Chief Financial Officer, 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 non-binding 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. Long-dated and illiquid complex or structured transactions, FTRs and counterparty credit risk can introduce the need for internally developed modeling inputs based upon extrapolations and assumptions of observable market data 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 the contracts being classified as Level 3 is the inability to substantiate energy price curves in the market. A significant portion of the Level 3 instruments have been economically hedged which greatly limits potential earnings volatility.

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 TNC's Long-term Debt as of September 30, 2012 and December 31, 2011 are summarized in the following table:

	<u>September 30, 2012</u>		<u>December 31, 2011</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 370,292	\$ 417,567	\$ 370,229	\$ 414,646

Fair Value Measurements of Financial Assets and Liabilities

The following tables set forth, by level within the fair value hierarchy, TNC's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2012 and December 31, 2011. As required by the accounting guidance for "Fair Value Measurements and Disclosures," financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Management's assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. There have not been any significant changes in management's valuation techniques.

Assets and Liabilities Measured at Fair Value on a Recurring Basis September 30, 2012

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Risk Management Assets					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 36	\$ -	\$ (7)	\$ 29
Risk Management Liabilities					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 12	\$ -	\$ (12)	\$ -
Interest Rate/Foreign Currency Hedges (a)	-	15,320	-	2	15,322
Total Risk Management Liabilities	<u>\$ -</u>	<u>\$ 15,332</u>	<u>\$ -</u>	<u>\$ (10)</u>	<u>\$ 15,322</u>

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

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Risk Management Liabilities					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 64	\$ -	\$ (64)	\$ -
Interest Rate/Foreign Currency Hedges	-	9,005	-	-	9,005
Total Risk Management Liabilities	<u>\$ -</u>	<u>\$ 9,069</u>	<u>\$ -</u>	<u>\$ (64)</u>	<u>\$ 9,005</u>

(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, 2011, TNC had no assets measured at fair value on a recurring basis.

There were no transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2012 and 2011.

8. INCOME TAXES

AEP System Tax Allocation Agreement

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

Federal and State Income Tax Audit Status

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

TNC and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns and TNC and other AEP subsidiaries are currently under examination in several state and local jurisdictions. Management believes that previously filed tax returns have positions that may be challenged by these tax authorities. However, management believes that adequate provisions for income taxes have been made for potential liabilities resulting from such challenges and that the ultimate resolution of these audits will not materially impact net income. With few exceptions, TNC is no longer subject to state or local income tax examinations by tax authorities for years before 2000.

9. FINANCING ACTIVITIES

Long-term Debt

Long-term debt principal payments made during the first nine months of 2012 are shown in the table below:

<u>Type of Debt</u>	<u>Principal Amount Paid</u>	<u>Interest Rate</u>	<u>Due Date</u>
Notes Payable	<u>(in thousands)</u> \$ 4	(%) 4.50	2059

Dividend Restrictions

Federal Power Act

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

Money Pool – AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of the subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP’s utility subsidiaries, and a Nonutility Money Pool, which funds AEP’s majority of the nonutility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions approved in a regulatory order. The amount of outstanding borrowings from the Utility Money Pool as of September 30, 2012 and December 31, 2011 is included in Advances from Affiliates on TNC’s condensed balance sheets. TNC’s Utility Money Pool activity and corresponding authorized borrowing limit for the nine months ended September 30, 2012 are described in the following table:

Maximum Borrowings from Utility Money Pool	Maximum Loans to Utility Money Pool	Average Borrowings from Utility Money Pool	Average Loans to Utility Money Pool	Borrowings from Utility Money Pool as of September 30, 2012	Authorized Short-Term Borrowing Limit
(in thousands)					
\$ 51,228	\$ -	\$ 41,426	\$ -	\$ 45,363	\$ 250,000

The activity in the above table does not include short-term lending activity of TNC’s 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 the Nonutility Money Pool as of September 30, 2012 and December 31, 2011 is included in Advances to Affiliates on TNC’s condensed balance sheets. For the nine months ended September 30, 2012, TNGC had the following activity in the Nonutility Money Pool:

Maximum Borrowings from Nonutility Money Pool	Maximum Loans to Nonutility Money Pool	Average Borrowings from Nonutility Money Pool	Average Loans to Nonutility Money Pool	Loans to Nonutility Money Pool as of September 30, 2012
(in thousands)				
\$ -	\$ 11,088	\$ -	\$ 10,781	\$ 10,632

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the nine months ended September 30, 2012 and 2011 are summarized in the following table:

Nine Months Ended September 30,	Maximum Interest Rates for Funds Borrowed from Utility Money Pool	Minimum Interest Rates for Funds Borrowed from Utility Money Pool	Maximum Interest Rates for Funds Loaned to Utility Money Pool	Minimum Interest Rates for Funds Loaned to Utility Money Pool	Average Interest Rates for Funds Borrowed from Utility Money Pool	Average Interest Rates for Funds Loaned to Utility Money Pool
2012	0.56 %	0.44 %	- %	- %	0.48 %	- %
2011	0.56 %	0.06 %	- %	- %	0.30 %	- %

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Nonutility Money Pool for the nine months ended September 30, 2012 and 2011 are summarized in the following table:

Nine Months Ended September 30,	Maximum Interest Rates for Funds Borrowed from Nonutility Money Pool	Minimum Interest Rates for Funds Borrowed from Nonutility Money Pool	Maximum Interest Rates for Funds Loaned to Nonutility Money Pool	Minimum Interest Rates for Funds Loaned to Nonutility Money Pool	Average Interest Rates for Funds Borrowed from Nonutility Money Pool	Average Interest Rates for Funds Loaned to Nonutility Money Pool
2012	- %	- %	0.56 %	0.44 %	- %	0.48 %
2011	- %	- %	0.58 %	0.36 %	- %	0.45 %

10. SUSTAINABLE COST REDUCTIONS

In April 2012, management initiated a process to identify employee repositioning opportunities and efficiencies that will result in sustainable cost savings. The process will result in involuntary severances and is expected to be completed in early 2013. The severance program provides two weeks of base pay for every year of service along with other severance benefits.

TNC recorded charges to expense in 2012 related to the sustainable cost reductions initiative.

<u>Expense Allocation from AEPSC</u>	<u>Incurred</u>	<u>Settled</u>	<u>Remaining Balance at September 30, 2012</u>
(in thousands)			
\$ 227	\$ 167	\$ (391)	\$ 3

These expenses relate primarily to severance benefits. They are included primarily in Other Operation on the condensed statements of income and Other Current Liabilities on the condensed balance sheets. At this time, management is unable to estimate the total amount to be incurred in future periods related to this initiative or to quantify the effects on future net income, cash flows and financial condition.