

# **AEP Texas North Company and Subsidiary**

2013 Third Quarter Report

Consolidated Financial Statements



## **TABLE OF CONTENTS**

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	<b>Page Number</b>
Glossary of Terms	1
Condensed Consolidated Statements of Income – Unaudited	2
Condensed Consolidated Statements of Comprehensive Income (Loss) – Unaudited	3
Condensed Consolidated Statements of Changes in Common Shareholder’s Equity – Unaudited	4
Condensed Consolidated Balance Sheets – Unaudited	5
Condensed Consolidated Statements of Cash Flows – Unaudited	7
Index of Condensed Notes to Condensed Consolidated Financial Statements – Unaudited	8

## GLOSSARY OF TERMS

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

Term	Meaning
AEP or Parent	American Electric Power Company, Inc., an electric utility holding company.
AEP System	American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AOCI	Accumulated Other Comprehensive Income.
CAA	Clean Air Act.
CO <sub>2</sub>	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, 2013 and 2012  
(in thousands)  
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>REVENUES</b>				
Electric Transmission and Distribution	\$ 55,939	\$ 53,753	\$ 155,673	\$ 153,985
Sales to AEP Affiliates	25,411	22,920	76,395	59,871
Other Revenues	112	72	930	392
<b>TOTAL REVENUES</b>	<u>81,462</u>	<u>76,745</u>	<u>232,998</u>	<u>214,248</u>
<b>EXPENSES</b>				
Fuel and Other Consumables Used for Electric Generation	14,337	12,256	40,620	26,198
Other Operation	20,270	19,547	61,804	61,830
Maintenance	5,893	5,798	18,901	15,650
Depreciation and Amortization	14,119	13,524	41,485	40,217
Taxes Other Than Income Taxes	5,805	5,082	11,766	14,285
<b>TOTAL EXPENSES</b>	<u>60,424</u>	<u>56,207</u>	<u>174,576</u>	<u>158,180</u>
<b>OPERATING INCOME</b>	21,038	20,538	58,422	56,068
<b>Other Income (Expense):</b>				
Other Income	71	25	118	41
Interest Expense	(4,870)	(5,624)	(16,122)	(16,419)
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	16,239	14,939	42,418	39,690
Income Tax Expense	5,587	4,941	14,576	12,666
<b>NET INCOME</b>	<u>\$ 10,652</u>	<u>\$ 9,998</u>	<u>\$ 27,842</u>	<u>\$ 27,024</u>

*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, 2013 and 2012**  
**(in thousands)**  
**(Unaudited)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net Income	\$ 10,652	\$ 9,998	\$ 27,842	\$ 27,024
<b><u>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES</u></b>				
Cash Flow Hedges, Net of Tax of \$123 and \$523 for the Three Months Ended September 30, 2013 and 2012, Respectively, and \$759 and \$2,176 for the Nine Months Ended September 30, 2013 and 2012, Respectively	229	(972)	1,410	(4,042)
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$94 and \$63 for the Three Months Ended September 30, 2013 and 2012, Respectively, and \$282 and \$188 for the Nine Months Ended September 30, 2013 and 2012, Respectively	<u>175</u>	<u>117</u>	<u>524</u>	<u>350</u>
<b>TOTAL OTHER COMPREHENSIVE INCOME (LOSS)</b>	<u>404</u>	<u>(855)</u>	<u>1,934</u>	<u>(3,692)</u>
<b>TOTAL COMPREHENSIVE INCOME</b>	<u>\$ 11,056</u>	<u>\$ 9,143</u>	<u>\$ 29,776</u>	<u>\$ 23,332</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, 2013 and 2012**  
(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>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2011</b>	\$ 137,214	\$ 3,276	\$ 208,280	\$ (21,385)	\$ 327,385
Common Stock Dividends			(15,000)		(15,000)
Net Income			27,024		27,024
Other Comprehensive Loss				(3,692)	(3,692)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2012</b>	<u>\$ 137,214</u>	<u>\$ 3,276</u>	<u>\$ 220,304</u>	<u>\$ (25,077)</u>	<u>\$ 335,717</u>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2012</b>	\$ 137,214	\$ 3,276	\$ 218,969	\$ (23,217)	\$ 336,242
Common Stock Dividends			(7,500)		(7,500)
Net Income			27,842		27,842
Other Comprehensive Income				1,934	1,934
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2013</b>	<u>\$ 137,214</u>	<u>\$ 3,276</u>	<u>\$ 239,311</u>	<u>\$ (21,283)</u>	<u>\$ 358,518</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, 2013 and December 31, 2012**

**(in thousands)**

**(Unaudited)**

	<b>September 30, 2013</b>	<b>December 31, 2012</b>
<b>CURRENT ASSETS</b>		
Advances to Affiliates	\$ 10,348	\$ 10,791
Accounts Receivable:		
Customers	13,835	11,556
Affiliated Companies	14,390	17,457
Accrued Unbilled Revenues	5,452	6,523
Miscellaneous	-	6
Allowance for Uncollectible Accounts	(29)	(305)
Total Accounts Receivable	<u>33,648</u>	<u>35,237</u>
Fuel	3,851	11,814
Materials and Supplies	16,140	15,302
Risk Management Assets	7	16
Prepayments and Other Current Assets	<u>2,556</u>	<u>1,955</u>
<b>TOTAL CURRENT ASSETS</b>	<u>66,550</u>	<u>75,115</u>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Electric:		
Generation	310,840	309,870
Transmission	528,658	508,716
Distribution	675,951	658,724
Other Property, Plant and Equipment	104,115	95,442
Construction Work in Progress	<u>39,575</u>	<u>31,570</u>
<b>Total Property, Plant and Equipment</b>	1,659,139	1,604,322
Accumulated Depreciation and Amortization	<u>547,863</u>	<u>525,557</u>
<b>TOTAL PROPERTY, PLANT AND EQUIPMENT – NET</b>	<u>1,111,276</u>	<u>1,078,765</u>
<b>OTHER NONCURRENT ASSETS</b>		
Regulatory Assets	60,911	56,366
Deferred Charges and Other Noncurrent Assets	<u>6,099</u>	<u>1,520</u>
<b>TOTAL OTHER NONCURRENT ASSETS</b>	<u>67,010</u>	<u>57,886</u>
<b>TOTAL ASSETS</b>	<u>\$ 1,244,836</u>	<u>\$ 1,211,766</u>

*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, 2013 and December 31, 2012**  
**(Unaudited)**

	<b>September 30,</b> <b>2013</b>	<b>December 31,</b> <b>2012</b>
<b>(in thousands)</b>		
<b>CURRENT LIABILITIES</b>		
Advances from Affiliates	\$ 19,198	\$ 50,361
Accounts Payable:		
General	10,738	7,585
Affiliated Companies	10,958	15,098
Long-term Debt Due Within One Year – Nonaffiliated	7	225,006
Risk Management Liabilities	6	14,781
Accrued Taxes	14,818	22,528
Accrued Interest	5,062	5,916
Other Current Liabilities	13,716	15,655
<b>TOTAL CURRENT LIABILITIES</b>	<b>74,503</b>	<b>356,930</b>
<b>NONCURRENT LIABILITIES</b>		
Long-term Debt – Nonaffiliated	420,288	145,293
Deferred Income Taxes	148,667	140,473
Regulatory Liabilities and Deferred Investment Tax Credits	182,478	174,426
Employee Benefits and Pension Obligations	8,259	9,341
Deferred Credits and Other Noncurrent Liabilities	52,123	49,061
<b>TOTAL NONCURRENT LIABILITIES</b>	<b>811,815</b>	<b>518,594</b>
<b>TOTAL LIABILITIES</b>	<b>886,318</b>	<b>875,524</b>
Rate Matters (Note 3)		
Commitments and Contingencies (Note 4)		
<b>COMMON SHAREHOLDER'S EQUITY</b>		
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	239,311	218,969
Accumulated Other Comprehensive Income (Loss)	(21,283)	(23,217)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY</b>	<b>358,518</b>	<b>336,242</b>
<b>TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY</b>	<b>\$ 1,244,836</b>	<b>\$ 1,211,766</b>

*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, 2013 and 2012**  
(in thousands)  
(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>OPERATING ACTIVITIES</b>		
<b>Net Income</b>	\$ 27,842	\$ 27,024
<b>Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:</b>		
Depreciation and Amortization	41,485	40,217
Deferred Income Taxes	6,696	(1,841)
Change in Other Noncurrent Assets	(5,849)	(6,365)
Change in Other Noncurrent Liabilities	(8,193)	606
<b>Changes in Certain Components of Working Capital:</b>		
Accounts Receivable, Net	1,589	(6,816)
Fuel, Materials and Supplies	7,125	(6,384)
Accounts Payable	(3,140)	2,483
Accrued Taxes, Net	(8,123)	3,434
Other Current Assets	(426)	(516)
Other Current Liabilities	(4,708)	2,027
<b>Net Cash Flows from Operating Activities</b>	54,298	53,869
<b>INVESTING ACTIVITIES</b>		
Construction Expenditures	(71,494)	(64,502)
Change in Advances to Affiliates, Net	443	456
Proceeds from Sales of Assets	3,895	4,128
Other Investing Activities	3,115	1,454
<b>Net Cash Flows Used for Investing Activities</b>	(64,041)	(58,464)
<b>FINANCING ACTIVITIES</b>		
Issuance of Long-term Debt – Nonaffiliated	273,513	-
Change in Advances from Affiliates, Net	(31,163)	19,474
Retirement of Long-term Debt – Nonaffiliated	(225,005)	(4)
Principal Payments for Capital Lease Obligations	(419)	(504)
Dividends Paid on Common Stock	(7,500)	(15,000)
Other Financing Activities	317	426
<b>Net Cash Flows from Financing Activities</b>	9,743	4,392
<b>Net Decrease in Cash and Cash Equivalents</b>	-	(203)
<b>Cash and Cash Equivalents at Beginning of Period</b>	-	203
<b>Cash and Cash Equivalents at End of Period</b>	\$ -	\$ -
<b>SUPPLEMENTARY INFORMATION</b>		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 14,442	\$ 16,969
Net Cash Paid for Income Taxes	16,662	14,774
Noncash Acquisitions Under Capital Leases	773	694
Construction Expenditures Included in Current Liabilities as of September 30,	5,026	3,585

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

## INDEX OF CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	<u>Page Number</u>
Significant Accounting Matters	9
Comprehensive Income	9
Rate Matters	11
Commitments, Guarantees and Contingencies	12
Benefit Plans	13
Business Segments	13
Derivatives and Hedging	14
Fair Value Measurements	16
Income Taxes	19
Financing Activities	20
Variable Interest Entities	21
Sustainable Cost Reductions	22

## 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, 2013 is not necessarily indicative of results that may be expected for the year ending December 31, 2013. The condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2012 financial statements and notes thereto, which are included in TNC's 2012 Annual Report.

Management reviewed subsequent events through October 25, 2013, the date that the third quarter 2013 report was issued.

## 2. COMPREHENSIVE INCOME

### *Presentation of Comprehensive Income*

The following tables provide the components of changes in AOCI for the three and nine months ended September 30, 2013. All amounts in the following table are presented net of related income taxes.

#### Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended September 30, 2013

	Cash Flow Hedges			Total
	Commodity	Interest Rate and Foreign Currency	Pension and OPEB	
	(in thousands)			
<b>Balance in AOCI as of June 30, 2013</b>	\$ (15)	\$ (8,399)	\$ (13,273)	\$ (21,687)
Change in Fair Value Recognized in AOCI	26	-	-	26
Amounts Reclassified from AOCI	(14)	217	175	378
Net Current Period Other Comprehensive Income	12	217	175	404
<b>Balance in AOCI as of September 30, 2013</b>	<u>\$ (3)</u>	<u>\$ (8,182)</u>	<u>\$ (13,098)</u>	<u>\$ (21,283)</u>

#### Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Nine Months Ended September 30, 2013

	Cash Flow Hedges			Total
	Commodity	Interest Rate and Foreign Currency	Pension and OPEB	
	(in thousands)			
<b>Balance in AOCI as of December 31, 2012</b>	\$ 13	\$ (9,608)	\$ (13,622)	\$ (23,217)
Change in Fair Value Recognized in AOCI	12	340	-	352
Amounts Reclassified from AOCI	(28)	1,086	524	1,582
Net Current Period Other Comprehensive Income	(16)	1,426	524	1,934
<b>Balance in AOCI as of September 30, 2013</b>	<u>\$ (3)</u>	<u>\$ (8,182)</u>	<u>\$ (13,098)</u>	<u>\$ (21,283)</u>

### ***Reclassifications Out of Accumulated Other Comprehensive Income***

The following tables provide details of reclassifications from AOCI for the three and nine months ended September 30, 2013. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 5 for additional details.

#### **Reclassifications from Accumulated Other Comprehensive Income (Loss) For the Three Months Ended September 30, 2013**

<b>Gains and Losses on Cash Flow Hedges</b>	<b>Amount of (Gain) Loss Reclassified from AOCI (in thousands)</b>
Commodity:	
Other Operation Expense	\$ (5)
Maintenance Expense	(5)
Property, Plant and Equipment	(11)
Subtotal - Commodity	(21)
Interest Rate and Foreign Currency:	
Interest Expense	334
Subtotal - Interest Rate and Foreign Currency	334
Reclassifications from AOCI, before Income Tax (Expense) Credit	313
Income Tax (Expense) Credit	110
<b>Reclassifications from AOCI, Net of Income Tax (Expense) Credit</b>	<b>203</b>
<b>Amortization of Pension and OPEB</b>	
Prior Service Cost (Credit)	(16)
Actuarial (Gains)/Losses	285
Reclassifications from AOCI, before Income Tax (Expense) Credit	269
Income Tax (Expense) Credit	94
<b>Reclassifications from AOCI, Net of Income Tax (Expense) Credit</b>	<b>175</b>
<b>Total Reclassifications from AOCI, Net of Income Tax (Expense) Credit</b>	<b>\$ 378</b>

#### **Reclassifications from Accumulated Other Comprehensive Income (Loss) For the Nine Months Ended September 30, 2013**

<b>Gains and Losses on Cash Flow Hedges</b>	<b>Amount of (Gain) Loss Reclassified from AOCI (in thousands)</b>
Commodity:	
Other Operation Expense	\$ (11)
Maintenance Expense	(11)
Property, Plant and Equipment	(21)
Subtotal - Commodity	(43)
Interest Rate and Foreign Currency:	
Interest Expense	1,671
Subtotal - Interest Rate and Foreign Currency	1,671
Reclassifications from AOCI, before Income Tax (Expense) Credit	1,628
Income Tax (Expense) Credit	570
<b>Reclassifications from AOCI, Net of Income Tax (Expense) Credit</b>	<b>1,058</b>
<b>Amortization of Pension and OPEB</b>	
Prior Service Cost (Credit)	(46)
Actuarial (Gains)/Losses	852
Reclassifications from AOCI, before Income Tax (Expense) Credit	806
Income Tax (Expense) Credit	282
<b>Reclassifications from AOCI, Net of Income Tax (Expense) Credit</b>	<b>524</b>
<b>Total Reclassifications from AOCI, Net of Income Tax (Expense) Credit</b>	<b>\$ 1,582</b>

The following tables provide details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on the condensed balance sheets and the reasons for changes in cash flow hedges for the three and nine months ended September 30, 2012. 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)		
<b>Balance in AOCI as of June 30, 2012</b>	\$ (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
Property, Plant and Equipment	2	-	2
<b>Balance in AOCI as of September 30, 2012</b>	<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, 2012**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
	(in thousands)		
<b>Balance in AOCI as of December 31, 2011</b>	\$ (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	-	-	-
Property, Plant and Equipment	(4)	-	(4)
<b>Balance in AOCI as of September 30, 2012</b>	<u>\$ 21</u>	<u>\$ (9,958)</u>	<u>\$ (9,937)</u>

### 3. RATE MATTERS

As discussed in TNC's 2012 Annual Report, TNC is involved in rate and regulatory proceedings at the FERC and the PUCT. The Rate Matters note within TNC's 2012 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 2013 and updates TNC's 2012 Annual Report.

#### *Regulatory Assets Not Yet Being Recovered*

<u>Noncurrent Regulatory Assets</u>	<u>September 30,</u> <u>2013</u>	<u>December 31,</u> <u>2012</u>
	(in thousands)	
<b>Regulatory assets not yet being recovered pending future proceedings:</b>		
<u>Regulatory Assets Currently Not Earning a Return</u>		
Rate Case Expenses	\$ 3	\$ 3
<b>Total Regulatory Assets Not Yet Being Recovered</b>	<u>\$ 3</u>	<u>\$ 3</u>

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

#### **4. 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 2012 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 2012 Annual Report "Disposition" section of Note 4. As of September 30, 2013, 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, 2013, 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 CO<sub>2</sub> 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. In May 2013, the U.S. Court of Appeals for the Fifth Circuit affirmed the district court's dismissal of the complaint. The plaintiffs did not appeal to the U.S. Supreme Court.

## *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 CO<sub>2</sub> 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. 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 filed seeking further review in the U.S. Supreme Court. In May 2013, the U.S. Supreme Court denied the plaintiffs' request for review.

## **5. BENEFIT PLANS**

TNC participates in an AEP sponsored qualified pension plan and an 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 health 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 (credit) for the plans for the three and nine months ended September 30, 2013 and 2012:

	<b>Pension Plans</b>		<b>Other Postretirement Benefit Plans</b>	
	<b>Three Months Ended September 30,</b>		<b>Three Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
	(in thousands)			
Service Cost	\$ 401	\$ 440	\$ 102	\$ 209
Interest Cost	1,046	1,165	398	581
Expected Return on Plan Assets	(1,532)	(1,762)	(643)	(598)
Amortization of Prior Service Cost (Credit)	27	(104)	(394)	(110)
Amortization of Net Actuarial Loss	943	782	367	323
<b>Net Periodic Benefit Cost (Credit)</b>	<b>\$ 885</b>	<b>\$ 521</b>	<b>\$ (170)</b>	<b>\$ 405</b>

	<b>Pension Plans</b>		<b>Other Postretirement Benefit Plans</b>	
	<b>Nine Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
	(in thousands)			
Service Cost	\$ 1,202	\$ 1,319	\$ 306	\$ 625
Interest Cost	3,138	3,493	1,196	1,743
Expected Return on Plan Assets	(4,596)	(5,286)	(1,929)	(1,793)
Amortization of Prior Service Cost (Credit)	81	(312)	(1,183)	(328)
Amortization of Net Actuarial Loss	2,828	2,347	1,101	966
<b>Net Periodic Benefit Cost (Credit)</b>	<b>\$ 2,653</b>	<b>\$ 1,561</b>	<b>\$ (509)</b>	<b>\$ 1,213</b>

## **6. BUSINESS SEGMENTS**

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

## 7. 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, 2013 and December 31, 2012 were 345 thousand gallons and 379 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. As of September 30, 2013, TNC did not have any outstanding derivative contracts for interest rate hedges. The gross notional volumes of TNC's outstanding derivative contracts for interest rate hedges as of December 31, 2012 were \$125 million.

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, 2013 condensed balance sheet, TNC netted \$5 thousand of cash collateral paid to third parties against short-term and long-term risk management liabilities. For the December 31, 2012 condensed balance sheet, TNC had no netting of cash collateral paid to third parties against short-term and long-term risk management liabilities.

The following tables represent the gross fair value impact of TNC's derivative activity on the condensed balance sheets as of September 30, 2013 and December 31, 2012:

**Fair Value of Derivative Instruments**  
September 30, 2013

Balance Sheet Location	Hedging Contracts		Gross Amounts of Risk Management Assets/ Liabilities Recognized (in thousands)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Asset/Liabilities Presented in the Statement of Financial Position (c)
	Commodity (a)	Interest Rate (a)			
Current Risk Management Assets	\$ 9	\$ -	\$ 9	\$ (2)	\$ 7
Long-term Risk Management Assets	-	-	-	-	-
<b>Total Assets</b>	<u>9</u>	<u>-</u>	<u>9</u>	<u>(2)</u>	<u>7</u>
Current Risk Management Liabilities	8	-	8	(2)	6
Long-term Risk Management Liabilities	5	-	5	(5)	-
<b>Total Liabilities</b>	<u>13</u>	<u>-</u>	<u>13</u>	<u>(7)</u>	<u>6</u>
<b>Total MTM Derivative Contract Net Assets (Liabilities)</b>	<u>\$ (4)</u>	<u>\$ -</u>	<u>\$ (4)</u>	<u>\$ 5</u>	<u>\$ 1</u>



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

<b>Balance Sheet Location</b>	<b>Hedging Contracts</b>		<b>Gross Amounts of Risk Management Assets/Liabilities Recognized</b>	<b>Gross Amounts Offset in the Statement of Financial Position (b)</b>	<b>Net Amounts of Asset/Liabilities Presented in the Statement of Financial Position (c)</b>
	<b>Commodity (a)</b>	<b>Interest Rate (a)</b>			
			(in thousands)		
Current Risk Management Assets	\$ 27	\$ -	\$ 27	\$ (11)	\$ 16
Long-term Risk Management Assets	-	-	-	-	-
<b>Total Assets</b>	<u>27</u>	<u>-</u>	<u>27</u>	<u>(11)</u>	<u>16</u>
Current Risk Management Liabilities	11	14,781	14,792	(11)	14,781
Long-term Risk Management Liabilities	-	-	-	-	-
<b>Total Liabilities</b>	<u>11</u>	<u>14,781</u>	<u>14,792</u>	<u>(11)</u>	<u>14,781</u>
<b>Total MTM Derivative Contract Net Assets (Liabilities)</b>	<u>\$ 16</u>	<u>\$ (14,781)</u>	<u>\$ (14,765)</u>	<u>\$ -</u>	<u>\$ (14,765)</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."
- (c) There are no derivative contracts subject to a master netting arrangement or similar agreement which are not offset in the statement of financial position.

***Accounting for Cash Flow Hedging Strategies***

For cash flow hedges (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), 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, 2013 and 2012, 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, 2013 and 2012, TNC designated interest rate derivatives as cash flow hedges.

During the three and nine months ended September 30, 2013 and 2012, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies discussed above.

For 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, 2013 and 2012, see Note 2.

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TNC's condensed balance sheets as of September 30, 2013 and December 31, 2012 were:

**Impact of Cash Flow Hedges on the Condensed Balance Sheet  
September 30, 2013**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
	(in thousands)		
Hedging Assets (a)	\$ 7	\$ -	\$ 7
Hedging Liabilities (a)	11	-	11
AOCI Loss Net of Tax	(3)	(8,182)	(8,185)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	1	(869)	(868)

**Impact of Cash Flow Hedges on the Condensed Balance Sheet  
December 31, 2012**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
	(in thousands)		
Hedging Assets (a)	\$ 16	\$ -	\$ 16
Hedging Liabilities (a)	-	14,781	14,781
AOCI Gain (Loss) Net of Tax	13	(9,608)	(9,595)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	13	(921)	(908)

- (a) Hedging Assets and Hedging Liabilities are included in Risk Management Assets and Liabilities on TNC's condensed balance sheets.

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, 2013, the maximum length of time that TNC is hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions was 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, 2013, TNC had no liabilities for contracts with cross-default provisions prior to contractual netting arrangements. As of December 31, 2012, TNC had \$15 million of liabilities for contracts with cross-default provisions prior to contractual netting arrangements.

## **8. 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 Operating Officer, Chief Financial Officer, Executive Vice President of Energy Supply, Senior Vice President of Commercial Operations and Chief Risk Officer.

For commercial activities, exchange traded derivatives, namely futures contracts, are generally fair valued based on unadjusted quoted prices in active markets and are classified as Level 1. Level 2 inputs primarily consist of OTC broker quotes in moderately active or less active markets, as well as exchange traded contracts where there is insufficient market liquidity to warrant inclusion in Level 1. Management verifies price curves using these broker quotes and classifies these fair values within Level 2 when substantially all of the fair value can be corroborated. Management typically obtains multiple broker quotes, which are nonbinding in nature, but are based on recent trades in the marketplace. When multiple broker quotes are obtained, the quoted bid and ask prices are averaged. In certain circumstances, a broker quote may be discarded if it is a clear outlier. Management uses a historical correlation analysis between the broker quoted location and the illiquid locations. 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 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, 2013 and December 31, 2012 are summarized in the following table:

	<u>September 30, 2013</u>		<u>December 31, 2012</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 420,295	\$ 430,376	\$ 370,299	\$ 414,547

***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, 2013 and December 31, 2012. 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, 2013**

	Level 1	Level 2	Level 3	Other	Total
	(in thousands)				
<b>Assets:</b>					
<b>Risk Management Assets</b>					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 7	\$ -	\$ -	\$ 7

**Liabilities:**

	Level 1	Level 2	Level 3	Other	Total
<b>Risk Management Liabilities</b>					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 11	\$ -	\$ (5)	\$ 6

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

	Level 1	Level 2	Level 3	Other	Total
	(in thousands)				
<b>Assets:</b>					
<b>Risk Management Assets</b>					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 27	\$ -	\$ (11)	\$ 16

**Liabilities:**

	Level 1	Level 2	Level 3	Other	Total
<b>Risk Management Liabilities</b>					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 11	\$ -	\$ (11)	\$ -
Interest Rate/Foreign Currency Hedges	\$ -	\$ 14,781	\$ -	\$ -	\$ 14,781
<b>Total Risk Management Liabilities</b>	\$ -	\$ 14,792	\$ -	\$ (11)	\$ 14,781

(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."

There were no transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2013 and 2012.

## **9. 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***

The IRS examination of years 2009 and 2010 started in October 2011 and was completed in the second quarter of 2013. The completion of the federal audit did not result in a material impact on net income or financial condition. Cash flows will be negatively impacted by \$8 million with the payment of the previously accrued taxes. 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 materially impact 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. 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. TNC is no longer subject to state or local income tax examinations by tax authorities for years before 2008.

### ***Federal Tax Regulations***

In the third quarter of 2013, the U.S. Treasury Department issued final regulations regarding the deduction and capitalization of expenditures related to tangible property, effective for the tax years beginning in 2014. The U.S. Treasury Department had previously issued guidance in the form of proposed and temporary regulations which was generally effective for tax years beginning in 2012, which was moved to tax years beginning in 2014 in November, 2012. In addition, the IRS has issued Revenue Procedures under the Industry Issue Resolutions program that provides specific guidance for the implementation of the regulations for the electric utility industry. The impact of these final regulations is not material to net income, cash flows or financial condition.

## 10. FINANCING ACTIVITIES

### *Long-term Debt*

Long-term debt issued, retired and principal payments made during the first nine months of 2013 are shown in the tables below:

<b>Issuances:</b>	<b>Type of Debt</b>	<b>Principal Amount</b>	<b>Interest Rate</b>	<b>Due Date</b>
		<b>(in thousands)</b>	<b>(%)</b>	
	Other Long-term Debt	\$ 75,000 (a)	Variable	2016
	Senior Unsecured Notes	125,000	3.09	2023
	Senior Unsecured Notes	75,000	4.48	2043

  

<b>Retirements and Principal Payments:</b>	<b>Type of Debt</b>	<b>Principal Amount Paid</b>	<b>Interest Rate</b>	<b>Due Date</b>
		<b>(in thousands)</b>	<b>(%)</b>	
	Senior Unsecured Notes	\$ 225,000	5.50	2013
	Notes Payable	5	4.50	2059

(a) Draw on a \$75 million three-year revolving credit facility to be used for general corporate purposes.

### *Dividend Restrictions*

TNC pays dividends to Parent provided funds are legally available. Various financing arrangements and regulatory requirements may impose certain restrictions on the ability of TNC to transfer funds to Parent in the form of dividends.

### *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 book value of the common stock. This restriction does not limit the ability of TNC to pay dividends out of retained earnings.

### *Leverage Restrictions*

Pursuant to the credit agreement leverage restrictions, TNC must maintain a percentage of debt to total capitalization at a level that does not exceed 67.5%.

### *Money Pool – 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, and a Nonutility Money Pool, which funds a majority of AEP’s nonutility subsidiaries. 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 borrowings from the Utility Money Pool as of September 30, 2013 and December 31, 2012 are 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, 2013 are described in the following table:

<b>Maximum Borrowings from the Utility Money Pool</b>	<b>Maximum Loans to the Utility Money Pool</b>	<b>Average Borrowings from the Utility Money Pool</b>	<b>Average Loans to the Utility Money Pool</b>	<b>Borrowings from the Utility Money Pool as of September 30, 2013</b>	<b>Authorized Short-Term Borrowing Limit</b>
<b>(in thousands)</b>					
\$ 102,565	\$ 131,243	\$ 71,980	\$ 131,243	\$ 19,198	\$ 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 amounts of outstanding loans to the Nonutility Money Pool as of September 30, 2013 and December 31, 2012 are included in Advances to Affiliates on TNC's condensed balance sheets. For the nine months ended September 30, 2013, TNGC had the following activity in the Nonutility Money Pool:

<b>Maximum Borrowings from the Nonutility Money Pool</b>	<b>Maximum Loans to the Nonutility Money Pool</b>	<b>Average Borrowings from the Nonutility Money Pool</b>	<b>Average Loans to the Nonutility Money Pool</b>	<b>Loans to the Nonutility Money Pool as of September 30, 2013</b>
(in thousands)				
\$ -	\$ 10,792	\$ -	\$ 10,516	\$ 10,348

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, 2013 and 2012 are summarized in the following table:

<b>Nine Months Ended September 30,</b>	<b>Maximum Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Minimum Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Maximum Interest Rate for Funds Loaned to the Utility Money Pool</b>	<b>Minimum Interest Rate for Funds Loaned to the Utility Money Pool</b>	<b>Average Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Average Interest Rate for Funds Loaned to the Utility Money Pool</b>
2013	0.43 %	0.28 %	0.36 %	0.36 %	0.34 %	0.36 %
2012	0.56 %	0.44 %	-	-	0.48 %	-

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, 2013 and 2012 are summarized in the following table:

<b>Nine Months Ended September 30,</b>	<b>Maximum Interest Rate for Funds Borrowed from the Nonutility Money Pool</b>	<b>Minimum Interest Rate for Funds Borrowed from the Nonutility Money Pool</b>	<b>Maximum Interest Rate for Funds Loaned to the Nonutility Money Pool</b>	<b>Minimum Interest Rate for Funds Loaned to the Nonutility Money Pool</b>	<b>Average Interest Rate for Funds Borrowed from the Nonutility Money Pool</b>	<b>Average Interest Rate for Funds Loaned to the Nonutility Money Pool</b>
2013	-	-	0.43 %	0.28 %	-	0.34 %
2012	-	-	0.56 %	0.44 %	-	0.48 %

## **11. 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, 2013 and 2012 were \$6 million and \$7 million, respectively, and for the nine months ended September 30, 2013 and 2012 were \$17 million and \$18 million, respectively. The carrying amount of liabilities associated with AEPSC as of September 30, 2013 and December 31, 2012 was \$2 million and \$4 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

## **12. SUSTAINABLE COST REDUCTIONS**

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

TNC recorded a charge of \$1.5 million to Other Operation expense in 2012 primarily related to severance benefits as a result of the sustainable cost reductions initiative. In addition, the sustainable cost reduction activity for the nine months ended September 30, 2013 is described in the following table:

<b>Balance as of December 31, 2012</b>	<b>Expense Allocation from AEPSC</b>	<b>Incurred</b>	<b>Settled</b>	<b>Adjustments</b>	<b>Remaining Balance as of September 30, 2013</b>
(in thousands)					
\$ 371	\$ 36	-	\$ (108)	\$ (231)	68

These expenses, net of adjustments, relate primarily to severance benefits and are included primarily in Other Operation expense on the condensed statements of income. The remaining liability is included in Other Current Liabilities on the condensed balance sheets. Management does not expect additional costs to be incurred related to this initiative.