

# AEP Generating Company

2015 Annual Report

Audited Financial Statements





## TABLE OF CONTENTS

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## Page Number

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Glossary of Terms	1
Independent Auditors' Report	2
Statements of Income	3
Statements of Changes in Common Shareholder's Equity	4
Balance Sheets	5
Statements of Cash Flows	7
Index of Notes to Financial Statements	8

## GLOSSARY OF TERMS

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

<b>Term</b>	<b>Meaning</b>
AEGCo	AEP Generating Company, an AEP electric utility subsidiary.
AEP	American Electric Power Company, Inc., an investor-owned electric public utility holding company which includes American Electric Power Company, Inc. (Parent) and majority owned consolidated subsidiaries and consolidated affiliates.
AEP System	American Electric Power System, an electric system, owned and operated by AEP subsidiaries.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AFUDC	Allowance for Funds Used During Construction.
AGR	AEP Generation Resources Inc., a nonregulated AEP subsidiary that acquired the generation assets and liabilities of OPCo.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
ASU	Accounting Standards Update.
CCT	Cook Coal Terminal.
CWIP	Construction Work in Progress.
EIS	Energy Insurance Services, Inc., a nonaffiliated captive insurance company and consolidated variable interest entity of AEP.
FASB	Financial Accounting Standards Board.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
IRS	Internal Revenue Service.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
MW	Megawatt.
NSR	New Source Review.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
OPEB	Other Postretirement Benefit Plans.
Parent	American Electric Power Company, Inc., the equity owner of AEP subsidiaries within the AEP consolidation.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
Rockport Plant	A generation plant, consisting of two 1,310 MW coal-fired generating units near Rockport, Indiana. AEGCo and I&M jointly-own Unit 1. In 1989, AEGCo and I&M entered into a sale-and-leaseback transaction with Wilmington Trust Company, an unrelated, unconsolidated trustee for Rockport Plant, Unit 2.
SWEPCo	Southwestern Electric Power Company, an AEP electric utility subsidiary.
UMWA	United Mine Workers of America.
UPA	Unit Power Agreement.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholder of  
AEP Generating Company:

We have audited the accompanying financial statements of AEP Generating Company (the "Company"), which comprise the balance sheets as of December 31, 2015 and 2014, and the related statements of income, changes in common shareholder's equity, and cash flows for each of the three years in the period ended December 31, 2015, and the related notes to the financial statements.

### Management's Responsibility for the Financial Statements

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

### Auditors' Responsibility

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

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

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

### Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of AEP Generating Company as of December 31, 2015 and 2014, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2015 in accordance with accounting principles generally accepted in the United States of America.

*Deloitte & Touche LLP*

Columbus, Ohio  
February 23, 2016

**AEP GENERATING COMPANY**  
**STATEMENTS OF INCOME**  
For the Years Ended December 31, 2015, 2014 and 2013  
(in thousands)

	Years Ended December 31,		
	2015	2014	2013
<b>REVENUES</b>			
Sales to AEP Affiliates	\$ 541,667	\$ 571,829	\$ 507,771
Other Revenues – Affiliated	21,001	22,965	9,599
Other Revenues – Nonaffiliated	4,218	5,799	2,198
<b>TOTAL REVENUES</b>	<u>566,886</u>	<u>600,593</u>	<u>519,568</u>
<b>EXPENSES</b>			
Fuel and Other Consumables Used for Electric Generation	307,896	328,792	281,804
Rent – Rockport Plant, Unit 2	68,283	68,283	68,283
Other Operation	54,953	59,339	37,916
Maintenance	33,253	34,644	33,425
Depreciation and Amortization	44,949	42,033	40,061
Taxes Other Than Income Taxes	5,008	4,516	4,613
<b>TOTAL EXPENSES</b>	<u>514,342</u>	<u>537,607</u>	<u>466,102</u>
<b>OPERATING INCOME</b>	52,544	62,986	53,466
<b>Other Income (Expense):</b>			
Interest Income	—	44	242
Allowance for Equity Funds Used During Construction	1,232	1,396	215
Interest Expense	(11,736)	(12,376)	(12,992)
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	42,040	52,050	40,931
Income Tax Expense	12,677	24,001	16,870
<b>NET INCOME</b>	<u>\$ 29,363</u>	<u>\$ 28,049</u>	<u>\$ 24,061</u>

*The common stock of AEGCo is wholly-owned by Parent.*

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

**AEP GENERATING COMPANY**  
**STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY**  
**For the Years Ended December 31, 2015, 2014 and 2013**  
**(in thousands)**

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Total</u>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2012</b>	\$ 1,000	\$ 238,184	\$ 12,466	\$ 251,650
Contribution of Cook Coal Terminal from Parent		22,303		22,303
Common Stock Dividends			(29,000)	(29,000)
Net Income			24,061	24,061
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2013</b>	1,000	260,487	7,527	269,014
Common Stock Dividends			(25,500)	(25,500)
Net Income			28,049	28,049
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2014</b>	1,000	260,487	10,076	271,563
Common Stock Dividends			(34,450)	(34,450)
Net Income			29,363	29,363
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2015</b>	<u>\$ 1,000</u>	<u>\$ 260,487</u>	<u>\$ 4,989</u>	<u>\$ 266,476</u>

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

**AEP GENERATING COMPANY**  
**BALANCE SHEETS**  
**ASSETS**  
**December 31, 2015 and 2014**  
**(in thousands)**

	<b>December 31,</b>	
	<b>2015</b>	<b>2014</b>
<b>CURRENT ASSETS</b>		
Accounts Receivable:		
Customers	\$ 2,637	\$ 2,052
Affiliated Companies	43,845	45,122
Miscellaneous	17	540
Total Accounts Receivable	46,499	47,714
Fuel	46,522	35,007
Materials and Supplies	25,716	23,786
Accrued Tax Benefits	8,034	—
Prepayments and Other Current Assets	7,182	2,034
<b>TOTAL CURRENT ASSETS</b>	<b>133,953</b>	<b>108,541</b>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Electric:		
Generation	1,663,479	1,537,842
Transmission	9,688	9,688
Other Property, Plant and Equipment	37,887	38,760
Construction Work in Progress	73,630	116,698
<b>Total Property, Plant and Equipment</b>	1,784,684	1,702,988
Accumulated Depreciation and Amortization	1,056,847	1,021,688
<b>TOTAL PROPERTY, PLANT AND EQUIPMENT – NET</b>	<b>727,837</b>	<b>681,300</b>
<b>OTHER NONCURRENT ASSETS</b>		
Regulatory Assets	43,160	63,276
Deferred Charges and Other Noncurrent Assets	1,545	1,720
<b>TOTAL OTHER NONCURRENT ASSETS</b>	<b>44,705</b>	<b>64,996</b>
<b>TOTAL ASSETS</b>	<b>\$ 906,495</b>	<b>\$ 854,837</b>

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



**AEP GENERATING COMPANY**  
**BALANCE SHEETS**  
**LIABILITIES AND COMMON SHAREHOLDER'S EQUITY**  
**December 31, 2015 and 2014**

	<b>December 31,</b>	
	<b>2015</b>	<b>2014</b>
<b>CURRENT LIABILITIES</b>	<b>(in thousands)</b>	
Advances from Affiliates	\$ 113,908	\$ 31,161
Accounts Payable:		
General	19,411	11,430
Affiliated Companies	32,915	30,215
Long-term Debt Due Within One Year – Nonaffiliated	52,273	52,273
Accrued Taxes	5,555	18,097
Accrued Rent – Rockport Plant, Unit 2	4,963	4,963
Other Current Liabilities	6,312	6,946
<b>TOTAL CURRENT LIABILITIES</b>	<b>235,337</b>	<b>155,085</b>
<b>NONCURRENT LIABILITIES</b>		
Long-term Debt – Nonaffiliated	152,032	159,273
Deferred Income Taxes	87,636	81,643
Regulatory Liabilities and Deferred Investment Tax Credits	43,624	44,717
Deferred Gain on Sale-and-Leaseback – Rockport Plant, Unit 2	38,624	44,195
UMWA Pension Withdrawal Liability	38,617	40,186
Deferred Credits and Other Noncurrent Liabilities	44,149	58,175
<b>TOTAL NONCURRENT LIABILITIES</b>	<b>404,682</b>	<b>428,189</b>
<b>TOTAL LIABILITIES</b>	<b>640,019</b>	<b>583,274</b>
Commitments and Contingencies (Note 4)		
<b>COMMON SHAREHOLDER'S EQUITY</b>		
Common Stock – Par Value – \$1,000 Per Share:		
Authorized – 1,000 Shares		
Outstanding – 1,000 Shares	1,000	1,000
Paid-in Capital	260,487	260,487
Retained Earnings	4,989	10,076
<b>TOTAL COMMON SHAREHOLDER'S EQUITY</b>	<b>266,476</b>	<b>271,563</b>
<b>TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY</b>	<b>\$ 906,495</b>	<b>\$ 854,837</b>

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

**AEP GENERATING COMPANY**  
**STATEMENTS OF CASH FLOWS**  
**For the Years Ended December 31, 2015, 2014 and 2013**  
**(in thousands)**

	Years Ended December 31,		
	2015	2014	2013
<b>OPERATING ACTIVITIES</b>			
<b>Net Income</b>	\$ 29,363	\$ 28,049	\$ 24,061
<b>Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:</b>			
Depreciation and Amortization	44,949	42,033	40,061
Deferred Income Taxes	15,579	(747)	7,729
Deferred Investment Tax Credits	(1,965)	(1,967)	(1,984)
Amortization of Deferred Gain on Sale-and-Leaseback – Rockport Plant, Unit 2	(5,571)	(5,571)	(5,571)
Allowance for Equity Funds Used During Construction	(1,232)	(1,396)	(215)
Change in Other Noncurrent Assets	2,106	4,374	3,491
Change in Other Noncurrent Liabilities	(7,542)	7,890	2,656
<b>Changes in Certain Components of Working Capital:</b>			
Accounts Receivable	1,215	8,729	2,914
Fuel, Materials and Supplies	(13,445)	(6,924)	(91)
Accounts Payable	8,935	7,332	(11,280)
Accrued Taxes, Net	(20,576)	8,425	3,631
Other Current Assets	(5,886)	368	2,350
Other Current Liabilities	(734)	44	(2,269)
<b>Net Cash Flows from Operating Activities</b>	<u>45,196</u>	<u>90,639</u>	<u>65,483</u>
<b>INVESTING ACTIVITIES</b>			
Construction Expenditures	(85,011)	(61,771)	(59,199)
Other Investing Activities	174	2,724	476
<b>Net Cash Flows Used for Investing Activities</b>	<u>(84,837)</u>	<u>(59,047)</u>	<u>(58,723)</u>
<b>FINANCING ACTIVITIES</b>			
Change in Advances from Affiliates, Net	82,748	2,577	28,859
Retirement of Long-term Debt – Nonaffiliated	(7,273)	(7,273)	(7,273)
Principal Payments for Capital Lease Obligations	(1,384)	(1,398)	(887)
Dividends Paid on Common Stock	(34,450)	(25,500)	(29,000)
Other Financing Activities	—	2	1,541
<b>Net Cash Flows from (Used for) Financing Activities</b>	<u>39,641</u>	<u>(31,592)</u>	<u>(6,760)</u>
<b>Net Change in Cash and Cash Equivalents</b>	—	—	—
<b>Cash and Cash Equivalents at Beginning of Period</b>	—	—	—
<b>Cash and Cash Equivalents at End of Period</b>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
<b>SUPPLEMENTARY INFORMATION</b>			
Cash Paid for Interest, Net of Capitalized Amounts	\$ 11,066	\$ 11,553	\$ 12,229
Net Cash Paid for Income Taxes	19,676	10,676	1,037
Noncash Acquisitions Under Capital Leases	13	744	1,691
Construction Expenditures Included in Current Liabilities as of December 31,	2,214	108	582
Noncash Contribution of Cook Coal Terminal from Parent	—	—	22,303

See Notes to Financial Statements beginning on page 8.

## INDEX OF NOTES TO FINANCIAL STATEMENTS

Note	Page Number
Organization and Summary of Significant Accounting Policies	9
New Accounting Pronouncements	15
Effects of Regulation	17
Commitments, Guarantees and Contingencies	18
Benefit Plans	20
Business Segments	30
Fair Value Measurements	31
Income Taxes	32
Leases	35
Financing Activities	37
Related Party Transactions	39
Variable Interest Entities	41
Property, Plant and Equipment	42
Cost Reduction Program	44
Unaudited Quarterly Financial Information	45

## **1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### **ORGANIZATION**

AEGCo engages in the generation and wholesale sale of electric power to its affiliates, AGR, I&M and KPCo. AEGCo and I&M co-own Unit 1 of the Rockport Plant. Unit 2 of the Rockport Plant is owned by a third party and leased to I&M and AEGCo. I&M operates the Rockport Plant. AEGCo derives operating revenues from the sale of Rockport Plant energy and capacity to I&M and KPCo pursuant to FERC-approved long-term UPAs through December 2022. Under the terms of its UPA, I&M agreed to purchase all of AEGCo's Rockport energy and capacity unless it is sold to other utilities or affiliates. I&M assigned 30% of its rights to AEGCo's energy and capacity to KPCo.

In 2007, OPCo and AEGCo entered into a 10-year UPA for the entire output from the Lawrenceburg Plant. The UPA has an option for an additional 2-year period. I&M operates the plant under an agreement with AEGCo. Under the UPA, OPCo pays AEGCo for the capacity, depreciation, fuel, operation and maintenance and tax expenses. These payments are due regardless of whether the plant is operating. The fuel and operation and maintenance payments are based on actual costs incurred. All expenses are trueed up periodically. Effective January 1, 2014, OPCo assigned its rights and liabilities under the Lawrenceburg UPA to AGR, which includes AGR's option to extend for an additional 2 years.

The UPAs provide for a FERC-approved rate of return on common equity, a return on other capital (net of temporary cash investments) and recovery of costs including operation and maintenance, fuel and taxes. Under the terms of the UPAs, AEGCo accumulates all expenses monthly and prepares bills for its affiliates. In the month the expenses are incurred, AEGCo recognizes the billing revenues and establishes a receivable from the affiliated companies. The costs of operating the plants are billed to the affiliates receiving the benefits under the UPAs.

In 2013, OPCo transferred ownership of CCT to AEGCo. CCT performs coal transloading services for I&M and railcar maintenance services for I&M, PSO and SWEPCo.

The acquisition of CCT qualifies as an acquisition of a business under common control, which is typically accounted for as if the transfer had occurred at the beginning of the earliest period presented, pursuant to accounting guidance for "Business Combinations." However, management determined the retrospective application of this transfer to be quantitatively and qualitatively immaterial when taken as a whole in relation to AEGCo's financial statements. As a result, AEGCo's financial statements were not retrospectively adjusted to reflect the transfer.

### **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

#### ***Rates and Service Regulation***

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

The FERC regulates wholesale power markets and wholesale power transactions. AEGCo's wholesale power transactions are generally cost-based regulated under FERC-approved unit power agreements.

### ***Accounting for the Effects of Cost-Based Regulation***

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

### ***Use of Estimates***

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

### ***Inventory***

Fossil fuel inventories and materials and supplies inventories are carried at average cost.

### ***Property, Plant and Equipment***

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

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

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

### ***Allowance for Funds Used During Construction***

AFUDC represents the estimated cost of borrowed and equity funds used to finance construction projects that is capitalized and recovered through depreciation over the service life of regulated electric utility plant. AEGCo records the equity component of AFUDC in Other Income and the debt component of AFUDC as a reduction to Interest Expense.

### ***Valuation of Nonderivative Financial Instruments***

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

### ***Fair Value Measurements of Assets and Liabilities***

The accounting guidance for “Fair Value Measurements and Disclosures” establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). Where observable inputs are available for substantially the full term of the asset or liability, the instrument is categorized in Level 2. When quoted market prices are not available, pricing may be completed using comparable securities, dealer values, operating data and general market conditions to determine fair value. Valuation models utilize various inputs such as commodity, interest rate and, to a lesser degree, volatility and credit that include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets, market corroborated inputs (i.e. inputs derived principally from, or correlated to, observable market data) and other observable inputs for the asset or liability.

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

Assets in the benefits trusts are classified using the following methods. Equities are classified as Level 1 holdings if they are actively traded on exchanges. Items classified as Level 1 are investments in money market funds, fixed income and equity mutual funds and domestic equity securities. They are valued based on observable inputs primarily unadjusted quoted prices in active markets for identical assets. Items classified as Level 2 are primarily investments in individual fixed income securities and cash equivalent funds. Fixed income securities generally do not trade on exchanges and do not have an official closing price but their valuation inputs are based on observable market data. Pricing vendors calculate bond valuations using financial models and matrices. The models use observable inputs including yields on benchmark securities, quotes by securities brokers, rating agency actions, discounts or premiums on securities compared to par prices, changes in yields for U.S. Treasury securities, corporate actions by bond issuers, prepayment schedules and histories, economic events and, for certain securities, adjustments to yields to reflect changes in the rate of inflation. Other securities with model-derived valuation inputs that are observable are also classified as Level 2 investments. Investments with unobservable valuation inputs are classified as Level 3 investments. Benefit plan assets included in Level 3 are primarily real estate and private equity investments that are valued using methods requiring judgment including appraisals. The fair value of real estate investments is measured using market capitalization rates, recent sales of comparable investments and independent third-party appraisals. The fair value of private equity investments is measured using cost and purchase multiples, operating results, discounted future cash flows and market based comparable data. Depending on the specific situation, one or multiple approaches are used to determine the valuation of a real estate or private equity investment.

### ***Revenue Recognition and Accounts Receivable***

Under terms of the UPAs, AEGCo accumulates all expenses monthly and prepares bills for its affiliates. In the month the expenses are incurred, AEGCo recognizes the billing revenues and establishes receivables from the affiliate companies.

AEGCo also accumulates costs for its CCT division and prepares bills monthly for both affiliated and nonaffiliated companies.

### ***Maintenance***

Maintenance costs are expensed as incurred.

## ***Income Taxes and Investment Tax Credits***

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

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

Investment tax credits are accounted for under the flow-through method except where regulatory commissions have reflected investment tax credits in the rate-making process on a deferral basis. Investment tax credits that have been deferred are amortized over the life of the plant investment.

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

## ***Debt***

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

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

## ***Investments Held in Trust for Future Liabilities***

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

## ***Benefit Plans***

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

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

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

The objective of the investment policy for the pension fund is to maintain the funded status of the plan while providing for growth in the plan assets to offset the growth in the plan liabilities. The current target asset allocations are as follows:

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

  

<b>OPEB Plans Assets</b>	<b>Target</b>
Equity	65%
Fixed Income	33%
Cash and Cash Equivalents	2%

The investment policy for each benefit plan contains various investment limitations. The investment policies establish concentration limits for securities and prohibit the purchase of securities issued by AEP (with the exception of proportionate and immaterial holdings of AEP securities in passive index strategies). However, the investment policies do not preclude the benefit trust funds from receiving contributions in the form of AEP securities, provided that the AEP securities acquired by each plan may not exceed the limitations imposed by law.

For equity investments, the concentration limits are as follows:

- No security in excess of 5% of all equities.
- Cash equivalents must be less than 10% of an investment manager's equity portfolio.
- No individual stock may be more than 10% and 7% for pension and OPEB investments, respectively, of each manager's equity portfolio.
- No investment in excess of 5% of an outstanding class of any company.
- No securities may be bought or sold on margin or other use of leverage.

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

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

For obligations of non-government issuers within the fixed income portfolio, the following limitations apply:

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

Each investment manager's portfolio is compared to a diversified benchmark index.

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



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

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

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

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

### ***Earnings Per Share (EPS)***

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

### ***Subsequent Events***

Management reviewed subsequent events through February 23, 2016, the date that AEGCo's 2015 annual report was issued.

## **2. NEW ACCOUNTING PRONOUNCEMENTS**

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

### ***ASU 2014-08 "Presentation of Financial Statements and Property, Plant and Equipment" (ASU 2014-08)***

In April 2014, the FASB issued ASU 2014-08 changing the presentation of discontinued operations on the statements of income and other requirements for reporting discontinued operations. Under the new standard, a disposal of a component or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results when the component meets the criteria to be classified as held-for-sale or is disposed. The amendments in this update also require additional disclosures about discontinued operations and disposal of an individually significant component of an entity that does not qualify for discontinued operations. This standard must be prospectively applied to all reporting periods presented in financial reports issued after the effective date.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2014. If applicable, this standard will change the presentation of financial statements but will not affect the calculation of net income, comprehensive income or earnings per share. Management adopted ASU 2014-08 effective January 1, 2015. There were no events requiring the application of this new accounting guidance.

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

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

The FASB deferred implementation of ASU 2014-09 under the terms in ASU 2015-14, "Revenue from Contracts with Customers (Topic: 606): Deferral of the Effective Date." The new accounting guidance is effective for interim and annual periods beginning after December 15, 2017. Early adoption is permitted for annual periods beginning after December 15, 2016. As applicable, this standard may change the amount of revenue recognized in the income statements in each reporting period. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption on revenue or net income. Management plans to adopt ASU 2014-09 effective January 1, 2018.

### ***ASU 2015-01 "Income Statement – Extraordinary and Unusual Items" (ASU 2015-01)***

In January 2015, the FASB issued ASU 2015-01 eliminating the concept of extraordinary items for presentation on the face of the income statement. Under the new standard, a material event or transaction that is unusual in nature, infrequent or both shall be reported as a separate component of income from continuing operations. Alternatively, it may be disclosed in the notes to financial statements.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2015. As applicable, this standard may change the presentation of amounts in the income statements. Management adopted ASU 2015-01 effective January 1, 2016.

### ***ASU 2015-03 "Simplifying the Presentation of Debt Issuance Costs" (ASU 2015-03)***

In April 2015, the FASB issued ASU 2015-03 simplifying the presentation of debt issuance costs on the balance sheets. Under the new standard, debt issuance costs related to a recognized debt liability will be presented on the balance sheets as a direct deduction from the carrying amount of that debt liability, consistent with discounts.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2015 with early adoption permitted. Management adopted ASU 2015-03 in October 2015 and applied the new standard retrospectively for all periods presented. Prior to adoption, AEGCo included debt issuance costs in Deferred Charges and Other Noncurrent Assets on the balance sheets. The effect of the reclassification between assets and liabilities for AEGCo was \$727 thousand as of December 31, 2014.

***ASU 2015-05 “Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement” (ASU 2015-05)***

In April 2015, the FASB issued ASU 2015-05 providing guidance to customers about whether a cloud computing arrangement includes a software license. The new accounting guidance is effective for interim and annual periods beginning after December 15, 2015 with early adoption permitted. Management adopted ASU 2015-05 prospectively, effective January 1, 2016, with no impact on results of operations, financial position or cash flows.

***ASU 2015-11 “Simplifying the Measurement of Inventory” (ASU 2015-11)***

In July 2015, the FASB issued ASU 2015-11 simplifying the guidance on the subsequent measurement of inventory, excluding inventory measured using last-in, first-out or the retail inventory method. Under the new standard, inventory should be at the lower of cost and net realizable value. The new accounting guidance is effective for interim and annual periods beginning after December 15, 2016 with early adoption permitted. Management does not expect the new standard to impact its results of operations, financial position or cash flows. Management plans to adopt ASU 2015-11 prospectively, effective January 1, 2017.

***ASU 2015-17 “Balance Sheet Classification of Deferred Taxes” (ASU 2015-17)***

In November 2015, the FASB issued ASU 2015-17 simplifying the presentation of deferred income taxes on the balance sheets. Under the new standard, deferred tax assets and liabilities are classified as noncurrent on the balance sheets. The new accounting guidance is effective for annual periods beginning after December 15, 2016 with early adoption permitted. Management adopted ASU 2015-17 upon its issuance date and applied the new standard prospectively. As a result, the new standard impacted the December 31, 2015 presentation of deferred tax assets and liabilities on the balance sheet.

***ASU 2016-01 “Recognition and Measurement of Financial Assets and Financial Liabilities” (ASU 2016-01)***

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

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

### 3. EFFECTS OF REGULATION

Regulatory assets and liabilities are comprised of the following items:

<b>Regulatory Assets:</b>	<b>December 31,</b>		<b>Remaining</b>
	<b>2015</b>	<b>2014</b>	<b>Recovery Period</b>
	<b>(in thousands)</b>		
<b>Noncurrent Regulatory Assets</b>			
<b>Regulatory assets approved for recovery:</b>			
<u>Regulatory Assets Currently Earning a Return</u>			
Asset Retirement Obligation	\$ 2,676	\$ 2,770	29 years
<u>Regulatory Assets Currently Not Earning a Return</u>			
UMWA Pension Withdrawal	22,479	25,447	10 years
Pension and OPEB Funded Status	11,683	19,994	12 years
Income Taxes, Net	4,401	12,934	14 years
Unamortized Loss on Reacquired Debt	1,921	2,131	10 years
<b>Total Regulatory Assets Approved for Recovery</b>	<b>43,160</b>	<b>63,276</b>	
<b>Total Noncurrent Regulatory Assets</b>	<b>\$ 43,160</b>	<b>\$ 63,276</b>	
<b>Regulatory Liabilities:</b>	<b>December 31,</b>		<b>Remaining</b>
	<b>2015</b>	<b>2014</b>	<b>Refund Period</b>
	<b>(in thousands)</b>		
<b>Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits</b>			
<b>Regulatory liabilities approved for payment:</b>			
<u>Regulatory Liabilities Currently Paying a Return</u>			
Asset Removal Costs	\$ 30,005	\$ 29,132	(a)
Deferred Investment Tax Credits	13,619	15,585	7 years
<b>Total Regulatory Liabilities Approved for Payment</b>	<b>43,624</b>	<b>44,717</b>	
<b>Total Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits</b>	<b>\$ 43,624</b>	<b>\$ 44,717</b>	

(a) Relieved as removal costs are incurred.

#### **4. COMMITMENTS, GUARANTEES AND CONTINGENCIES**

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

For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material effect on the financial statements.

#### **COMMITMENTS**

##### ***Construction and Commitments***

AEGCo has substantial construction commitments to support its operations and environmental investments. In managing the overall construction program and in the normal course of business, AEGCo contractually commits to third-party construction vendors for certain material purchases and other construction services. AEGCo also purchases fuel, materials, supplies, services and property, plant and equipment under contract as part of its normal course of business. Certain supply contracts contain penalty provisions for early termination.

In accordance with the accounting guidance for "Commitments", the following table summarizes AEGCo's actual contractual commitments as of December 31, 2015:

<u>Contractual Commitments</u>	<u>Less Than 1 Year</u>	<u>2-3 Years</u>	<u>4-5 Years</u>	<u>After 5 Years</u>	<u>Total</u>
			(in thousands)		
Fuel Purchase Contracts (a)	\$ 18,723	\$ 37,344	\$ 37,395	\$ 7,725	\$ 101,187

(a) Represents contractual commitments to purchase coal and other consumables as fuel for electric generation along with related transportation of the fuel.

#### **GUARANTEES**

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

##### ***Letters of Credit***

AEGCo has \$45 million of variable rate Pollution Control Bonds supported by bilateral letters of credit for \$46 million. The letters of credit mature in July 2017.

##### ***Indemnifications and Other Guarantees***

###### ***Contracts***

AEGCo enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of December 31, 2015, there were no material liabilities recorded for any indemnifications.

## *Lease Obligations*

AEGCo leases certain equipment under master lease agreements. See “Master Lease Agreements” section of Note 9 for disclosure of lease residual value guarantees.

## **CONTINGENCIES**

### ***Insurance and Potential Losses***

AEGCo maintains insurance coverage normal and customary for an electric utility, subject to various deductibles. AEGCo also maintains property and casualty insurance that may cover certain physical damage or third-party injuries caused by cyber security incidents. Insurance coverage includes all risks of physical loss or damage to assets, subject to insurance policy conditions and exclusions. Covered property generally includes power plants, substations, facilities and inventories. The insurance programs also generally provide coverage against loss arising from certain claims made by third parties and are in excess of AEGCo’s retentions. Coverage is generally provided by a combination of the protected cell of EIS and/or various industry mutual and/or commercial insurance carriers.

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

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

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

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

### ***Rockport Plant Litigation***

In July 2013, the Wilmington Trust Company filed a complaint in U.S. District Court for the Southern District of New York against AEGCo and I&M alleging that it will be unlawfully burdened by the terms of the modified NSR consent decree after the Rockport Plant, Unit 2 lease expiration in December 2022. The terms of the consent decree allow the installation of environmental emission control equipment, repowering or retirement of the unit. The plaintiff further alleges that the defendants’ actions constitute breach of the lease and participation agreement. The plaintiff seeks a judgment declaring that the defendants breached the lease, must satisfy obligations related to installation of emission control equipment and indemnify the plaintiff. The New York court granted a motion to transfer this case to the U.S. District Court for the Southern District of Ohio. In October 2013, a motion to dismiss the case was filed on behalf of AEGCo and I&M. In January 2015, the court issued an opinion and order granting the motion in part and denying the motion in part. The court dismissed certain of the plaintiff’s claims. Several claims remain, including the claim for breach of the participation agreement and a claim alleging breach of an implied covenant of good faith and fair dealing. In June 2015, AEGCo and I&M filed a motion for partial judgment on the claims seeking dismissal of the breach of participation agreement claim as well as any claim for indemnification of costs associated with this case. The plaintiff subsequently filed an amended complaint to add another claim under the lease and also filed a motion for partial summary judgment. In November 2015, AEGCo and I&M filed a motion to strike the plaintiff’s motion for partial judgment and filed a motion to dismiss the case for failure to state a claim. Management will continue to defend against the remaining claims. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

## 5. BENEFIT PLANS

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

AEGCo participates in an AEP sponsored qualified pension plan. Substantially all of AEGCo’s employees who are not UMWA members are covered by the qualified plan. AEGCo also participates in OPEB plans sponsored by AEP to provide health and life insurance benefits for retired employees.

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

### *Actuarial Assumptions for Benefit Obligations*

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

Assumptions	Pension Plan		Other Postretirement Benefit Plans	
	2015	2014	2015	2014
Discount Rate	4.30%	4.00%	4.30%	4.00%
Rate of Compensation Increase	5.30% (a)	4.35% (a)	NA	NA

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

NA Not applicable.

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

For 2015, the rate of compensation increase assumed varies with the age of the employee, ranging from 3.5% per year to 12% per year, with an average increase of 5.3%.

### *Actuarial Assumptions for Net Periodic Benefit Costs*

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

Assumptions	Pension Plan			Other Postretirement Benefit Plans		
	2015	2014	2013	2015	2014	2013
Discount Rate	4.00%	4.70%	3.95%	4.00%	4.70%	3.95%
Expected Return on Plan Assets	6.00%	6.00%	6.50%	6.75%	6.75%	7.00%
Rate of Compensation Increase	4.35% (a)	4.85% (a)	4.85% (a)	NA	NA	NA

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

NA Not applicable.

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

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

<b>Health Care Trend Rates</b>	<b>2015</b>	<b>2014</b>
Initial	6.25%	6.50%
Ultimate	5.00%	5.00%
Year Ultimate Reached	2020	2020

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

	<b>1% Increase</b>	<b>1% Decrease</b>
	<b>(in thousands)</b>	
Effect on Total Service and Interest Cost Components of Net Periodic Postretirement Health Care Benefit Cost	\$ 775	\$ (578)
Effect on the Health Care Component of the Accumulated Postretirement Benefit Obligation	6,652	(5,231)

### ***Significant Concentrations of Risk within Plan Assets***

In addition to establishing the target asset allocation of plan assets, the investment policy also places restrictions on securities to limit significant concentrations within plan assets. The investment policy establishes guidelines that govern maximum market exposure, security restrictions, prohibited asset classes, prohibited types of transactions, minimum credit quality, average portfolio credit quality, portfolio duration and concentration limits. The guidelines were established to mitigate the risk of loss due to significant concentrations in any investment. The plans are monitored to control security diversification and ensure compliance with the investment policy. As of December 31, 2015, the assets were invested in compliance with all investment limits. See "Investments Held in Trust for Future Liabilities" section of Note 1 for limit details.



**Benefit Plan Obligations, Plan Assets and Funded Status as of December 31, 2015 and 2014**

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

	Pension Plan		Other Postretirement Benefit Plans	
	2015	2014	2015	2014
<b>Change in Benefit Obligation</b>				
Benefit Obligation as of January 1,	\$ 4,075	\$ 3,538	\$ 48,587	\$ 44,271
Service Cost	105	79	1,430	1,260
Interest Cost	155	174	1,960	2,139
Actuarial (Gain) Loss	(392)	475	(9,389)	964
Benefit Payments	(216)	(191)	(1,055)	(158)
Participant Contributions	—	—	30	38
Medicare Subsidy	—	—	86	73
<b>Benefit Obligation as of December 31,</b>	<b>\$ 3,727</b>	<b>\$ 4,075</b>	<b>\$ 41,649</b>	<b>\$ 48,587</b>
<b>Change in Fair Value of Plan Assets</b>				
Fair Value of Plan Assets as of January 1,	\$ 4,193	\$ 3,958	\$ 23,252	\$ 22,353
Actual Gain (Loss) on Plan Assets	28	404	(594)	966
Company Contributions	16	22	8,670	53
Participant Contributions	—	—	30	38
Benefit Payments	(216)	(191)	(1,055)	(158)
<b>Fair Value of Plan Assets as of December 31,</b>	<b>\$ 4,021</b>	<b>\$ 4,193</b>	<b>\$ 30,303</b>	<b>\$ 23,252</b>
<b>Funded (Underfunded) Status as of December 31,</b>	<b>\$ 294</b>	<b>\$ 118</b>	<b>\$ (11,346)</b>	<b>\$ (25,335)</b>

**Amounts Recognized on the Balance Sheets as of December 31, 2015 and 2014**

	Pension Plan		Other Postretirement Benefit Plans	
	2015	2014	2015	2014
<b>December 31,</b>				
<b>(in thousands)</b>				
Deferred Charges and Other Noncurrent Assets – Prepaid Benefit Costs	\$ 294	\$ 118	\$ 165	\$ 322
Deferred Credits and Other Noncurrent Liabilities – Accrued Long-term Benefit Liability	—	—	(11,511)	(25,657)
<b>Funded (Underfunded) Status</b>	<b>\$ 294</b>	<b>\$ 118</b>	<b>\$ (11,346)</b>	<b>\$ (25,335)</b>

*Amounts Included in Regulatory Assets as of December 31, 2015 and 2014*

<b>Components</b>	<b>Pension Plan</b>		<b>Other Postretirement Benefit Plans</b>	
	<b>December 31,</b>			
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
	<b>(in thousands)</b>			
Net Actuarial Loss	\$ 246	\$ 514	\$ 11,980	\$ 20,090
Prior Service Cost (Credit)	2	3	(545)	(613)
<b>Recorded as</b>				
Regulatory Assets	\$ 248	\$ 517	\$ 11,435	\$ 19,477

Components of the change in amounts included in Regulatory Assets during the years ended December 31, 2015 and 2014 are as follows:

<b>Components</b>	<b>Pension Plan</b>		<b>Other Postretirement Benefit Plans</b>	
	<b>December 31,</b>			
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
	<b>(in thousands)</b>			
Actuarial (Gain) Loss During the Year	\$ (189)	\$ 291	\$ (7,201)	\$ 1,485
Amortization of Actuarial Loss	(79)	(96)	(909)	(1,125)
Amortization of Prior Service Credit (Cost)	(1)	(1)	68	68
<b>Change for the Year Ended December 31,</b>	<u>\$ (269)</u>	<u>\$ 194</u>	<u>\$ (8,042)</u>	<u>\$ 428</u>

*Pension and Other Postretirement Benefits Plans' Assets*

The fair value tables within Pension and Other Postretirement Benefits Plans' Assets present the classification of assets for AEP within the fair value hierarchy. All Level 1, 2, 3 and Other amounts can be allocated to AEGCo as of December 31, 2015 and 2014 using the percentages in the table below:

<b>Pension Plan</b>		<b>Other Postretirement Benefit Plans</b>	
<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
0.1%	0.1%	1.9%	1.4%

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

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	\$ 315.7	\$ —	\$ —	\$ —	\$ 315.7	6.6 %
International	402.3	—	—	—	402.3	8.4 %
Options	—	15.6	—	—	15.6	0.3 %
Real Estate Investment Trusts	4.0	—	—	—	4.0	0.1 %
Common Collective Trust – Global	—	369.7	—	—	369.7	7.8 %
Common Collective Trust – International	—	16.1	—	—	16.1	0.3 %
Subtotal – Equities	722.0	401.4	—	—	1,123.4	23.5 %
Fixed Income:						
Common Collective Trust – Debt	—	34.2	—	—	34.2	0.7 %
United States Government and Agency Securities	—	421.9	—	—	421.9	8.9 %
Corporate Debt	—	1,983.2	—	—	1,983.2	41.6 %
Foreign Debt	—	421.4	0.1	—	421.5	8.8 %
State and Local Government	—	12.8	—	—	12.8	0.3 %
Other – Asset Backed	—	23.4	—	—	23.4	0.5 %
Subtotal – Fixed Income	—	2,896.9	0.1	—	2,897.0	60.8 %
Infrastructure	—	—	42.0	—	42.0	0.9 %
Real Estate	—	—	253.7	—	253.7	5.3 %
Alternative Investments	—	—	378.7	—	378.7	8.0 %
Securities Lending	—	263.0	—	—	263.0	5.5 %
Securities Lending Collateral (a)	—	—	—	(264.7)	(264.7)	(5.5)%
Cash and Cash Equivalents	—	48.6	—	—	48.6	1.0 %
Other – Pending Transactions and Accrued Income (b)	—	—	—	25.9	25.9	0.5 %
<b>Total</b>	<u>\$ 722.0</u>	<u>\$ 3,609.9</u>	<u>\$ 674.5</u>	<u>\$ (238.8)</u>	<u>\$ 4,767.6</u>	<u>100.0 %</u>

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

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

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

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

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

Asset Class	Level 1	Level 2	Level 3 (in millions)	Other	Total	Year End Allocation
Equities:						
Domestic	\$ 465.1	\$ —	\$ —	\$ —	\$ 465.1	29.5%
International	484.3	—	—	—	484.3	30.7%
Options	—	15.6	—	—	15.6	1.0%
Common Collective Trust – Global	—	19.0	—	—	19.0	1.2%
Common Collective Trust – International	—	12.6	—	—	12.6	0.8%
Subtotal – Equities	949.4	47.2	—	—	996.6	63.2%
Fixed Income:						
Common Collective Trust – Debt	—	100.9	—	—	100.9	6.4%
United States Government and Agency Securities	—	58.4	—	—	58.4	3.7%
Corporate Debt	—	117.7	—	—	117.7	7.4%
Foreign Debt	—	20.7	—	—	20.7	1.3%
State and Local Government	—	4.2	—	—	4.2	0.3%
Other – Asset Backed	—	8.4	—	—	8.4	0.5%
Subtotal – Fixed Income	—	310.3	—	—	310.3	19.6%
Trust Owned Life Insurance:						
International Equities	—	28.3	—	—	28.3	1.8%
United States Bonds	—	184.3	—	—	184.3	11.7%
Subtotal – Trust Owned Life Insurance	—	212.6	—	—	212.6	13.5%
Cash and Cash Equivalents	44.9	7.2	—	—	52.1	3.3%
Other – Pending Transactions and Accrued Income (a)	—	—	—	5.8	5.8	0.4%
<b>Total</b>	<b>\$ 994.3</b>	<b>\$ 577.3</b>	<b>\$ —</b>	<b>\$ 5.8</b>	<b>\$ 1,577.4</b>	<b>100.0%</b>

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

The following table presents the classification of pension plan assets for AEP within the fair value hierarchy as of December 31, 2014:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
			(in millions)			
Equities:						
Domestic	\$ 588.6	\$ —	\$ —	\$ —	\$ 588.6	11.9 %
International	502.2	—	—	—	502.2	10.1 %
Options	—	14.1	—	—	14.1	0.3 %
Real Estate Investment Trusts	54.3	—	—	—	54.3	1.1 %
Common Collective Trust – Global	—	377.0	—	—	377.0	7.6 %
Common Collective Trust – International	—	18.5	—	—	18.5	0.4 %
Subtotal – Equities	1,145.1	409.6	—	—	1,554.7	31.4 %
Fixed Income:						
Common Collective Trust – Debt	—	30.2	—	—	30.2	0.6 %
United States Government and Agency Securities	—	449.8	—	—	449.8	9.0 %
Corporate Debt	—	1,799.5	—	—	1,799.5	36.2 %
Foreign Debt	—	400.5	0.1	—	400.6	8.1 %
State and Local Government	—	14.9	—	—	14.9	0.3 %
Other – Asset Backed	—	29.1	—	—	29.1	0.6 %
Subtotal – Fixed Income	—	2,724.0	0.1	—	2,724.1	54.8 %
Infrastructure	—	—	12.5	—	12.5	0.3 %
Real Estate	—	—	235.8	—	235.8	4.7 %
Alternative Investments	—	—	378.9	—	378.9	7.6 %
Securities Lending	—	219.8	—	—	219.8	4.4 %
Securities Lending Collateral (a)	—	—	—	(221.5)	(221.5)	(4.5)%
Cash and Cash Equivalents	—	53.3	—	—	53.3	1.1 %
Other – Pending Transactions and Accrued Income (b)	—	—	—	9.9	9.9	0.2 %
<b>Total</b>	<b>\$ 1,145.1</b>	<b>\$ 3,406.7</b>	<b>\$ 627.3</b>	<b>\$ (211.6)</b>	<b>\$ 4,967.5</b>	<b>100.0 %</b>

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

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

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

	Foreign Debt	Infrastructure	Real Estate	Alternative Investments	Total Level 3
	(in millions)				
<b>Balance as of January 1, 2014</b>	\$ 0.1	\$ —	\$ 238.2	\$ 329.6	\$ 567.9
Actual Return on Plan Assets					
Relating to Assets Still Held as of the Reporting Date	—	(0.3)	5.5	32.0	37.2
Relating to Assets Sold During the Period	—	0.1	19.0	15.8	34.9
Purchases and Sales	—	12.7	(26.9)	1.5	(12.7)
Transfers into Level 3	—	—	—	—	—
Transfers out of Level 3	—	—	—	—	—
<b>Balance as of December 31, 2014</b>	<b>\$ 0.1</b>	<b>\$ 12.5</b>	<b>\$ 235.8</b>	<b>\$ 378.9</b>	<b>\$ 627.3</b>

The following table presents the classification of OPEB plan assets for AEP within the fair value hierarchy as of December 31, 2014:

<u>Asset Class</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>	<u>Year End Allocation</u>
			(in millions)			
Equities:						
Domestic	\$ 466.1	\$ —	\$ —	\$ —	\$ 466.1	27.5%
International	566.6	—	—	—	566.6	33.5%
Options	—	16.4	—	—	16.4	1.0%
Common Collective Trust – Global	—	29.6	—	—	29.6	1.8%
Subtotal – Equities	<u>1,032.7</u>	<u>46.0</u>	<u>—</u>	<u>—</u>	<u>1,078.7</u>	<u>63.8%</u>
Fixed Income:						
Common Collective Trust – Debt	—	103.7	—	—	103.7	6.1%
United States Government and Agency Securities	—	71.1	—	—	71.1	4.2%
Corporate Debt	—	125.5	—	—	125.5	7.4%
Foreign Debt	—	21.3	—	—	21.3	1.3%
State and Local Government	—	5.9	—	—	5.9	0.3%
Other – Asset Backed	—	4.9	—	—	4.9	0.3%
Subtotal – Fixed Income	<u>—</u>	<u>332.4</u>	<u>—</u>	<u>—</u>	<u>332.4</u>	<u>19.6%</u>
Trust Owned Life Insurance:						
International Equities	—	10.3	—	—	10.3	0.6%
United States Bonds	—	212.1	—	—	212.1	12.5%
Subtotal – Trust Owned Life Insurance	<u>—</u>	<u>222.4</u>	<u>—</u>	<u>—</u>	<u>222.4</u>	<u>13.1%</u>
Cash and Cash Equivalents	46.8	9.6	—	—	56.4	3.3%
Other – Pending Transactions and Accrued Income (a)	—	—	—	4.0	4.0	0.2%
<b>Total</b>	<u>\$ 1,079.5</u>	<u>\$ 610.4</u>	<u>\$ —</u>	<u>\$ 4.0</u>	<u>\$ 1,693.9</u>	<u>100.0%</u>

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

### ***Determination of Pension Expense***

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

As of December 31, 2015 and 2014, the accumulated benefit obligation for the qualified pension plan was \$3.6 million and \$3.9 million, respectively.

### ***Estimated Future Benefit Payments and Contributions***

AEGCo expects contributions and payments for the OPEB plans of \$2.7 million during 2016. Contributions to the pension trust, when needed, are at least the minimum amount required by the Employee Retirement Income Security Act and additional discretionary contributions may also be made to maintain the funded status of the plan.

The table below reflects the total benefits expected to be paid from the plan or from AEGCo's assets. The payments include the participants' contributions to the plan for their share of the cost. Future benefit payments are dependent on the number of employees retiring, whether the retiring employees elect to receive pension benefits as annuities or as lump sum distributions, future integration of the benefit plans with changes to Medicare and other legislation, future levels of interest rates and variances in actuarial results. The estimated payments for pension benefits and OPEB are as follows:

	<b>Pension Plan</b>	<b>Other Postretirement Benefit Plans</b>	
	<b>Pension Payments</b>	<b>Benefit Payments</b>	<b>Medicare Subsidy Receipts</b>
		(in thousands)	
2016	\$ 237	\$ 1,061	\$ 25
2017	253	1,126	28
2018	261	1,210	37
2019	260	1,329	44
2020	253	1,411	56
Years 2021 to 2025, in Total	1,303	7,879	445

### ***Components of Net Periodic Benefit Cost***

The following table provides the components of net periodic benefit cost for the years ended December 31, 2015, 2014 and 2013:

	<b>Pension Plan</b>			<b>Other Postretirement Benefit Plans</b>		
	Years Ended December 31,					
	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>
	(in thousands)					
Service Cost	\$ 105	\$ 79	\$ 25	\$ 1,430	\$ 1,260	\$ 680
Interest Cost	155	174	60	1,960	2,139	867
Expected Return on Plan Assets	(231)	(219)	(95)	(1,600)	(1,572)	(44)
Amortization of Prior Service Cost (Credit)	1	1	—	(68)	(68)	(28)
Amortization of Net Actuarial Loss	79	96	54	909	1,125	699
<b>Net Periodic Benefit Cost</b>	<u>\$ 109</u>	<u>\$ 131</u>	<u>\$ 44</u>	<u>\$ 2,631</u>	<u>\$ 2,884</u>	<u>\$ 2,174</u>

Estimated amounts expected to be amortized to net periodic benefit costs and the impact on the balance sheet during 2016 are shown in the following table:

<b>Components</b>	<b>Pension Plan</b>	<b>Other Postretirement Benefit Plans</b>
	(in thousands)	
Net Actuarial Loss	\$ 61	\$ 458
Prior Service Cost (Credit)	1	(68)
<b>Total Estimated 2016 Amortization</b>	<u>\$ 62</u>	<u>\$ 390</u>
<b>Expected to be Recorded as</b>		
Regulatory Asset	\$ 62	\$ 390
<b>Total</b>	<u>\$ 62</u>	<u>\$ 390</u>

### ***American Electric Power System Retirement Savings Plan***

AEGCo participates in an AEP sponsored defined contribution retirement savings plan, the American Electric Power System Retirement Savings Plan, for substantially all employees who are not covered by a retirement savings plan of the UMWA. This qualified plan offers participants an opportunity to contribute a portion of their pay, includes features under Section 401(k) of the Internal Revenue Code and provides for matching contributions. The matching contributions to the plan are 100% of the first 1% of eligible employee contributions and 70% of the next 5% of contributions. The cost for matching contributions totaled \$92 thousand in 2015, \$85 thousand in 2014 and \$26 thousand in 2013.

### ***UMWA Benefits***

AEGCo provides health and welfare benefits for certain unionized employees, retirees and their survivors who meet eligibility requirements. UMWA trustees make final interpretive determinations with regard to all benefits. AEGCo administers the health and welfare benefits and pays them from its general assets.

UMWA pension benefits are provided through the United Mine Workers of America 1974 Pension Plan (Employer Identification Number: 52-1050282, Plan Number 002), a multiemployer plan. The UMWA pension benefits are administered by a board of trustees appointed in equal numbers by the UMWA and the Bituminous Coal Operators' Association (BCOA), an industry bargaining association. AEP makes contributions to the United Mine Workers of America 1974 Pension Plan based on provisions in its labor agreement. The UMWA pension plan is different from single-employer plans as an employer's contributions may be used to provide benefits to employees of other participating employers. Required contributions not made by an employer may result in other employers bearing a greater amount of the unfunded plan obligations, while a withdrawing employer may be subject to a withdrawal liability. Under the Pension Protection Act of 2006 (PPA), the UMWA pension plan was in Critical and Declining Status for the plan year ending June 30, 2015 and in Critical Status for the plan year ending June 30, 2014, without utilization of extended amortization provisions. The Plan adopted a Rehabilitation Plan in February 2015, as required under the PPA. The prior funding improvement plan is no longer in effect.

Contributions to the UMWA pension plan in 2015, 2014 and 2013 were made under a collective bargaining agreement that is scheduled to expire December 31, 2017. The amounts contributed were immaterial and represent less than 5% of the total contributions in the plan's latest annual report for the years ended June 30, 2015, 2014 and 2013. UMWA pension contributions included a surcharge of 5% from December 2014 through June 2015. Beginning July 2015, the surcharge on contributions was increased to 10%. Under the terms of the UMWA pension plan, contributions will be required to continue beyond the expiration of the current collective bargaining agreement, whether or not the term of that agreement is extended or a subsequent agreement is entered, so long as both the UMWA pension plan remains in effect and AEGCo continues to operate the facility covered by the current collective bargaining agreement. The contribution rate applicable would be determined by reference to the National Bituminous Coal Wage Agreement between the UMWA and the BCOA. If the UMWA pension plan would terminate or AEGCo would cease operation of the facility without arranging for a successor operator to assume its liability, the withdrawal liability obligation would be triggered.

Based upon the plan to retrofit the Rockport Plant with dry sorbent injection technology to meet environmental emission control requirements and the timing of the closure of CCT expected to be in or after 2025, AEGCo records a UMWA pension withdrawal liability on the balance sheet. The UMWA pension withdrawal liability is re-measured annually and is based on the company's proportionate share of the plan's unfunded vested liabilities. As of December 31, 2015 and 2014, the liability balance was \$38.6 million and \$40.2 million, respectively. AEGCo also records a related UMWA pension withdrawal regulatory asset on the balance sheet which is being recovered through billings for transloading services and should be fully collected before the planned closure. As of December 31, 2015 and 2014, the regulatory asset balance was \$22.5 million and \$25.4 million, respectively.



## **6. BUSINESS SEGMENTS**

AEGCo has one reportable segment, an electricity generation business. AEGCo's other activities are insignificant.

## 7. FAIR VALUE MEASUREMENTS

### *Fair Value Measurements of Long-term Debt*

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

The 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 AEGCo’s Long-term Debt as of December 31, 2015 and 2014 are summarized in the following table:

	2015		2014	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
		(in thousands)		
Long-term Debt	\$ 204,305	\$ 247,738	\$ 211,546	\$ 261,598

## 8. INCOME TAXES

The details of AEGCo's income taxes as reported are as follows:

	Years Ended December 31,		
	2015	2014	2013
	(in thousands)		
Income Tax Expense (Credit):			
Current	\$ (937)	\$ 26,715	\$ 11,125
Deferred	15,579	(747)	7,729
Deferred Investment Tax Credits	(1,965)	(1,967)	(1,984)
<b>Income Tax Expense</b>	<u>\$ 12,677</u>	<u>\$ 24,001</u>	<u>\$ 16,870</u>

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

	Years Ended December 31,		
	2015	2014	2013
	(in thousands)		
Net Income	\$ 29,363	\$ 28,049	\$ 24,061
Income Tax Expense	12,677	24,001	16,870
<b>Pretax Income</b>	<u>\$ 42,040</u>	<u>\$ 52,050</u>	<u>\$ 40,931</u>
Income Taxes on Pretax Income at Statutory Rate (35%)	\$ 14,714	\$ 18,218	\$ 14,326
Increase (Decrease) in Income Taxes Resulting from the Following Items:			
Depreciation	3,692	4,200	2,357
AFUDC	(615)	(668)	(256)
Rockport Plant, Unit 2 Investment Tax Credit	374	374	374
Investment Tax Credits, Net	(1,965)	(1,967)	(1,984)
State and Local Income Taxes, Net	(511)	5,760	923
Tax Adjustments	(3,349)	(1,869)	1,446
Other	337	(47)	(316)
<b>Income Tax Expense</b>	<u>\$ 12,677</u>	<u>\$ 24,001</u>	<u>\$ 16,870</u>
<b>Effective Income Tax Rate</b>	30.2 %	46.1 %	41.2 %

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

	December 31,	
	2015	2014
	(in thousands)	
Deferred Tax Assets	\$ 45,062	\$ 52,137
Deferred Tax Liabilities	(132,698)	(132,797)
<b>Net Deferred Tax Liabilities</b>	<u>\$ (87,636)</u>	<u>\$ (80,660)</u>
Property Related Temporary Differences	\$ (98,507)	\$ (91,444)
Amounts Due from Customers for Future Federal Income Taxes	(311)	(2,557)
Deferred State Income Taxes	(3,682)	(5,481)
Net Deferred Gain on Sale-and-Leaseback – Rockport Plant, Unit 2	13,726	15,706
Postretirement Benefits	13,720	18,909
Regulatory Assets	(11,957)	(15,904)
All Other, Net	(625)	111
<b>Net Deferred Tax Liabilities</b>	<u>\$ (87,636)</u>	<u>\$ (80,660)</u>

## ***AEP System Tax Allocation Agreement***

AEGCo 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***

AEGCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011, 2012 and 2013 started in April 2014. 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, AEGCo 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.

AEGCo and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns. AEGCo and other AEP subsidiaries are currently under examination in several state and local jurisdictions. However, it is possible that previously filed tax returns have positions that may be challenged by these tax authorities. Management believes that adequate provisions for income taxes have been made for potential liabilities resulting from such challenges and that the ultimate resolution of these audits will not materially impact net income. AEGCo is no longer subject to state or local income tax examinations by tax authorities for years before 2009.

### ***Tax Credit Carryforward***

As of December 31, 2015 and 2014, AEGCo had unused federal income tax credits of \$133 thousand and \$137 thousand, respectively, not all of which have an expiration date. Included in the credit carryforward are federal general business tax credits of \$112 thousand and \$117 thousand as of December 31, 2015 and 2014, respectively. If these credits are not utilized, the federal general business tax credits will expire in the years 2031 through 2034.

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

### ***Uncertain Tax Positions***

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

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

	<b>Years Ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
	<b>(in thousands)</b>		
Interest Expense	\$ 213	\$ 166	\$ —
Interest Income	—	—	38
Reversal of Prior Period Interest Expense	—	31	—

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

	<b>December 31,</b>	
	<b>2015</b>	<b>2014</b>
	<b>(in thousands)</b>	
Accrual for Receipt of Interest	\$ —	\$ —
Accrual for Payment of Interest and Penalties	328	181

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

	<u>2015</u>	<u>2014</u>	<u>2013</u>
		<b>(in thousands)</b>	
<b>Balance as of January 1,</b>	\$ 4,928	\$ 208	\$ 971
Increase – Tax Positions Taken During a Prior Period	—	4,928	—
Decrease – Tax Positions Taken During a Prior Period	—	—	(763)
Increase – Tax Positions Taken During the Current Year	—	—	—
Decrease – Tax Positions Taken During the Current Year	—	—	—
Increase – Settlements with Taxing Authorities	—	4	—
Decrease – Lapse of the Applicable Statute of Limitations	—	(212)	—
<b>Balance as of December 31,</b>	<u>\$ 4,928</u>	<u>\$ 4,928</u>	<u>\$ 208</u>

The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate is \$4.9 million for 2015 and 2014 and \$0 for 2013. Management believes there will be no significant net increase or decrease in unrecognized tax benefits within 12 months of the reporting date.

### ***Federal Tax Legislation***

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

The Tax Increase Prevention Act of 2014 (the 2014 Act) was enacted in December 2014. Included in the 2014 Act was a one-year extension of the 50% bonus depreciation. The 2014 Act also retroactively extended the life of research and development, employment and several energy tax credits, which expired at the end of 2013. The enacted provisions did not materially impact AEGCo's net income or financial condition but did have a favorable impact on cash flows in 2015.

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

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

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

### ***State Tax Legislation***

Legislation was passed by the state of Indiana in May 2011 enacting a phased reduction in corporate income tax rate from 8.5% to 6.5%. The 8.5% Indiana corporate income tax rate will be reduced 0.5% each year beginning after June 30, 2012, with the final reduction occurring in years beginning after June 30, 2015.

During the third quarter of 2013, it was determined that the state of West Virginia had achieved certain minimum levels of shortfall reserve funds. As a result, the West Virginia corporate income tax rate was reduced from 7% to 6.5% in 2014.

The enacted provisions did not materially impact AEGCo's net income, cash flows or financial condition.

## 9. LEASES

Leases of property, plant and equipment are for remaining periods up to 9 years and require payments of related property taxes, maintenance and operating costs. The majority of the leases have purchase or renewal options and will be renewed or replaced by other leases.

Lease rentals for both operating and capital leases are generally charged to Other Operation and Maintenance expense in accordance with rate-making treatment for regulated operations. For capital leases, a capital lease asset and offsetting liability are recorded at the present value of the remaining lease payments for each reporting period. The components of rental costs are as follows:

Lease Rental Costs	Years Ended December 31,		
	2015	2014	2013
		(in thousands)	
Net Lease Expense on Operating Leases	\$ 77,285	\$ 77,558	\$ 73,574
Amortization of Capital Leases	1,383	1,336	893
Interest on Capital Leases	648	703	654
<b>Total Lease Rental Costs</b>	<u>\$ 79,316</u>	<u>\$ 79,597</u>	<u>\$ 75,121</u>

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

	December 31,	
	2015	2014
	(in thousands)	
<b>Property, Plant and Equipment Under Capital Leases</b>		
Generation	\$ 14,713	\$ 14,701
Other Property, Plant and Equipment	2,546	3,155
Total Property, Plant and Equipment Under Capital Leases	17,259	17,856
Accumulated Amortization	5,749	4,953
<b>Net Property, Plant and Equipment Under Capital Leases</b>	<u>\$ 11,510</u>	<u>\$ 12,903</u>
<b>Obligations Under Capital Leases</b>		
Noncurrent Liability	\$ 10,264	\$ 11,525
Liability Due Within One Year	1,246	1,378
<b>Total Obligations Under Capital Leases</b>	<u>\$ 11,510</u>	<u>\$ 12,903</u>

Future minimum lease payments consisted of the following as of December 31, 2015:

Future Minimum Lease Payments	Capital Leases	Noncancelable Operating Leases
	(in thousands)	
2016	\$ 1,837	\$ 82,578
2017	1,604	78,464
2018	1,353	78,444
2019	1,255	78,435
2020	1,248	78,320
Later Years	8,014	157,997
<b>Total Future Minimum Lease Payments</b>	15,311	<u>\$ 554,238</u>
Less Estimated Interest Element	3,801	
<b>Estimated Present Value of Future Minimum Lease Payments</b>	<u>\$ 11,510</u>	

### ***Master Lease Agreements***

AEGCo 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, AEGCo is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of December 31, 2015, the maximum potential loss for these lease agreements was \$34 thousand assuming the fair value of the equipment is zero at the end of the lease term.

### ***Rockport Lease***

AEGCo and I&M entered into a sale-and-leaseback transaction in 1989 with Wilmington Trust Company (Owner Trustee), an unrelated, unconsolidated trustee for Rockport Plant, Unit 2 (the Plant). The Owner Trustee was capitalized with equity from six owner participants with no relationship to AEP or any of its subsidiaries and debt from a syndicate of banks and securities in a private placement to certain institutional investors.

The gain from the sale was deferred and is being amortized over the term of the lease, which expires in 2022. The Owner Trustee owns the Plant and leases it to AEGCo and I&M. The lease is accounted for as an operating lease with the payment obligations included in the future minimum lease payments schedule earlier in this note. The lease term is for 33 years with potential renewal options. At the end of the lease term, AEGCo and I&M have the option to renew the lease or the Owner Trustee can sell the Plant. AEP, AEGCo and I&M have no ownership interest in the Owner Trustee and do not guarantee its debt. AEGCo's future minimum lease payments for this sale-and-leaseback transaction as of December 31, 2015 are as follows:

<u>Future Minimum Lease Payments</u>	<b>(in thousands)</b>
2016	\$ 73,854
2017	73,854
2018	73,854
2019	73,854
2020	73,854
Later Years	147,708
<b>Total Future Minimum Lease Payments</b>	<u><u>\$ 516,978</u></u>

## 10. FINANCING ACTIVITIES

### *Long-term Debt*

The following details long-term debt outstanding as of December 31, 2015 and 2014:

Type of Debt	Maturity	Interest Rate as of December 31,		Outstanding as of December 31,	
		2015	2014	2015	2014
Senior Unsecured Notes	2037	6.33%	6.33%	\$ 159,305	\$ 166,546
Pollution Control Bonds (a)	2015-2016 (b)	0.01%	0.05%	45,000	45,000
<b>Total Long-term Debt Outstanding</b>				<u>\$ 204,305</u>	<u>\$ 211,546</u>

- (a) For AEGCo's pollution control bonds, interest rates are subject to periodic adjustment and may be purchased on demand at periodic interest adjustment dates. Insurance policies support certain series.
- (b) AEGCo's pollution control bonds are subject to redemption earlier than the maturity date. Consequently, these bonds have been classified for maturity purposes as Long-term Debt Due Within One Year - Nonaffiliated on AEGCo's balance sheets.

Long-term debt outstanding as of December 31, 2015 is payable as follows:

	2016	2017	2018	2019	2020	After 2020	Total
				(in thousands)			
Principal Amount	\$ 52,273	\$ 7,273	\$ 7,273	\$ 7,273	\$ 7,273	\$ 123,635	\$ 205,000
Debt Issuance Costs							(695)
<b>Total Long-term Debt Outstanding</b>							<u>\$ 204,305</u>

### *Dividend Restrictions*

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

### *Federal Power Act*

The Federal Power Act prohibits AEGCo from participating "in the making or paying of any dividends of such public utility from any funds properly included in capital account." This restriction does not limit the ability of AEGCo to pay dividends out of retained earnings.

### *Leverage Restrictions*

Pursuant to the credit agreement leverage restrictions, AEGCo must maintain a percentage of debt to total capitalization at a level that does not exceed 67.5%. As of December 31, 2015, none of AEGCo's retained earnings have restrictions related to the payment of dividends to Parent.



### Corporate Borrowing Program – AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of AEP’s subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP’s utility subsidiaries. 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 December 31, 2015 and 2014 are included in Advances from Affiliates on AEGCo’s balance sheets. AEGCo’s Utility Money Pool activity and corresponding authorized borrowing limits for the years ended December 31, 2015 and 2014 are described in the following table:

<b>Year</b>	<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 December 31,</b>	<b>Authorized Short-Term Borrowing Limit</b>
<b>(in thousands)</b>						
2015	\$ 113,908	\$ —	\$ 46,892	\$ —	\$ 113,908	\$ 200,000
2014	59,541	26,099	14,852	9,324	31,161	200,000

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the years ended December 31, 2015, 2014 and 2013 are summarized in the following table:

<b>Years Ended December 31,</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>
2015	0.87%	0.37%	—%	—%	0.50%	—%
2014	0.59%	0.25%	0.33%	0.24%	0.31%	0.28%
2013	0.43%	0.24%	0.41%	0.31%	0.31%	0.36%

Interest expense and interest income related to the Utility Money Pool are included in Interest Expense and Interest Income, respectively, on AEGCo’s statements of income. For amounts borrowed from and advanced to the Utility Money Pool, AEGCo incurred the following amounts of interest expense and earned the following amounts of interest income, respectively, for the years ended December 31, 2015, 2014 and 2013:

	<b>Years Ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
	<b>(in thousands)</b>		
Interest Expense	\$ 236	\$ 24	\$ 172
Interest Income	—	13	112

## 11. RELATED PARTY TRANSACTIONS

For other related party transactions, also see “AEP System Tax Allocation Agreement” section of Note 8 and “Utility Money Pool – AEP System” section of Note 10.

### *Affiliated Revenues*

AEGCo’s revenues derived from sales to affiliates for the years ended December 31, 2015, 2014 and 2013 were \$542 million, \$572 million and \$508 million, respectively. These related party revenues are reported in Sales to AEP Affiliates on AEGCo’s statements of income.

### *Unit Power Agreements (UPA)*

#### *Lawrenceburg UPA*

In March 2007, OPCo and AEGCo entered into a 10-year UPA for the entire output from the Lawrenceburg Generating Station effective with AEGCo’s purchase of the plant in May 2007. AEGCo’s gross investment in the plant was \$760 million and \$740 million as of December 31, 2015 and 2014, respectively, net depreciation of \$446 million and \$439 million, respectively. Effective January 1, 2014, the Lawrenceburg UPA was assigned by OPCo to AGR. AGR has an option to extend the UPA for an additional two years. I&M operates the plant under an agreement with AEGCo. Under the UPA, AGR pays AEGCo for the capacity, depreciation, fuel, operation and maintenance and tax expenses. These payments are due regardless of whether the plant is operating. The fuel and operation and maintenance payments are based on actual costs incurred. All expenses are trued up periodically.

The following is a schedule by years of minimum future rentals associated with the Lawrenceburg operating lease as of December 31, 2015:

	<u>Future Minimum Lease Rentals</u>	<u>(in thousands)</u>
2016		\$ 38,832
2017		29,048
<b>Total Future Minimum Lease Rentals</b>		<u>\$ 67,880</u>

#### *UPA between AEGCo and I&M*

A UPA between AEGCo and I&M (the I&M Power Agreement) provides for the sale by AEGCo to I&M of all the power (and the energy associated therewith) available to AEGCo at the Rockport Plant unless it is sold to another utility. Subsequently, I&M assigns 30% of the power to KPCo. See the “UPA between AEGCo and KPCo” section below. I&M is obligated, whether or not power is available from AEGCo, to pay as a demand charge for the right to receive such power (and as an energy charge for any associated energy taken by I&M) net of amounts received by AEGCo from any other sources, sufficient to enable AEGCo to pay all its operating and other expenses, including a rate of return on the common equity of AEGCo as approved by the FERC. The I&M Power Agreement will continue in effect until the expiration of the lease term of Unit 2 of the Rockport Plant unless extended in specified circumstances.

#### *UPA between AEGCo and KPCo*

Pursuant to an assignment between I&M and KPCo and a UPA between KPCo and AEGCo, AEGCo sells KPCo 30% of the power (and the energy associated therewith) available to AEGCo from both units of the Rockport Plant. KPCo pays to AEGCo in consideration for the right to receive such power the same amounts which I&M would have paid AEGCo under the terms of the I&M Power Agreement for such entitlement. The KPCo UPA ends in December 2022.

### ***Cook Coal Terminal***

On August 1, 2013, OPCo transferred its interest in Cook Coal Terminal to AEGCo. Cook Coal Terminal performs coal transloading and storage services at cost for AGR, I&M and OPCo. AEGCo recorded revenues of \$15.9 million, \$16.9 million and \$7.1 million for the years ended December 31, 2015, 2014 and 2013, respectively, for transloading services provided. AEGCo included revenues for these services in Other Revenues - Affiliated and expenses in Other Operation expenses on the statements of income.

Cook Coal Terminal also performs railcar maintenance services at cost for I&M, PSO and SWEPCo. Beginning August 1, 2013 and through corporate separation in Ohio on December 31, 2013, Cook Coal Terminal also performed railcar maintenance services at cost for OPCo. AEGCo recorded revenues of \$5.1 million, \$6.1 million and \$2.5 million for the years ended December 31, 2015, 2014 and 2013, respectively, for railcar maintenance provided. AEGCo included revenues for these services in Other Revenues - Affiliated and expenses in Other Operation expenses on the statements of income.

### ***I&M Barging and Other Services***

I&M provides barging and other transportation services to affiliates. AEGCo recorded expenses of \$16.1 million, \$22.7 million and \$19.7 million for the years ended December 31, 2015, 2014 and 2013, respectively, for barging services provided by I&M. These expenses were recorded in Fuel and Other Consumables Used for Electric Generation on AEGCo's statements of income.

### ***Central Machine Shop***

APCo operates a facility which repairs and rebuilds specialized components for the generation plants across the AEP System. APCo defers the cost of performing these services on the balance sheet, then transfers the cost to the affiliate for reimbursement. AEGCo recorded its assigned portion of these billings as capital or maintenance expenses depending on the nature of the services received. These billings are recoverable under the UPAs. AEGCo's billed amounts were \$95 thousand, \$70 thousand and \$26 thousand for the years ended December 31, 2015, 2014 and 2013, respectively.

### ***Sales and Purchases of Property***

AEGCo had affiliated sales and purchases of electric property individually amounting to \$100 thousand or more and sales and purchases of meters and transformers. There were no gains or losses recorded on the transactions. The following table shows the sales and purchases, recorded at net book value, for the years ended December 31, 2015, 2014 and 2013:

	<b>Years Ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
	<b>(in thousands)</b>		
Sales	\$ 177	\$ 2,725	\$ 465
Purchases	5,182	—	—

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

## **12. 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 AEGCo is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE’s variability AEGCo 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. AEGCo 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. Parent is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC’s cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC’s cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. AEGCo’s total billings from AEPSC for the years ended December 31, 2015, 2014 and 2013 were \$9.4 million, \$9 million and \$8.3 million, respectively. The carrying amount of liabilities associated with AEPSC as of December 31, 2015 and 2014 was \$0.9 million and \$1 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

### 13. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is shown functionally on the face of AEGCo's balance sheets. The following table includes AEGCo's total plant balances for the years ended December 31, 2015 and 2014:

	Years Ended December 31,	
	2015	2014
	(in thousands)	
Regulated Property, Plant and Equipment		
Generation	\$ 1,663,479	\$ 1,537,842
Transmission	9,688	9,688
Other	37,757	38,630
CWIP	73,630	116,698
Less: Accumulated Depreciation	1,056,847	1,021,688
Total Regulated Property, Plant and Equipment - Net	727,707	681,170
Nonregulated Property, Plant and Equipment - Net	130	130
<b>Total Property, Plant and Equipment - Net</b>	<b>\$ 727,837</b>	<b>\$ 681,300</b>

#### Depreciation

AEGCo provides for depreciation of Property, Plant and Equipment on a straight-line basis over the estimated useful lives of property, generally using composite rates by functional class. The following table provides total regulated annual composite depreciation rates and depreciable lives for AEGCo. Nonregulated depreciation rate ranges and depreciable life ranges are Not Applicable or Not Meaningful (NM) for 2015, 2014 and 2013.

Functional Class of Property	2015		2014		2013	
	Annual Composite Depreciation Rate	Depreciable Life Ranges	Annual Composite Depreciation Rate	Depreciable Life Ranges	Annual Composite Depreciation Rate	Depreciable Life Ranges
		(in years)		(in years)		(in years)
Generation	2.7%	40 - 60	2.7%	31 - 37	2.6%	31 - 37
Transmission	1.5%	NM	1.5%	NM	1.5%	NM
Other	10.6%	NM	8.6%	NM	7.9%	NM

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

#### Asset Retirement Obligations (ARO)

AEGCo records ARO in accordance with the accounting guidance for "Asset Retirement and Environmental Obligations" for the retirement of ash disposal facilities and asbestos removal.

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

The following is a reconciliation of the 2015 and 2014 aggregate carrying amounts of ARO for AEGCo:

Year	ARO as of January 1,	Accretion Expense	Liabilities Incurred	Liabilities Settled	Revisions in Cash Flow Estimates	ARO as of December 31,
	(in thousands)					
2015	\$ 4,669	\$ 397	\$ —	\$ (24)	\$ 2,879	\$ 7,921
2014	4,340	343	—	(14)	—	4,669

***Allowance for Funds Used During Construction (AFUDC)***

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

	Years Ended December 31,		
	2015	2014	2013
	(in thousands)		
Allowance for Equity Funds Used During Construction	\$ 1,232	\$ 1,396	\$ 215
Allowance for Borrowed Funds Used During Construction	454	332	252

***Jointly-owned Electric Facilities***

AEGCo, jointly with I&M, owns one generating unit (Unit 1) of the Rockport Plant. AEGCo and I&M each have a 50% ownership share of the Rockport Plant. Using its own financing, each participating company is obligated to pay its share of the costs in the same proportion as its ownership interest. AEGCo's proportionate share of the operating costs associated with this facility is included in its statements of income and the investment and accumulated depreciation are reflected in its balance sheets under Property, Plant and Equipment as follows:

	Fuel Type	Percent of Ownership	Utility Plant in Service	Construction Work in Progress	Accumulated Depreciation
(in thousands)					
<b><u>AEGCo's Share as of December 31, 2015</u></b>					
Rockport Generating Plant (a)(b)	Coal	50.0%	\$ 918,919	\$ 56,836	\$ 624,125
<b><u>AEGCo's Share as of December 31, 2014</u></b>					
Rockport Generating Plant (a)(b)	Coal	50.0%	\$ 800,990	\$ 112,245	\$ 596,427

(a) Operated by I&M.

(b) Amounts include AEGCo's 50% ownership of both Unit 1 and capital additions for Unit 2. Unit 2 is subject to an operating lease with a non-affiliated company. See the "Rockport Lease" section of Note 9.

## **14. COST REDUCTION PROGRAM**

### ***2012 Sustainable Cost Reductions***

In April 2012, management initiated a process to identify strategic repositioning opportunities and efficiencies that will result in sustainable cost savings. Management selected a consulting firm to 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.

AEGCo recorded charges to Other Operation expense of \$298 thousand for the year ended December 31, 2013, primarily related to the sustainable cost reductions initiative. AEGCo had no employees at the time of the severances but received allocated expenses.

## 15. UNAUDITED QUARTERLY FINANCIAL INFORMATION

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

	<u>March 31</u>	<u>2015 Quarterly Periods Ended</u>		<u>December 31</u>	
		<u>June 30</u>	<u>September 30</u>		
		<u>(in thousands)</u>			
Total Revenues	\$ 148,992	\$ 138,740	\$ 154,026	\$ 125,128	
Operating Income	13,494	12,683	15,342	11,025	
Net Income	7,073	6,595	8,021	7,674	

  

	<u>March 31</u>	<u>2014 Quarterly Periods Ended</u>		<u>December 31</u>	
		<u>June 30</u>	<u>September 30</u>		
		<u>(in thousands)</u>			
Total Revenues	\$ 177,421	\$ 142,860	\$ 133,724	\$ 146,588	
Operating Income	15,561	15,298	16,155	15,972	
Net Income	7,725	6,009	6,657	7,658	