

# **AEP Texas North Company and Subsidiary**

2016 Second Quarter Report

Consolidated Financial Statements





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## GLOSSARY OF TERMS

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

<b>Term</b>	<b>Meaning</b>
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.
AOCI	Accumulated Other Comprehensive Income.
ASU	Accounting Standards Update.
FASB	Financial Accounting Standards Board.
FERC	Federal Energy Regulatory Commission.
FTR	Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices.
GAAP	Accounting Principles Generally Accepted in the United States of America.
IRS	Internal Revenue Service.
MTM	Mark-to-Market.
Nonutility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain nonutility subsidiaries.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
Parent	American Electric Power Company, Inc., the equity owner of AEP subsidiaries within the AEP consolidation.
PUCT	Public Utility Commission of Texas.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
TNC	AEP Texas North Company, an AEP electric utility subsidiary.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
**For the Three and Six Months Ended June 30, 2016 and 2015**  
(in thousands)  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
<b>REVENUES</b>				
Electric Transmission and Distribution	\$ 55,911	\$ 54,193	\$ 112,010	\$ 111,273
Sales to AEP Affiliates	19,433	19,987	34,574	42,067
Other Revenues	241	427	573	606
<b>TOTAL REVENUES</b>	<u>75,585</u>	<u>74,607</u>	<u>147,157</u>	<u>153,946</u>
<b>EXPENSES</b>				
Fuel and Other Consumables Used for Electric Generation	7,048	7,885	10,531	15,989
Other Operation	22,540	22,806	47,761	46,942
Maintenance	6,605	7,300	12,235	17,268
Depreciation and Amortization	16,486	15,624	29,727	30,100
Taxes Other Than Income Taxes	4,468	4,643	9,450	9,467
<b>TOTAL EXPENSES</b>	<u>57,147</u>	<u>58,258</u>	<u>109,704</u>	<u>119,766</u>
<b>OPERATING INCOME</b>	18,438	16,349	37,453	34,180
<b>Other Income (Expense):</b>				
Other Income	522	38	1,487	89
Interest Expense	<u>(6,045)</u>	<u>(4,912)</u>	<u>(11,721)</u>	<u>(9,812)</u>
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	12,915	11,475	27,219	24,457
Income Tax Expense	<u>3,933</u>	<u>3,983</u>	<u>7,870</u>	<u>8,447</u>
<b>NET INCOME</b>	<u>\$ 8,982</u>	<u>\$ 7,492</u>	<u>\$ 19,349</u>	<u>\$ 16,010</u>

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

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

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
**For the Three and Six Months Ended June 30, 2016 and 2015**  
**(in thousands)**  
**(Unaudited)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net Income	\$ 8,982	\$ 7,492	\$ 19,349	\$ 16,010
<b>OTHER COMPREHENSIVE INCOME, NET OF TAXES</b>				
Cash Flow Hedges, Net of Tax of \$117 and \$117 for the Three Months Ended June 30, 2016 and 2015, Respectively, and \$234 and \$234 for the Six Months Ended June 30, 2016 and 2015, Respectively	216	217	434	434
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$36 and \$41 for the Three Months Ended June 30, 2016 and 2015, Respectively, and \$72 and \$82 for the Six Months Ended June 30, 2016 and 2015, Respectively	68	76	135	152
<b>TOTAL OTHER COMPREHENSIVE INCOME</b>	<u>284</u>	<u>293</u>	<u>569</u>	<u>586</u>
<b>TOTAL COMPREHENSIVE INCOME</b>	<u>\$ 9,266</u>	<u>\$ 7,785</u>	<u>\$ 19,918</u>	<u>\$ 16,596</u>

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

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN**  
**COMMON SHAREHOLDER'S EQUITY**  
**For the Six Months Ended June 30, 2016 and 2015**  
**(in thousands)**  
**(Unaudited)**

	<b>Common Stock</b>	<b>Paid-in Capital</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Total</b>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2014</b>	\$ 137,214	\$ 3,276	\$ 249,195	\$ (17,595)	\$ 372,090
Capital Contribution from Parent		25,000			25,000
Common Stock Dividends			(12,000)		(12,000)
Net Income			16,010		16,010
Other Comprehensive Income				586	586
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2015</b>	<u>\$ 137,214</u>	<u>\$ 28,276</u>	<u>\$ 253,205</u>	<u>\$ (17,009)</u>	<u>\$ 401,686</u>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2015</b>	\$ 137,214	\$ 28,276	\$ 251,459	\$ (16,276)	\$ 400,673
Common Stock Dividends			(12,000)		(12,000)
Net Income			19,349		19,349
Other Comprehensive Income				569	569
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2016</b>	<u>\$ 137,214</u>	<u>\$ 28,276</u>	<u>\$ 258,808</u>	<u>\$ (15,707)</u>	<u>\$ 408,591</u>

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

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

**ASSETS**

**June 30, 2016 and December 31, 2015**

**(in thousands)**

**(Unaudited)**

	<b>June 30, 2016</b>	<b>December 31, 2015</b>
<b>CURRENT ASSETS</b>		
Advances to Affiliates	\$ 8,673	\$ 23,112
Accounts Receivable:		
Customers	14,129	13,265
Affiliated Companies	15,742	6,693
Accrued Unbilled Revenues	10,028	8,472
Miscellaneous	1,665	916
Allowance for Uncollectible Accounts	(479)	(355)
Total Accounts Receivable	<u>41,085</u>	<u>28,991</u>
Fuel	7,119	10,205
Materials and Supplies	13,687	14,184
Accrued Tax Benefits	37,043	6,240
Prepayments and Other Current Assets	422	961
<b>TOTAL CURRENT ASSETS</b>	<u>108,029</u>	<u>83,693</u>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Electric:		
Generation	336,630	342,542
Transmission	674,371	630,759
Distribution	796,299	776,057
Other Property, Plant and Equipment	109,575	101,012
Construction Work in Progress	73,993	78,308
<b>Total Property, Plant and Equipment</b>	<u>1,990,868</u>	<u>1,928,678</u>
Accumulated Depreciation and Amortization	607,337	591,910
<b>TOTAL PROPERTY, PLANT AND EQUIPMENT – NET</b>	<u>1,383,531</u>	<u>1,336,768</u>
<b>OTHER NONCURRENT ASSETS</b>		
Regulatory Assets	61,183	55,730
Long-term Risk Management Assets	19	—
Deferred Charges and Other Noncurrent Assets	16,690	37,300
<b>TOTAL OTHER NONCURRENT ASSETS</b>	<u>77,892</u>	<u>93,030</u>
<b>TOTAL ASSETS</b>	<u>\$ 1,569,452</u>	<u>\$ 1,513,491</u>

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



**AEP TEXAS NORTH COMPANY AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**LIABILITIES AND COMMON SHAREHOLDER'S EQUITY**  
**June 30, 2016 and December 31, 2015**  
**(Unaudited)**

	<b>June 30, 2016</b>	<b>December 31, 2015</b>
<b>(in thousands)</b>		
<b>CURRENT LIABILITIES</b>		
Advances from Affiliates	\$ 38,826	\$ —
Accounts Payable:		
General	20,450	27,402
Affiliated Companies	12,335	11,277
Long-term Debt Due Within One Year – Nonaffiliated	7	75,007
Risk Management Liabilities	14	111
Accrued Taxes	16,551	15,269
Accrued Interest	5,333	5,281
Other Current Liabilities	10,962	14,189
<b>TOTAL CURRENT LIABILITIES</b>	<b>104,478</b>	<b>148,536</b>
<b>NONCURRENT LIABILITIES</b>		
Long-term Debt – Nonaffiliated	543,325	468,158
Deferred Income Taxes	224,762	205,617
Regulatory Liabilities and Deferred Investment Tax Credits	199,352	193,127
Oklaunion Purchase Power Agreement	50,877	50,217
Deferred Credits and Other Noncurrent Liabilities	38,067	47,163
<b>TOTAL NONCURRENT LIABILITIES</b>	<b>1,056,383</b>	<b>964,282</b>
<b>TOTAL LIABILITIES</b>	<b>1,160,861</b>	<b>1,112,818</b>
Rate Matters (Note 4)		
Commitments and Contingencies (Note 5)		
<b>COMMON SHAREHOLDER'S EQUITY</b>		
Common Stock – Par Value – \$25 Per Share:		
Authorized – 7,800,000 Shares		
Outstanding – 5,488,560 Shares	137,214	137,214
Paid-in Capital	28,276	28,276
Retained Earnings	258,808	251,459
Accumulated Other Comprehensive Income (Loss)	(15,707)	(16,276)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY</b>	<b>408,591</b>	<b>400,673</b>
<b>TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY</b>	<b>\$ 1,569,452</b>	<b>\$ 1,513,491</b>

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

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Six Months Ended June 30, 2016 and 2015**  
(in thousands)  
(Unaudited)

	<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>
<b>OPERATING ACTIVITIES</b>		
<b>Net Income</b>	\$ 19,349	\$ 16,010
<b>Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:</b>		
Depreciation and Amortization	29,727	30,100
Deferred Income Taxes	17,797	4,608
Allowance for Equity Funds Used During Construction	(892)	5
Property Taxes	(7,054)	(6,801)
Change in Other Noncurrent Assets	(7,352)	(3,370)
Change in Other Noncurrent Liabilities	67	382
<b>Changes in Certain Components of Working Capital:</b>		
Accounts Receivable, Net	(12,094)	(542)
Fuel, Materials and Supplies	3,583	(393)
Accounts Payable	614	(2,502)
Accrued Taxes, Net	1,807	1,776
Other Current Assets	100	294
Other Current Liabilities	(3,546)	(2,876)
<b>Net Cash Flows from Operating Activities</b>	<b>42,106</b>	<b>36,691</b>
<b>INVESTING ACTIVITIES</b>		
Construction Expenditures	(85,366)	(74,887)
Change in Advances to Affiliates, Net	14,439	312
Proceeds from Sales of Assets	1,891	1,342
Other Investing Activities	274	751
<b>Net Cash Flows Used for Investing Activities</b>	<b>(68,762)</b>	<b>(72,482)</b>
<b>FINANCING ACTIVITIES</b>		
Capital Contribution from Parent	—	25,000
Change in Advances from Affiliates, Net	38,826	23,031
Retirement of Long-term Debt – Nonaffiliated	(4)	(3)
Principal Payments for Capital Lease Obligations	(485)	(391)
Dividends Paid on Common Stock	(12,000)	(12,000)
Other Financing Activities	319	154
<b>Net Cash Flows from Financing Activities</b>	<b>26,656</b>	<b>35,791</b>
<b>Net Change in Cash and Cash Equivalents</b>	<b>—</b>	<b>—</b>
<b>Cash and Cash Equivalents at Beginning of Period</b>	<b>—</b>	<b>—</b>
<b>Cash and Cash Equivalents at End of Period</b>	<b>\$ —</b>	<b>\$ —</b>
<b>SUPPLEMENTARY INFORMATION</b>		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 10,722	\$ 8,738
Net Cash Paid (Received) for Income Taxes	(7,302)	5,036
Noncash Acquisitions Under Capital Leases	2,431	401
Construction Expenditures Included in Current Liabilities as of June 30,	13,670	10,349

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

## INDEX OF CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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## **1. SIGNIFICANT ACCOUNTING MATTERS**

### ***General***

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

In the opinion of management, the unaudited condensed consolidated interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three and six months ended June 30, 2016 is not necessarily indicative of results that may be expected for the year ending December 31, 2016. The condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2015 financial statements and notes thereto, which are included in TNC's 2015 Annual Report.

Management reviewed subsequent events through July 28, 2016, the date that the second quarter 2016 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 TNC's business. The following final pronouncements will impact the financial statements.

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

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

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

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

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

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

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

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

### ***ASU 2016-02 “Accounting for Leases” (ASU 2016-02)***

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

The new accounting guidance is effective for annual periods beginning after December 15, 2018 with early adoption permitted. The guidance will be applied by means of a modified retrospective approach. The modified retrospective approach will require lessees and lessors to recognize and measure leases at the beginning of the earliest period presented as well as a number of optional practical expedients that entities may elect to apply. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption. Management expects the new standard to impact TNC’s financial position, but not TNC’s results of operations or cash flows. Management plans to adopt ASU 2016-02 effective January 1, 2019.

### ***ASU 2016-09 “Compensation – Stock Compensation” (ASU 2016-09)***

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

The new accounting guidance is effective for annual periods beginning after December 15, 2016. Early adoption is permitted in any interim or annual period. Certain provisions require retrospective/modified retrospective transition while others are to be applied prospectively. Management plans to adopt ASU 2016-09 effective January 1, 2017.

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

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

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

### 3. COMPREHENSIVE INCOME

#### *Presentation of Comprehensive Income*

The following tables provide the components of changes in AOCI and details of reclassifications from AOCI for the three and six months ended June 30, 2016 and 2015. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 6 for additional details.

#### **Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended June 30, 2016**

	<u>Cash Flow Hedges</u>		<u>Pension and OPEB</u>	<u>Total</u>
	<u>Interest Rate and Foreign Currency</u>			
	(in thousands)			
<b>Balance in AOCI as of March 31, 2016</b>	\$ (6,011)	\$ (9,980)		\$(15,991)
Change in Fair Value Recognized in AOCI	—	—		—
Amount of (Gain) Loss Reclassified from AOCI				
Interest Expense	334	—		334
Amortization of Prior Service Cost (Credit)	—	(16)		(16)
Amortization of Actuarial (Gains)/Losses	—	120		120
Reclassifications from AOCI, before Income Tax (Expense) Credit	334	104		438
Income Tax (Expense) Credit	118	36		154
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	216	68		284
Net Current Period Other Comprehensive Income (Loss)	216	68		284
<b>Balance in AOCI as of June 30, 2016</b>	<u>\$ (5,795)</u>	<u>\$ (9,912)</u>		<u>\$(15,707)</u>

#### **Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended June 30, 2015**

	<u>Cash Flow Hedges</u>		<u>Pension and OPEB</u>	<u>Total</u>
	<u>Interest Rate and Foreign Currency</u>			
	(in thousands)			
<b>Balance in AOCI as of March 31, 2015</b>	\$ (6,880)	\$ (10,422)		\$(17,302)
Change in Fair Value Recognized in AOCI	—	—		—
Amount of (Gain) Loss Reclassified from AOCI				
Interest Expense	334	—		334
Amortization of Prior Service Cost (Credit)	—	(16)		(16)
Amortization of Actuarial (Gains)/Losses	—	134		134
Reclassifications from AOCI, before Income Tax (Expense) Credit	334	118		452
Income Tax (Expense) Credit	117	42		159
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	217	76		293
Net Current Period Other Comprehensive Income (Loss)	217	76		293
<b>Balance in AOCI as of June 30, 2015</b>	<u>\$ (6,663)</u>	<u>\$ (10,346)</u>		<u>\$(17,009)</u>

**Changes in Accumulated Other Comprehensive Income (Loss) by Component  
For the Six Months Ended June 30, 2016**

	<u>Cash Flow Hedges</u>		<u>Total</u>
	<u>Interest Rate and Foreign Currency</u>	<u>Pension and OPEB</u>	
	<u>(in thousands)</u>		
<b>Balance in AOCI as of December 31, 2015</b>	\$ (6,229)	\$ (10,047)	\$ (16,276)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	668	—	668
Amortization of Prior Service Cost (Credit)	—	(33)	(33)
Amortization of Actuarial (Gains)/Losses	—	240	240
Reclassifications from AOCI, before Income Tax (Expense) Credit	668	207	875
Income Tax (Expense) Credit	234	72	306
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	434	135	569
Net Current Period Other Comprehensive Income (Loss)	434	135	569
<b>Balance in AOCI as of June 30, 2016</b>	<u>\$ (5,795)</u>	<u>\$ (9,912)</u>	<u>\$ (15,707)</u>

**Changes in Accumulated Other Comprehensive Income (Loss) by Component  
For the Six Months Ended June 30, 2015**

	<u>Cash Flow Hedges</u>		<u>Total</u>
	<u>Interest Rate and Foreign Currency</u>	<u>Pension and OPEB</u>	
	<u>(in thousands)</u>		
<b>Balance in AOCI as of December 31, 2014</b>	\$ (7,097)	\$ (10,498)	\$ (17,595)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	668	—	668
Amortization of Prior Service Cost (Credit)	—	(33)	(33)
Amortization of Actuarial (Gains)/Losses	—	267	267
Reclassifications from AOCI, before Income Tax (Expense) Credit	668	234	902
Income Tax (Expense) Credit	234	82	316
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	434	152	586
Net Current Period Other Comprehensive Income (Loss)	434	152	586
<b>Balance in AOCI as of June 30, 2015</b>	<u>\$ (6,663)</u>	<u>\$ (10,346)</u>	<u>\$ (17,009)</u>



#### 4. RATE MATTERS

As discussed in TNC's 2015 Annual Report, TNC is involved in rate and regulatory proceedings at the FERC and the PUCT. The Effects of Regulation note within TNC's 2015 Annual Report should be read in conjunction with this report to gain a complete understanding of material rate matters still pending that could impact net income, cash flows and possibly financial condition. The following discusses ratemaking developments in 2016 and updates TNC's 2015 Annual Report.

##### *Regulatory Assets Pending Final Regulatory Approval*

<u>Noncurrent Regulatory Assets</u>	<u>June 30, 2016</u>	<u>December 31, 2015</u>
	(in thousands)	
<u>Regulatory Assets Currently Not Earning a Return</u>		
Rate Case Expenses	\$ 3	\$ 3
<b>Total Regulatory Assets Pending Final Regulatory Approval</b>	<u>\$ 3</u>	<u>\$ 3</u>

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

##### *Distribution Cost Recovery Factor (DCRF)*

In April 2016, TNC filed a request with the PUCT for approval of a DCRF rider to allow recovery of eligible net distribution investments. The request included a revenue requirement of \$16 million to be effective September 2016. Amounts approved would be subject to refund based upon a prudence review of the investments in TNC's next base rate case. In June 2016, TNC and intervenors filed a settlement agreement with the PUCT. The settlement agreement included a proposed annual revenue requirement of \$11 million, effective September 2016. In July 2016, the PUCT approved the settlement agreement.

##### *TCC and TNC Merger*

In June 2016, TCC and TNC filed applications with the PUCT and FERC that requested approval to merge TCC and TNC into AEP Utilities, Inc. Upon merger, AEP Utilities, Inc. will change its name to AEP Texas Inc. The proposed merger would be effective December 31, 2016. The applications proposed no changes to current TCC and TNC rates. A hearing at the PUCT is scheduled for August 2016.

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

TNC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, TNC's business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation against TNC 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. The Commitments, Guarantees and Contingencies note within TNC's 2015 Annual Report should be read in conjunction with this report.

### **GUARANTEES**

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

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

##### *Contracts*

TNC enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of June 30, 2016, there were no material liabilities recorded for any indemnifications.

##### *Master Lease Agreements*

TNC leases certain equipment under master lease agreements. Under the lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, TNC is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of June 30, 2016, the maximum potential loss for these lease agreements was \$2.6 million assuming the fair value of the equipment is zero at the end of the lease term.

## 6. BENEFIT PLANS

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

### *Components of Net Periodic Benefit Cost*

The following tables provide the components of TNC's net periodic benefit cost (credit) for the plans for the three and six months ended June 30, 2016 and 2015:

	<b>Pension Plans</b>		<b>Other Postretirement Benefit Plans</b>	
	<b>Three Months Ended June 30,</b>		<b>Three Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>			
Service Cost	\$ 454	\$ 461	\$ 43	\$ 48
Interest Cost	1,078	1,021	348	315
Expected Return on Plan Assets	(1,461)	(1,456)	(639)	(658)
Amortization of Prior Service Cost (Credit)	22	22	(395)	(395)
Amortization of Net Actuarial Loss	431	538	186	101
<b>Net Periodic Benefit Cost (Credit)</b>	<b>\$ 524</b>	<b>\$ 586</b>	<b>\$ (457)</b>	<b>\$ (589)</b>

	<b>Pension Plans</b>		<b>Other Postretirement Benefit Plans</b>	
	<b>Six Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>			
Service Cost	\$ 907	\$ 922	\$ 85	\$ 95
Interest Cost	2,156	2,041	695	631
Expected Return on Plan Assets	(2,921)	(2,913)	(1,278)	(1,316)
Amortization of Prior Service Cost (Credit)	44	45	(789)	(789)
Amortization of Net Actuarial Loss	862	1,076	372	202
<b>Net Periodic Benefit Cost (Credit)</b>	<b>\$ 1,048</b>	<b>\$ 1,171</b>	<b>\$ (915)</b>	<b>\$ (1,177)</b>

## **7. BUSINESS SEGMENTS**

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

## 8. DERIVATIVES AND HEDGING

AEPSC is agent for and transacts on behalf of TNC.

### *Risk Management Strategies*

TNC's vehicle fleet is exposed to gasoline and diesel fuel price volatility. TNC utilizes financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. TNC does not hedge all fuel price risk. The gross notional volumes of TNC's outstanding derivative contracts for heating oil and gasoline as of June 30, 2016 and December 31, 2015 were 620 thousand gallons and 516 thousand gallons, respectively.

### *Cash Flow Hedging Strategies*

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

## ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND THE IMPACT ON THE FINANCIAL STATEMENTS

According to the accounting guidance for "Derivatives and Hedging," TNC reflects the fair values of derivative instruments subject to netting agreements with the same counterparty net of related cash collateral. For certain risk management contracts, TNC is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the June 30, 2016 and December 31, 2015 balance sheets, TNC had no netting of cash collateral received from third parties against short-term and long-term risk management assets and \$33 thousand and \$143 thousand, respectively, of cash collateral paid to third parties against short-term and long-term risk management liabilities.

The following tables represent the gross fair value impact of TNC's derivative activity on the balance sheets as of June 30, 2016 and December 31, 2015:

Fair Value of Derivative Instruments  
June 30, 2016

Balance Sheet Location	Risk Management Contracts Commodity (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
		(in thousands)	
Current Risk Management Assets	\$ —	\$ —	\$ —
Long-term Risk Management Assets	19	—	19
<b>Total Assets</b>	<b>19</b>	<b>—</b>	<b>19</b>
Current Risk Management Liabilities	47	(33)	14
Long-term Risk Management Liabilities	—	—	—
<b>Total Liabilities</b>	<b>47</b>	<b>(33)</b>	<b>14</b>
<b>Total MTM Derivative Contract Net Assets (Liabilities)</b>	<b>\$ (28)</b>	<b>\$ 33</b>	<b>\$ 5</b>

**Fair Value of Derivative Instruments**  
December 31, 2015

Balance Sheet Location	Risk Management Contracts Commodity (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
	(in thousands)		
Current Risk Management Assets	\$ —	\$ —	\$ —
Long-term Risk Management Assets	—	—	—
<b>Total Assets</b>	<u>—</u>	<u>—</u>	<u>—</u>
Current Risk Management Liabilities	254	(143)	111
Long-term Risk Management Liabilities	—	—	—
<b>Total Liabilities</b>	<u>254</u>	<u>(143)</u>	<u>111</u>
<b>Total MTM Derivative Contract Net Assets (Liabilities)</b>	<u>\$ (254)</u>	<u>\$ 143</u>	<u>\$ (111)</u>

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

The table below presents TNC’s activity of derivative risk management contracts for the three and six months ended June 30, 2016 and 2015:

**Amount of Gain (Loss) Recognized on  
Risk Management Contracts  
For the Three and Six Months Ended June 30, 2016 and 2015**

Location of Gain (Loss)	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(in thousands)			
Other Operation Expense	\$ (33)	\$ (75)	\$ (105)	\$ (181)
Maintenance Expense	(37)	(59)	(114)	(131)
Regulatory Assets (a)	159	183	224	277
Regulatory Liabilities (a)	—	—	—	—
<b>Total Gain (Loss) on Risk Management Contracts</b>	<u>\$ 89</u>	<u>\$ 49</u>	<u>\$ 5</u>	<u>\$ (35)</u>

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

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

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

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

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

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

TNC reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Interest Expense on its statements of income in those periods in which hedged interest payments occur. During the three and six months ended June 30, 2016 and 2015, TNC did not apply cash flow hedging to outstanding interest rate derivatives.

During the three and six months ended June 30, 2016 and 2015, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies discussed above.

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

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TNC's balance sheets as of June 30, 2016 and December 31, 2015 were:

#### **Impact of Cash Flow Hedges on the Condensed Balance Sheet**

	<b>Interest Rate</b>	
	<b>June 30, 2016</b>	<b>December 31, 2015</b>
	<b>(in thousands)</b>	
AOCI Loss Net of Tax	\$ (5,795)	\$ (6,229)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(869)	(869)

The actual amounts that TNC reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ from the estimate above due to market price changes. As of June 30, 2016, TNC is not hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions.

## 9. FAIR VALUE MEASUREMENTS

### *Fair Value Hierarchy and Valuation Techniques*

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

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

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

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

The book values and fair values of TNC’s Long-term Debt as of June 30, 2016 and December 31, 2015 are summarized in the following table:

	<u>June 30, 2016</u>		<u>December 31, 2015</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	<u>(in thousands)</u>			
Long-term Debt	\$ 543,332	\$ 607,223	\$ 543,165	\$ 566,317



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

The following tables set forth, by level within the fair value hierarchy, TNC's financial assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2016 and December 31, 2015. As required by the accounting guidance for "Fair Value Measurements and Disclosures," financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Management's assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. There have not been any significant changes in management's valuation techniques.

**Assets and Liabilities Measured at Fair Value on a Recurring Basis  
June 30, 2016**

<b>Assets:</b>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
<b>Risk Management Assets</b>					
Risk Management Commodity Contracts (a)	<u>\$ —</u>	<u>\$ 46</u>	<u>\$ —</u>	<u>\$ (27)</u>	<u>\$ 19</u>
<b>Liabilities:</b>					
<b>Risk Management Liabilities</b>					
Risk Management Commodity Contracts (a)	<u>\$ —</u>	<u>\$ 74</u>	<u>\$ —</u>	<u>\$ (60)</u>	<u>\$ 14</u>

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

<b>Liabilities:</b>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
<b>Risk Management Liabilities</b>					
Risk Management Commodity Contracts (a)	<u>\$ —</u>	<u>\$ 254</u>	<u>\$ —</u>	<u>\$ (143)</u>	<u>\$ 111</u>

(a) Amounts in "Other" column primarily represent counterparty netting of risk management and hedging contracts and associated cash collateral under the accounting guidance for "Derivatives and Hedging."

As of December 31, 2015, TNC had no assets measured at fair value on a recurring basis.

There were no transfers between Level 1 and Level 2 during the three and six months ended June 30, 2016 and 2015.

## **10. INCOME TAXES**

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

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

### ***Federal and State Income Tax Audit Status***

TNC and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011, 2012 and 2013 started in April 2014. TNC and other AEP subsidiaries received a Revenue Agents Report in April 2016, completing the 2011 through 2013 audit cycle indicating an agreed upon audit. However, the audit is awaiting final approval by the Congressional Joint Committee on Taxation. Although the outcome of tax audits is uncertain, in management's opinion, adequate provisions for federal income taxes have been made for potential liabilities resulting from such matters. In addition, TNC accrues interest on these uncertain tax positions. Management is not aware of any issues for open tax years that upon final resolution are expected to materially impact net income.

TNC and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns. TNC and other AEP subsidiaries are currently under examination in several state and local jurisdictions. 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. TNC is no longer subject to state or local income tax examinations by tax authorities for years before 2009.

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

In March 2016, the Texas Comptroller of Public Accounts issued clarifying guidance regarding the treatment of transmission and distribution expenses included in the computation of taxable income for purposes of calculating the Texas gross margins tax. The guidance clarified which specific transmission and distribution expenses are included in the computation of the cost of goods sold deduction. This guidance resulted in a net favorable adjustment of \$1 million during the first six months of 2016 to TNC's net income.

## 11. FINANCING ACTIVITIES

### *Long-term Debt*

Long-term debt principal payments made during the first six months of 2016 are shown in the table below:

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

In July 2016, TNC retired its variable rate \$75 million Other Long-term Debt due in 2016 and issued \$75 million of variable rate Other Long-term Debt due in 2019.

### *Dividend Restrictions*

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

### *Federal Power Act*

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

### *Leverage Restrictions*

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

### *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, and a Nonutility Money Pool, which funds a majority of AEP’s nonutility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions of the AEP System Utility Money Pool agreement filed with the FERC. The amounts of outstanding loans to or borrowings from the Utility Money Pool as of June 30, 2016 and December 31, 2015 are included in Advances to Affiliates and Advances from Affiliates, respectively, on TNC’s balance sheets. TNC’s Utility Money Pool activity and corresponding authorized borrowing limit for the six months ended June 30, 2016 are described in the following table:

<u>Maximum Borrowings from the Utility Money Pool</u>	<u>Maximum Loans to the Utility Money Pool</u>	<u>Average Borrowings from the Utility Money Pool</u>	<u>Average Loans to the Utility Money Pool</u>	<u>Borrowings from the Utility Money Pool as of June 30, 2016</u>	<u>Authorized Short-Term Borrowing Limit</u>
(in thousands)					
\$ 46,230	\$ 14,394	\$ 28,779	\$ 4,024	\$ 38,826	\$ 250,000

The activity in the above table does not include short-term lending activity of TNC's wholly-owned subsidiary, AEP Texas North Generation Company LLC (TNGC), which is a participant in the Nonutility Money Pool. The amounts of outstanding loans to the Nonutility Money Pool as of June 30, 2016 and December 31, 2015 are included in Advances to Affiliates on TNC's balance sheets. For the six months ended June 30, 2016, TNGC had the following activity in the Nonutility Money Pool:

<b>Maximum Borrowings from the Nonutility Money Pool</b>	<b>Maximum Loans to the Nonutility Money Pool</b>	<b>Average Borrowings from the Nonutility Money Pool</b>	<b>Average Loans to the Nonutility Money Pool</b>	<b>Loans to the Nonutility Money Pool as of June 30, 2016</b>
\$ —	\$ 8,719	(in thousands) \$ —	\$ 8,556	\$ 8,673

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the six months ended June 30, 2016 and 2015 are summarized in the following table:

<b>Six Months Ended June 30,</b>	<b>Maximum Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Minimum Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Maximum Interest Rate for Funds Loaned to the Utility Money Pool</b>	<b>Minimum Interest Rate for Funds Loaned to the Utility Money Pool</b>	<b>Average Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Average Interest Rate for Funds Loaned to the Utility Money Pool</b>
<b>2016</b>	0.84%	0.69%	0.82%	0.69%	0.76%	0.76%
<b>2015</b>	0.59%	0.39%	—%	—%	0.47%	—%

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Nonutility Money Pool for the six months ended June 30, 2016 and 2015 are summarized in the following table:

<b>Six Months Ended June 30,</b>	<b>Maximum Interest Rate for Funds Borrowed from the Nonutility Money Pool</b>	<b>Minimum Interest Rate for Funds Borrowed from the Nonutility Money Pool</b>	<b>Maximum Interest Rate for Funds Loaned to the Nonutility Money Pool</b>	<b>Minimum Interest Rate for Funds Loaned to the Nonutility Money Pool</b>	<b>Average Interest Rate for Funds Borrowed from the Nonutility Money Pool</b>	<b>Average Interest Rate for Funds Loaned to the Nonutility Money Pool</b>
<b>2016</b>	—%	—%	0.84%	0.69%	—%	0.75%
<b>2015</b>	—%	—%	0.59%	0.39%	—%	0.47%

## **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 TNC is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE’s variability TNC absorbs, guarantees of indebtedness, voting rights including kick-out rights, the power to direct the VIE, variable interests held by related parties and other factors. Management believes that significant assumptions and judgments were applied consistently. TNC is not the primary beneficiary of any VIE and has not provided financial or other support to any VIE that was not previously contractually required.

AEPSC provides certain managerial and professional services to AEP’s subsidiaries. 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. TNC’s total billings from AEPSC for the three months ended June 30, 2016 and 2015 were \$8.9 million and \$8.7 million, respectively, and for the six months ended June 30, 2016 and 2015 were \$18.6 million and \$16.7 million, respectively. The carrying amount of liabilities associated with AEPSC as of June 30, 2016 and December 31, 2015 was \$3.1 million and \$4.5 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

### 13. PROPERTY, PLANT AND EQUIPMENT

#### *Asset Retirement Obligations (ARO)*

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

The following is a reconciliation of the aggregate carrying amounts of ARO for TNC:

<u>ARO as of December 31, 2015</u>	<u>Accretion Expense</u>	<u>Liabilities Incurred</u>	<u>Liabilities Settled</u>	<u>Revisions in Cash Flow Estimates</u>	<u>ARO as of June 30, 2016</u>
			(in thousands)		
\$ 21,564	\$ 540	\$ —	\$ (15)	\$ (10,069) (a)	\$ 12,020

(a) Revision related to Oklaunion ash ponds.