

AEP Texas and Subsidiaries

2017 Third Quarter Report

Consolidated Financial Statements



An **AEP** Company

BOUNDLESS ENERGYSM

TABLE OF CONTENTS

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

GLOSSARY OF TERMS

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

Term	Meaning
AEP	American Electric Power Company, Inc., an investor-owned electric public utility holding company which includes American Electric Power Company, Inc. (Parent) and majority owned consolidated subsidiaries and consolidated affiliates.
AEP System	American Electric Power System, an electric system, owned and operated by AEP subsidiaries.
AEP Texas	AEP Texas, an AEP electric utility subsidiary.
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	Formerly AEP Texas Central Company, now a division of AEP Texas.
Texas Restructuring Legislation	Legislation enacted in 1999 to restructure the electric utility industry in Texas.
TNC	Formerly AEP Texas North Company, now a division of AEP Texas.
Transition Funding	AEP Texas Central Transition Funding I LLC, AEP Texas Central Transition Funding II LLC and AEP Texas Central Transition Funding III LLC, wholly-owned subsidiaries of TCC and consolidated variable interest entities formed for the purpose of issuing and servicing securitization bonds related to Texas Restructuring Legislation.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
Wind Farms	Desert Sky and Trent Wind Farms, previously owned by a subsidiary of AEP Utilities, Inc., were transferred to an affiliated company on December 31, 2016.

AEP TEXAS AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three and Nine Months Ended September 30, 2017 and 2016
(in millions)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
REVENUES				
Electric Transmission and Distribution	\$ 411.5	\$ 379.1	\$ 1,111.4	\$ 1,040.2
Sales to AEP Affiliates	18.9	24.4	50.8	57.0
Other Revenues	0.8	0.4	2.1	2.2
TOTAL REVENUES	431.2	403.9	1,164.3	1,099.4
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	8.3	14.2	17.2	24.7
Other Operation	116.6	119.5	330.1	327.9
Maintenance	19.3	15.8	58.1	51.3
Depreciation and Amortization	124.0	112.0	343.0	316.0
Taxes Other Than Income Taxes	33.3	30.0	93.3	81.3
TOTAL EXPENSES	301.5	291.5	841.7	801.2
OPERATING INCOME	129.7	112.4	322.6	298.2
Other Income (Expense):				
Interest Income	0.5	0.8	1.6	2.6
Allowance for Equity Used During Construction	—	2.0	2.2	7.0
Interest Expense	(35.3)	(36.2)	(105.6)	(108.5)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAX EXPENSE	94.9	79.0	220.8	199.3
Income Tax Expense	30.6	23.5	74.2	59.1
INCOME FROM CONTINUING OPERATIONS	64.3	55.5	146.6	140.2
LOSS FROM DISCONTINUED OPERATIONS, NET OF TAX	—	47.4	—	49.4
NET INCOME	\$ 64.3	\$ 8.1	\$ 146.6	\$ 90.8

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

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

AEP TEXAS AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Three and Nine Months Ended September 30, 2017 and 2016
(in millions)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Net Income	\$ 64.3	\$ 8.1	\$ 146.6	\$ 90.8
OTHER COMPREHENSIVE INCOME, NET OF TAXES				
Cash Flow Hedges, Net of Tax of \$0.2 and \$0.1 for the Three Months Ended September 30, 2017 and 2016, Respectively, and \$0.4 and \$0.4 for the Nine Months Ended September 30, 2017 and 2016, Respectively	0.2	0.3	0.7	0.8
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$0 and \$0 for the Three Months Ended September 30, 2017 and 2016, Respectively, and \$0.1 and \$0.1 for the Nine Months Ended September 30, 2017 and 2016, Respectively	0.1	—	0.2	0.2
TOTAL OTHER COMPREHENSIVE INCOME	<u>0.3</u>	<u>0.3</u>	<u>0.9</u>	<u>1.0</u>
TOTAL COMPREHENSIVE INCOME	<u>\$ 64.6</u>	<u>\$ 8.4</u>	<u>\$ 147.5</u>	<u>\$ 91.8</u>

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

AEP TEXAS AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN
COMMON SHAREHOLDER'S EQUITY
For the Nine Months Ended September 30, 2017 and 2016
(in millions)
(Unaudited)

	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2015	\$ 804.9	\$ 887.0	\$ (17.2)	\$ 1,674.7
Common Stock Dividends		(25.5)		(25.5)
Net Income		90.8		90.8
Other Comprehensive Income			1.0	1.0
TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2016	<u>\$ 804.9</u>	<u>\$ 952.3</u>	<u>\$ (16.2)</u>	<u>\$ 1,741.0</u>
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2016	\$ 857.9	\$ 814.1	\$ (14.9)	\$ 1,657.1
Capital Contribution from Parent	200.0			200.0
Net Income		146.6		146.6
Other Comprehensive Income			0.9	0.9
TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2017	<u>\$ 1,057.9</u>	<u>\$ 960.7</u>	<u>\$ (14.0)</u>	<u>\$ 2,004.6</u>

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

AEP TEXAS AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
ASSETS
September 30, 2017 and December 31, 2016
(in millions)
(Unaudited)

	September 30,	December 31,
	2017	2016
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 0.1	\$ 0.6
Restricted Cash for Securitized Transition Funding	123.0	146.3
Advances to Affiliates	445.6	8.6
Accounts Receivable:		
Customers	124.5	94.4
Affiliated Companies	12.1	11.8
Accrued Unbilled Revenues	81.9	64.8
Miscellaneous	0.2	0.1
Allowance for Uncollectible Accounts	(0.6)	(0.6)
Total Accounts Receivable	<u>218.1</u>	<u>170.5</u>
Fuel	4.1	9.8
Materials and Supplies	54.8	49.0
Risk Management Assets	0.1	0.2
Accrued Tax Benefits	13.1	0.7
Prepayments and Other Current Assets	6.5	3.5
TOTAL CURRENT ASSETS	<u>865.4</u>	<u>389.2</u>
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	350.6	349.6
Transmission	2,882.9	2,623.6
Distribution	3,679.3	3,527.2
Other Property, Plant and Equipment	465.1	436.4
Construction Work in Progress	554.1	385.9
Total Property, Plant and Equipment	<u>7,932.0</u>	<u>7,322.7</u>
Accumulated Depreciation and Amortization	1,592.3	1,542.0
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	<u>6,339.7</u>	<u>5,780.7</u>
OTHER NONCURRENT ASSETS		
Regulatory Assets	427.1	347.2
Securitized Transition Assets		
(September 30, 2017 and December 31, 2016 Amounts Include \$932 and \$1,088.3, Respectively, Related to Transition Funding)	956.2	1,118.7
Deferred Charges and Other Noncurrent Assets	91.5	73.3
TOTAL OTHER NONCURRENT ASSETS	<u>1,474.8</u>	<u>1,539.2</u>
TOTAL ASSETS	<u>\$ 8,679.9</u>	<u>\$ 7,709.1</u>

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

AEP TEXAS AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
September 30, 2017 and December 31, 2016
(in millions)
(Unaudited)

	<u>September 30,</u> <u>2017</u>	<u>December 31,</u> <u>2016</u>
CURRENT LIABILITIES		
Advances from Affiliates	\$ —	\$ 169.5
Accounts Payable:		
General	280.5	129.5
Affiliated Companies	23.2	30.5
Long-term Debt Due Within One Year – Nonaffiliated (September 30, 2017 and December 31, 2016 Amounts Include \$235.5 and \$222.2, Respectively, Related to Transition Funding)	306.4	263.1
Accrued Taxes	82.3	68.2
Accrued Interest (September 30, 2017 and December 31, 2016 Amounts Include \$11.6 and \$20.2, Respectively, Related to Transition Funding)	41.0	41.5
Other Current Liabilities	54.7	94.8
TOTAL CURRENT LIABILITIES	<u>788.1</u>	<u>797.1</u>
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated (September 30, 2017 and December 31, 2016 Amounts Include \$823.7 and \$1,023.6, Respectively, Related to Transition Funding)	3,416.1	2,954.6
Deferred Income Taxes	1,657.9	1,531.7
Regulatory Liabilities and Deferred Investment Tax Credits	696.1	660.8
Oklaunion Purchase Power Agreement	51.9	51.5
Deferred Credits and Other Noncurrent Liabilities	65.2	56.3
TOTAL NONCURRENT LIABILITIES	<u>5,887.2</u>	<u>5,254.9</u>
TOTAL LIABILITIES	<u>6,675.3</u>	<u>6,052.0</u>
Rate Matters (Note 4)		
Commitments and Contingencies (Note 5)		
COMMON SHAREHOLDER'S EQUITY		
Paid-in Capital	1,057.9	857.9
Retained Earnings	960.7	814.1
Accumulated Other Comprehensive Income (Loss)	(14.0)	(14.9)
TOTAL COMMON SHAREHOLDER'S EQUITY	<u>2,004.6</u>	<u>1,657.1</u>
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	<u>\$ 8,679.9</u>	<u>\$ 7,709.1</u>

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

AEP TEXAS AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2017 and 2016
(in millions)
(Unaudited)

	Nine Months Ended September 30,	
	2017	2016
OPERATING ACTIVITIES		
Net Income	\$ 146.6	\$ 90.8
Loss from Discontinued Operations, Net of Tax	—	(49.4)
Income from Continuing Operations	146.6	140.2
Adjustments to Reconcile Income from Continuing Operations to Net Cash Flows from Continuing Operating Activities:		
Depreciation and Amortization	343.0	316.0
Deferred Income Taxes	124.1	31.8
Allowance for Equity Funds Used During Construction	(2.2)	(7.0)
Mark-to-Market of Risk Management Contracts	0.1	(0.4)
Pension Contributions to Qualified Plant Trust	(8.8)	(8.2)
Property Taxes	(15.9)	(13.4)
Change in Regulatory Assets	(74.1)	2.1
Change in Other Noncurrent Assets	(27.3)	(18.0)
Change in Other Noncurrent Liabilities	7.4	(4.9)
Changes in Certain Components of Continuing Working Capital:		
Accounts Receivable, Net	(47.6)	(55.2)
Fuel, Materials and Supplies	(0.1)	7.9
Accounts Payable	77.3	(11.7)
Accrued Taxes, Net	1.7	(34.6)
Other Current Assets	(2.5)	(2.3)
Other Current Liabilities	(31.2)	(24.9)
Net Cash Flows from Continuing Operating Activities	490.5	317.4
INVESTING ACTIVITIES		
Construction Expenditures	(617.5)	(438.9)
Change in Restricted Cash for Securitized Transition Funding	23.3	92.6
Change in Advances to Affiliates, Net	(437.0)	152.9
Other Investing Activities	11.5	10.4
Net Cash Flows Used for Continuing Investing Activities	(1,019.7)	(183.0)
FINANCING ACTIVITIES		
Capital Contribution from Parent	200.0	—
Issuance of Long-term Debt – Nonaffiliated	749.9	199.2
Change in Advances from Affiliates, Net	(169.5)	88.6
Retirement of Long-term Debt – Nonaffiliated	(248.4)	(395.2)
Principal Payments for Capital Lease Obligations	(3.0)	(2.4)
Dividends Paid on Common Stock	—	(25.5)
Other Financing Activities	(0.3)	0.7
Net Cash Flows from (Used for) Continuing Financing Activities	528.7	(134.6)
Net Cash Flows from Discontinued Operating Activities	—	26.2
Net Cash Flows from Discontinued Investing Activities	—	0.4
Net Cash Flows Used for Discontinued Financing Activities	—	(25.7)
Net Increase (Decrease) in Cash and Cash Equivalents	(0.5)	0.7
Cash and Cash Equivalents at Beginning of Period	0.6	5.0
Cash and Cash Equivalents at End of Period	\$ 0.1	\$ 5.7
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 101.1	\$ 109.8
Net Cash Paid (Received) for Income Taxes	(23.3)	62.2
Noncash Acquisitions Under Capital Leases	5.3	5.8
Construction Expenditures Included in Current Liabilities as of September 30,	166.1	60.0

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

INDEX OF CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Page Number
Significant Accounting Matters	9
New Accounting Pronouncements	10
Comprehensive Income	13
Rate Matters	15
Commitments, Guarantees and Contingencies	16
Disposition	17
Benefit Plans	18
Derivatives and Hedging	19
Fair Value Measurements	22
Income Taxes	24
Financing Activities	25

1. SIGNIFICANT ACCOUNTING MATTERS

General

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

In the opinion of management, the unaudited condensed consolidated interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three and nine months ended September 30, 2017 is not necessarily indicative of results that may be expected for the year ending December 31, 2017. The condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2016 financial statements and notes thereto, which are included in AEP Texas' 2016 Annual Report.

Subsequent Events

Management reviewed subsequent events through October 26, 2017, the date that the third quarter 2017 report was available to be issued.

2. NEW ACCOUNTING PRONOUNCEMENTS

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

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

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

The FASB deferred implementation of ASU 2014-09 under the terms in ASU 2015-14, "Revenue from Contracts with Customers (Topic: 606): Deferral of the Effective Date." The new accounting guidance is effective for interim and annual periods beginning after December 15, 2018 with early adoption permitted.

Management continues to analyze the impact of the new revenue standard and related ASUs. During 2016 and 2017, revenue contract assessments were completed. Material revenue streams were identified within the AEP System and representative contract/transaction types were sampled. Performance obligations identified within each material revenue stream were evaluated to determine whether the obligations were satisfied at a point in time or over time. Contracts determined to be satisfied over time generally qualified for the invoicing practical expedient since the invoiced amounts reasonably represented the value to customers of performance obligations fulfilled to date. Based upon the completed assessments, management does not expect a material impact to the timing of revenue recognized or net income and plans to elect the modified retrospective transition approach upon adoption. The evaluation of revenue streams, new contracts and the new revenue standard's disclosure requirements continues during the fourth quarter of 2017, in particular with respect to various on going industry implementation issues. Management will continue to analyze the related impacts to revenue recognition and monitor any new industry implementation issues that arise. Further, given industry conclusions related to implementation issues, including contributions in aid of construction and collectability, management does not anticipate changes to current accounting systems. Management plans to adopt ASU 2014-09 effective January 1, 2018.

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 sheets 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, 2018 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 sheets 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, 2019 with early adoption permitted. The guidance will be applied by means of a modified retrospective approach. The modified retrospective approach will require lessees and lessors to recognize and measure leases at the beginning of the earliest period presented.

Management continues to analyze the impact of the new lease standard. During 2016 and 2017, lease contract assessments were completed. The AEP System lease population was identified and representative lease contracts were sampled. Based upon the completed assessments, management prepared a system gap analysis to outline new disclosure compliance requirements compared to current system capabilities. Multiple lease system options were also evaluated. Management plans to elect certain of the following practical expedients upon adoption:

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

Evaluation of new lease contracts continues and the process of implementing a compliant lease system solution began in the third quarter of 2017. Management expects the new standard to impact financial position, but not results of operations or cash flows. Management also continues to monitor unresolved industry implementation issues, including items related to pole attachments, easements and right-of-ways, and will analyze the related impacts to lease accounting. Management plans to adopt ASU 2016-02 effective January 1, 2019.

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

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

Management adopted ASU 2016-09 effective January 1, 2017. As a result of the adoption of this guidance, management made an accounting policy election to recognize the effect of forfeitures in compensation cost when they occur. There was an immaterial impact on results of operations and financial position and no impact on cash flows at adoption.

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

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

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

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

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

The new accounting guidance is effective for annual periods beginning after December 15, 2018. Early adoption is permitted in any interim or annual period. The guidance will be applied by means of a retrospective approach. Management is analyzing the impact of the new standard. Management plans to adopt ASU 2016-18 effective for the 2017 Annual Report.

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

In March 2017, the FASB issued ASU 2017-07 requiring that an employer report the service cost component of pension and postretirement benefits in the same line item or items as other compensation costs. The other components of net benefit cost are required to be presented in the statements of income separately from the service cost component and outside of a subtotal of income from operations. In addition, only the service cost component will be eligible for capitalization as applicable following labor. For 2016, AEP Texas’ actual non-service cost components were a credit of \$7 million, of which approximately 50% was capitalized.

The new accounting guidance is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early adoption is permitted as of the beginning of an annual period for which financial statements have not been issued or made available for issuance. Management plans to adopt ASU 2017-07 effective January 1, 2018.

ASU 2017-12 “Derivatives and Hedging” (ASU 2017-12)

In August 2017, the FASB issued ASU 2017-12 amending the recognition and presentation requirements for hedge accounting activities. The objectives are to improve the financial reporting of hedging relationships to better portray the economic results of an entity’s risk management activities in its financial statements and reduce the complexity of applying hedge accounting. Under the new standard, the concept of recognizing hedge ineffectiveness within the statements of income for cash flow hedges, which has historically been immaterial to AEP, will be eliminated. In addition, certain required tabular disclosures relating to fair value and cash flow hedges will be modified.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2019 with early adoption permitted for any interim or annual period after August 2017. Management is analyzing the impact of this new standard, including the possibility of early adoption, and at this time, cannot estimate the impact of adoption on net income.

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 nine months ended September 30, 2017 and 2016. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 7 for additional details.

Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended September 30, 2017

	<u>Cash Flow Hedges</u>		<u>Total</u>
	<u>Interest Rate</u>	<u>Pension and OPEB</u>	
	(in millions)		
Balance in AOCI as of June 30, 2017	\$ (4.9)	\$ (9.4)	\$ (14.3)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	0.3	—	0.3
Amortization of Prior Service Cost (Credit)	—	(0.1)	(0.1)
Amortization of Actuarial (Gains)/Losses	—	0.2	0.2
Reclassifications from AOCI, before Income Tax (Expense) Credit	0.3	0.1	0.4
Income Tax (Expense) Credit	0.1	—	0.1
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	0.2	0.1	0.3
Net Current Period Other Comprehensive Income	0.2	0.1	0.3
Balance in AOCI as of September 30, 2017	<u>\$ (4.7)</u>	<u>\$ (9.3)</u>	<u>\$ (14.0)</u>

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

	<u>Cash Flow Hedges</u>		<u>Total</u>
	<u>Interest Rate</u>	<u>Pension and OPEB</u>	
	(in millions)		
Balance in AOCI as of June 30, 2016	\$ (6.0)	\$ (10.5)	\$ (16.5)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	0.4	—	0.4
Amortization of Prior Service Cost (Credit)	—	(0.1)	(0.1)
Amortization of Actuarial (Gains)/Losses	—	0.1	0.1
Reclassifications from AOCI, before Income Tax (Expense) Credit	0.4	—	0.4
Income Tax (Expense) Credit	0.1	—	0.1
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	0.3	—	0.3
Net Current Period Other Comprehensive Income	0.3	—	0.3
Balance in AOCI as of September 30, 2016	<u>\$ (5.7)</u>	<u>\$ (10.5)</u>	<u>\$ (16.2)</u>

**Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Nine Months Ended September 30, 2017**

	<u>Cash Flow Hedges</u>		<u>Total</u>
	<u>Interest Rate</u>	<u>Pension and OPEB</u>	
	(in millions)		
Balance in AOCI as of December 31, 2016	\$ (5.4)	\$ (9.5)	\$ (14.9)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	1.0	—	1.0
Amortization of Prior Service Cost (Credit)	—	(0.1)	(0.1)
Amortization of Actuarial (Gains)/Losses	—	0.4	0.4
Reclassifications from AOCI, before Income Tax (Expense) Credit	1.0	0.3	1.3
Income Tax (Expense) Credit	0.3	0.1	0.4
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	0.7	0.2	0.9
Net Current Period Other Comprehensive Income	0.7	0.2	0.9
Balance in AOCI as of September 30, 2017	<u>\$ (4.7)</u>	<u>\$ (9.3)</u>	<u>\$ (14.0)</u>

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

	<u>Cash Flow Hedges</u>		<u>Total</u>
	<u>Interest Rate</u>	<u>Pension and OPEB</u>	
	(in millions)		
Balance in AOCI as of December 31, 2015	\$ (6.5)	\$ (10.7)	\$ (17.2)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	1.2	—	1.2
Amortization of Prior Service Cost (Credit)	—	(0.1)	(0.1)
Amortization of Actuarial (Gains)/Losses	—	0.4	0.4
Reclassifications from AOCI, before Income Tax (Expense) Credit	1.2	0.3	1.5
Income Tax (Expense) Credit	0.4	0.1	0.5
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	0.8	0.2	1.0
Net Current Period Other Comprehensive Income	0.8	0.2	1.0
Balance in AOCI as of September 30, 2016	<u>\$ (5.7)</u>	<u>\$ (10.5)</u>	<u>\$ (16.2)</u>

4. RATE MATTERS

As discussed in AEP Texas' 2016 Annual Report, AEP Texas is involved in rate and regulatory proceedings at the FERC and the PUCT. The Effects of Regulation note within AEP Texas' 2016 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 2017 and updates AEP Texas' 2016 Annual Report.

Regulatory Assets Pending Final Regulatory Approval

Noncurrent Regulatory Assets	September 30, 2017	December 31, 2016
	(in millions)	
<u>Regulatory Assets Currently Earning a Return</u>		
Storm-Related Costs	\$ 97.4	\$ 25.1
<u>Regulatory Assets Currently Not Earning a Return</u>		
Rate Case Expenses	0.1	0.1
Total Regulatory Assets Pending Final Regulatory Approval	<u>\$ 97.5</u>	<u>\$ 25.2</u>

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

AEP Texas Interim Transmission and Distribution Rates

As of September 30, 2017, AEP Texas' cumulative revenues from interim base rate increases from 2008 through 2017, subject to review, are estimated to be \$697 million. A base rate review could produce a refund if AEP Texas incurs a disallowance of the transmission or distribution investment on which an interim increase was based. Management is unable to determine a range of potential losses, if any, that are reasonably possible of occurring. A revenue decrease, including a refund of interim transmission and distribution rates, could reduce future net income and cash flows and impact financial condition.

Hurricane Harvey

In August 2017, Hurricane Harvey hit the coast of Texas, causing power outages in the AEP Texas service territory. AEP Texas has a PUCT approved catastrophe reserve in base rates and can defer incremental storm expenses. AEP Texas currently recovers approximately \$1 million of storm costs annually through base rates. As of September 30, 2017, the total balance of AEP Texas' deferred storm costs is approximately \$97 million including approximately \$73 million of incremental storm expenses as a regulatory asset related to Hurricane Harvey. Management is currently in the early stages of analyzing the impact of potential insurance claims and recoveries and, at this time, cannot estimate the impact of this amount. Any future insurance recoveries received will be applied to and will offset the regulatory asset and property, plant and equipment, as applicable. AEP Texas is currently evaluating recovery options for the regulatory asset; however, management believes the asset is probable of recovery. The other named hurricanes did not have a material impact on AEP's operations in the third quarter of 2017. If the ultimate costs of the incident are not recovered by insurance or through the regulatory process, it would have an adverse effect on future net income, cash flows and financial condition.

5. COMMITMENTS, GUARANTEES AND CONTINGENCIES

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

For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material effect on the financial statements. The Commitments, Guarantees and Contingencies note within AEP Texas' 2016 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.

Letters of Credit

An uncommitted facility gives the issuer of the facility the right to accept or decline each request made under the facility. AEP issues letters of credit on behalf of subsidiaries under five uncommitted facilities totaling \$445 million. As of September 30, 2017, AEP Texas' maximum future payment for letters of credit issued under the uncommitted credit facilities was \$3 million with a maturity of January 2018.

Indemnifications and Other Guarantees

Contracts

AEP Texas enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of September 30, 2017, there were no material liabilities recorded for any indemnifications.

Master Lease Agreements

AEP Texas leases certain equipment under master lease agreements. Under the lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, AEP Texas is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of September 30, 2017, the maximum potential loss for these lease agreements was \$10 million assuming the fair value of the equipment is zero at the end of the lease term.

6. DISPOSITION

2016

Wind Farms

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

In the fourth quarter of 2016, the Wind Farms were determined to be discontinued operations. Accordingly, results of operations of the Wind Farms have been classified as discontinued operations on AEP Texas' statements of income as shown in the following table:

	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2016
	(in millions)	
Revenue	\$ 4.8	\$ 13.2
Other Operation Expense	74.3	77.5
Maintenance Expense	0.7	2.8
Depreciation and Amortization Expense	2.8	8.4
Taxes Other Than Income Taxes	0.3	1.0
Total Expenses	<u>78.1</u>	<u>89.7</u>
Other Income (Expense)	(0.2)	(0.6)
Pretax Loss of Discontinued Operations	(73.5)	(77.1)
Income Tax Credit	<u>(26.1)</u>	<u>(27.7)</u>
Total Loss on Discontinued Operations as Presented on the Statements of Income	<u>\$ (47.4)</u>	<u>\$ (49.4)</u>

7. BENEFIT PLANS

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

Components of Net Periodic Benefit Cost

The following tables provide the components of AEP Texas' net periodic benefit cost (credit) for the plans:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended September 30,		Three Months Ended September 30,	
	2017	2016	2017	2016
	(in millions)			
Service Cost	\$ 2.1	\$ 1.9	\$ 0.3	\$ 0.2
Interest Cost	4.3	4.5	1.2	1.4
Expected Return on Plan Assets	(6.2)	(6.1)	(2.2)	(2.4)
Amortization of Prior Service Cost (Credit)	—	0.1	(1.5)	(1.5)
Amortization of Net Actuarial Loss	1.7	1.7	0.8	0.7
Net Periodic Benefit Cost (Credit)	\$ 1.9	\$ 2.1	\$ (1.4)	\$ (1.6)

	Pension Plans		Other Postretirement Benefit Plans	
	Nine Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(in millions)			
Service Cost	\$ 6.4	\$ 5.6	\$ 0.7	\$ 0.5
Interest Cost	12.9	13.3	3.7	3.9
Expected Return on Plan Assets	(18.8)	(18.2)	(6.6)	(7.1)
Amortization of Prior Service Cost (Credit)	—	0.3	(4.4)	(4.4)
Amortization of Net Actuarial Loss	5.2	5.2	2.4	2.1
Net Periodic Benefit Cost (Credit)	\$ 5.7	\$ 6.2	\$ (4.2)	\$ (5.0)

8. DERIVATIVES AND HEDGING

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

Risk Management Strategies

AEP Texas' vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEP Texas utilizes financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. AEP Texas does not hedge all fuel price risk. The gross notional volumes of AEP Texas' outstanding derivative contracts for heating oil and gasoline as of September 30, 2017 and December 31, 2016 were 2 million gallons and 2 million gallons, respectively.

Cash Flow Hedging Strategies

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

ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND THE IMPACT ON THE FINANCIAL STATEMENTS

According to the accounting guidance for "Derivatives and Hedging," AEP Texas reflects the fair values of derivative instruments subject to netting agreements with the same counterparty net of related cash collateral. For certain risk management contracts, AEP Texas is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the September 30, 2017 and December 31, 2016 balance sheets, AEP Texas netted \$80 thousand and \$185 thousand, respectively, of cash collateral received from third parties against short-term and long-term risk management assets.

The following tables represent the gross fair value impact of AEP Texas' derivative activity on the balance sheets:

Fair Value of Derivative Instruments September 30, 2017

Balance Sheet Location	Risk Management Contracts - Commodity (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
	(in millions)		
Current Risk Management Assets	\$ 0.2	\$ (0.1)	\$ 0.1
Long-term Risk Management Assets	—	—	—
Total Assets	0.2	(0.1)	0.1
Current Risk Management Liabilities	—	—	—
Long-term Risk Management Liabilities	—	—	—
Total Liabilities	—	—	—
Total MTM Derivative Contract Net Assets (Liabilities)	\$ 0.2	\$ (0.1)	\$ 0.1

Fair Value of Derivative Instruments December 31, 2016

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

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

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

**Amount of Gain (Loss) Recognized on
Risk Management Contracts**

<u>Location of Gain (Loss)</u>	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(in millions)			
Other Operation	\$ 0.1	\$ (0.1)	\$ 0.1	\$ (0.3)
Maintenance	0.1	(0.2)	0.1	(0.3)
Regulatory Assets (a)	0.1	0.1	—	0.7
Regulatory Liabilities (a)	0.1	—	(0.2)	—
Total Gain (Loss) on Risk Management Contracts	<u>\$ 0.4</u>	<u>\$ (0.2)</u>	<u>\$ —</u>	<u>\$ 0.1</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.

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

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

Accounting for Cash Flow Hedging Strategies

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

AEP Texas reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Interest Expense on its statements of income in those periods in which hedged interest payments occur. During the three and nine months ended September 30, 2017 and 2016, AEP Texas did not apply cash flow hedging to outstanding interest rate derivatives.

During the three and nine months ended September 30, 2017 and 2016, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies discussed above.

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

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

	Interest Rate	
	September 30,	December 31,
	2017	2016
	(in millions)	
AOCI Loss Net of Tax	\$ (4.7)	\$ (5.4)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(0.9)	(0.9)

The actual amounts that AEP Texas reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ from the estimate above due to market price changes. As of September 30, 2017, AEP Texas is not hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions.

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.

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.

For Restricted Cash for Securitized Transition Funding, items classified as Level 1 are investments in money market funds. They are valued based on observable inputs primarily unadjusted quoted prices in active markets for identical assets.

Fair Value Measurements of Long-term Debt

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

The book values and fair values of AEP Texas’ Long-term Debt are summarized in the following table:

	<u>September 30, 2017</u>		<u>December 31, 2016</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	<u>(in millions)</u>			
Long-term Debt	\$ 3,722.5	\$ 4,022.0	\$ 3,217.7	\$ 3,463.2

Fair Value Measurements of Financial Assets and Liabilities

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis September 30, 2017

Assets:	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in millions)				
Restricted Cash for Securitized Transition Funding	\$ 123.0	\$ —	\$ —	\$ —	\$ 123.0
Risk Management Assets					
Risk Management Commodity Contracts (a)	—	0.2	—	(0.1)	0.1
Total Assets	<u>\$ 123.0</u>	<u>\$ 0.2</u>	<u>\$ —</u>	<u>\$ (0.1)</u>	<u>\$ 123.1</u>

Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2016

Assets:	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in millions)				
Restricted Cash for Securitized Transition Funding	\$ 146.3	\$ —	\$ —	\$ —	\$ 146.3
Risk Management Assets					
Risk Management Commodity Contracts (a)	—	0.4	—	(0.2)	0.2
Total Assets	<u>\$ 146.3</u>	<u>\$ 0.4</u>	<u>\$ —</u>	<u>\$ (0.2)</u>	<u>\$ 146.5</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 September 30, 2017 and December 31, 2016, AEP Texas had no liabilities measured at fair value on a recurring basis.

There were no transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2017 and 2016.

10. INCOME TAXES

Effective Tax Rates (ETR)

The interim ETR for AEP Texas reflects the estimated annual ETR for 2017 and 2016, adjusted for tax expense associated with certain discrete items. The interim ETR differs from the federal statutory tax rate of 35% primarily due to tax adjustments, state income taxes and other book/tax differences which are accounted for on a flow-through basis.

The ETR for AEP Texas are included in the following table. Significant variances in the ETR are described below.

Three Months Ended September 30,		Nine Months Ended September 30,	
2017	2016	2017	2016
32.2%	29.7%	33.6%	29.7%

Three Months Ended September 30, 2017 Compared to Three Months Ended September 30, 2016

The increase in the ETR is primarily due to the recording of favorable state income tax adjustments in 2016 and an increase in pretax book income.

Nine Months Ended September 30, 2017 Compared to Nine Months Ended September 30, 2016

The increase in the ETR is primarily due to the recording of favorable state income tax adjustments in 2016.

Federal and State Income Tax Audit Status

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

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

11. FINANCING ACTIVITIES

Long-term Debt

Long-term debt issued, retired and principal payments made during the first nine months of 2017 are shown in the tables below:

<u>Type of Debt</u>	<u>Principal Amount (a)</u>	<u>Interest Rate</u>	<u>Due Date</u>
Issuances:	(in millions)	(%)	
Senior Unsecured Notes	\$ 400.0	2.40	2022
Pollution Control Bonds	60.0	1.75	2020
Senior Unsecured Notes	300.0	3.80	2047

<u>Type of Debt</u>	<u>Principal Amount Paid</u>	<u>Interest Rate</u>	<u>Due Date</u>
Retirements and Principal Payments:	(in millions)	(%)	
Securitization Bonds	\$ 27.2	0.88	2017
Securitization Bonds	161.2	5.17	2018
Pollution Control Bonds	60.0	5.20	2030

In October 2017, AEP Texas retired \$41 million of 5.625% Pollution Control Bonds due in 2017.

Dividend Restrictions

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

Federal Power Act

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

Leverage Restrictions

AEP Texas has credit agreements that contain a covenant that limit its debt to capitalization ratio to 67.5%. As of September 30, 2017, AEP Texas did not exceed its debt to capitalization limit. The payment of cash dividends indirectly results in an increase in the percentage of AEP Texas' debt to total capitalization. The method for calculating outstanding debt and capitalization is contractually defined in the credit agreements.

As of September 30, 2017, the Federal Power Act restriction does not limit the ability of AEP Texas to pay dividends out of retained earnings.

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 (borrowings from) the Utility Money Pool as of September 30, 2017 and December 31, 2016 are included in Advances to Affiliates and Advances from Affiliates on AEP Texas’ balance sheets. AEP Texas’ Utility Money Pool activity and corresponding authorized borrowing limit for the nine months ended September 30, 2017 are described in the following table:

Maximum Borrowings from the Utility Money Pool	Maximum Loans to the Utility Money Pool	Average Borrowings from the Utility Money Pool	Average Loans to the Utility Money Pool	Loans to the Utility Money Pool as of September 30, 2017	Authorized Short-Term Borrowing Limit
(in millions)					
\$ 296.0	\$ 451.7	\$ 194.8	\$ 430.0	\$ 437.3	\$ 400.0

The activity in the above table does not include short-term lending activity of AEP Texas’ wholly-owned subsidiary, AEP Texas North Generation Company LLC (TNGC), which is a participant in the Nonutility Money Pool. The amounts of outstanding loans to the Nonutility Money Pool as of September 30, 2017 and December 31, 2016 are included in Advances to Affiliates on AEP Texas’ balance sheets. For the nine months ended September 30, 2017, TNGC had the following activity in the Nonutility Money Pool:

Maximum Borrowings from the Nonutility Money Pool	Maximum Loans to the Nonutility Money Pool	Average Borrowings from the Nonutility Money Pool	Average Loans to the Nonutility Money Pool	Loans to the Nonutility Money Pool as of September 30, 2017
(in millions)				
\$ —	\$ 8.6	\$ —	\$ 8.3	\$ 8.3

In January 2017, management removed AEP Texas from the direct financing relationship with AEP to better reflect current business operations. The amounts of outstanding loans to AEP as of December 31, 2016 are included in Advances to Affiliates on AEP Texas’ balance sheets.

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

Nine Months Ended September 30,	Maximum Interest Rate for Funds Borrowed from the Utility Money Pool	Minimum Interest Rate for Funds Borrowed from the Utility Money Pool	Maximum Interest Rate for Funds Loaned to the Utility Money Pool	Minimum Interest Rate for Funds Loaned to the Utility Money Pool	Average Interest Rate for Funds Borrowed from the Utility Money Pool	Average Interest Rate for Funds Loaned to the Utility Money Pool
2017	1.49%	0.92%	1.43%	1.12%	1.29%	1.35%
2016	0.91%	0.75%	0.83%	0.69%	0.84%	0.72%

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

Nine Months Ended September 30,	Maximum Interest Rate for Funds Borrowed from the Nonutility Money Pool	Minimum Interest Rate for Funds Borrowed from the Nonutility Money Pool	Maximum Interest Rate for Funds Loaned to the Nonutility Money Pool	Minimum Interest Rate for Funds Loaned to the Nonutility Money Pool	Average Interest Rate for Funds Borrowed from the Nonutility Money Pool	Average Interest Rate for Funds Loaned to the Nonutility Money Pool
2017	—%	—%	1.49%	—%	—%	1.27%
2016	1.11%	0.97%	0.91%	0.75%	1.00%	0.82%

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

Nine Months Ended September 30,	Maximum Interest Rate for Funds Borrowed from AEP	Minimum Interest Rate for Funds Borrowed from AEP	Maximum Interest Rate for Funds Loaned to AEP	Minimum Interest Rate for Funds Loaned to AEP	Average Interest Rate for Funds Borrowed from AEP	Average Interest Rate for Funds Loaned to AEP
2017	—%	—%	—%	—%	—%	—%
2016	0.91%	0.69%	—%	—%	0.80%	—%