AEP Generating Company

2018 Third Quarter Report

Financial Statements

TABLE OF CONTENTS

	Page Number
Glossary of Terms	1
Condensed Statements of Income – Unaudited	2
Condensed Statements of Changes in Common Shareholder’s Equity – Unaudited	3
Condensed Balance Sheets – Unaudited	4
Condensed Statements of Cash Flows – Unaudited	6
Index of Condensed Notes to Condensed Financial Statements – Unaudited	7

GLOSSARY OF TERMS

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

Term	Meaning
AEGCo	AEP Generating Company, an AEP electric utility subsidiary.
AEP	American Electric Power Company, Inc., an investor-owned electric public utility holding company which includes American Electric Power Company, Inc. (Parent) and majority owned consolidated subsidiaries and consolidated affiliates.
AEP System	American Electric Power System, an electric system, owned and operated by AEP subsidiaries.
AFUDC	Allowance for Funds Used During Construction.
AGR	AEP Generation Resources Inc., a competitive AEP subsidiary in the Generation & Marketing segment.
ASU	Accounting Standards Update.
FASB	Financial Accounting Standards Board.
FERC	Federal Energy Regulatory Commission.
GAAP	Accounting Principles Generally Accepted in the United States of America.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
IRS	Internal Revenue Service.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
MW	Megawatt.
NO_x	Nitrogen oxide.
NSR	New Source Review.
OPEB	Other Postretirement Benefit Plans.
Parent	American Electric Power Company, Inc., the equity owner of AEP subsidiaries within the AEP consolidation.
Rockport Plant	A generation plant, consisting of two 1,310 MW coal-fired generating units near Rockport, Indiana. AEGCo and I&M jointly-own Unit 1. In 1989, AEGCo and I&M entered into a sale-and-leaseback transaction with Wilmington Trust Company, an unrelated, unconsolidated trustee for Rockport Plant, Unit 2.
SEC	U.S. Securities and Exchange Commission.
Tax Reform	On December 22, 2017, President Trump signed into law legislation referred to as the "Tax Cuts and Jobs Act" (the TCJA). The TCJA includes significant changes to the Internal Revenue Code of 1986, including a reduction in the corporate federal income tax rate from 35% to 21% effective January 1, 2018.
UMWA	United Mine Workers of America.
UPA	Unit Power Agreement.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.

AEP GENERATING COMPANY
CONDENSED STATEMENTS OF INCOME
For the Three and Nine Months Ended September 30, 2018 and 2017
(in thousands)
(Unaudited)

	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
REVENUES				
Sales to AEP Affiliates	$ 85,658	$ 89,193	$ 259,760	$ 258,533
Other Revenues – Affiliated	3,785	3,646	12,333	11,490
Other Revenues – Nonaffiliated	162	1,053	1,301	2,873
TOTAL REVENUES	89,605	93,892	273,394	272,896
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	42,458	47,470	132,598	126,924
Rent – Rockport Plant, Unit 2	17,070	17,070	51,212	51,212
Other Operation	5,578	5,750	17,578	20,146
Maintenance	5,501	5,010	15,976	16,672
Gain on Sale of Lawrenceburg Plant	—	—	—	(355,588)
Depreciation and Amortization	11,562	10,581	34,796	30,657
Taxes Other Than Income Taxes	1,146	1,116	3,383	3,329
TOTAL (INCOME) EXPENSES	83,315	86,997	255,543	(106,648)
OPERATING INCOME	6,290	6,895	17,851	379,544
Other Income (Expense):				
Interest Income	661	552	2,020	2,082
Allowance for Equity Funds Used During Construction	185	587	382	2,956
Non-Service Cost Components of Net Periodic Benefit Cost	261	142	782	427
Interest Expense	(1,298)	(853)	(3,791)	(3,792)
INCOME BEFORE INCOME TAX EXPENSE (CREDIT)	6,099	7,323	17,244	381,217
Income Tax Expense (Credit)	915	(1,369)	2,075	113,696
NET INCOME	$ 5,184	$ 8,692	$ 15,169	$ 267,521

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

See Condensed Notes to Condensed Financial Statements beginning on page 7.

AEP GENERATING COMPANY
CONDENSED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY
For the Nine Months Ended September 30, 2018 and 2017
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Total
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2016	$ 1,000	$ 285,487	$ 23,017	$ 309,504
Capital Contribution Returned to Parent		(110,000)		(110,000)
Common Stock Dividends			(200,000)	(200,000)
Net Income			267,521	267,521
TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2017	$ 1,000	$ 175,487	$ 90,538	$ 267,025
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2017	$ 1,000	$ 175,487	$ 94,475	$ 270,962
Net Income			15,169	15,169
TOTAL COMMON SHAREHOLDER'S EQUITY – SEPTEMBER 30, 2018	$ 1,000	$ 175,487	$ 109,644	$ 286,131

See Condensed Notes to Condensed Financial Statements beginning on page 7.

AEP GENERATING COMPANY
CONDENSED BALANCE SHEETS
ASSETS
September 30, 2018 and December 31, 2017
(in thousands)
(Unaudited)

	September 30, 2018	December 31, 2017
CURRENT ASSETS		
Advances to Affiliates	$ 140,792	$ 94,165
Accounts Receivable:		
Customers	115	31
Affiliated Companies	30,259	36,985
Miscellaneous	898	1,986
Total Accounts Receivable	31,272	39,002
Fuel	28,732	31,355
Materials and Supplies	18,408	19,456
Prepayments and Other Current Assets	7,665	3,379
TOTAL CURRENT ASSETS	226,869	187,357
PROPERTY, PLANT AND EQUIPMENT		
Electric Generation	1,123,017	1,111,563
Other Property, Plant and Equipment	34,929	35,316
Construction Work in Progress	33,576	27,721
Total Property, Plant and Equipment	1,191,522	1,174,600
Accumulated Depreciation and Amortization	709,241	677,587
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	482,281	497,013
OTHER NONCURRENT ASSETS		
Regulatory Assets	14,328	15,865
Deferred Charges and Other Noncurrent Assets	2,230	1,512
TOTAL OTHER NONCURRENT ASSETS	16,558	17,377
TOTAL ASSETS	$ 725,708	$ 701,747

See Condensed Notes to Condensed Financial Statements beginning on page 7.

AEP GENERATING COMPANY
CONDENSED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
September 30, 2018 and December 31, 2017
(Unaudited)

	September 30, 2018	December 31, 2017
CURRENT LIABILITIES	(in thousands)	
Accounts Payable:		
General	$ 2,458	$ 1,958
Affiliated Companies	18,115	19,988
Long-term Debt Due Within One Year – Nonaffiliated	169,973	169,891
Accrued Taxes	11,651	14,555
Accrued Rent – Rockport Plant, Unit 2	23,427	4,963
Other Current Liabilities	3,221	3,948
TOTAL CURRENT LIABILITIES	228,845	215,303
NONCURRENT LIABILITIES		
Deferred Income Taxes	32,100	30,131
Regulatory Liabilities and Deferred Investment Tax Credits	88,789	84,673
Deferred Gain on Sale-and-Leaseback – Rockport Plant, Unit 2	23,304	27,482
Deferred Credits and Other Noncurrent Liabilities	66,539	73,196
TOTAL NONCURRENT LIABILITIES	210,732	215,482
TOTAL LIABILITIES	439,577	430,785
Commitments and Contingencies (Note 3)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – $1,000 Per Share:		
Authorized – 1,000 Shares		
Outstanding – 1,000 Shares	1,000	1,000
Paid-in Capital	175,487	175,487
Retained Earnings	109,644	94,475
TOTAL COMMON SHAREHOLDER'S EQUITY	286,131	270,962
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	$ 725,708	$ 701,747

See Condensed Notes to Condensed Financial Statements beginning on page 7.

AEP GENERATING COMPANY
CONDENSED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2018 and 2017
(in thousands)
(Unaudited)

	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
OPERATING ACTIVITIES		
Net Income	$ 15,169	$ 267,521
Adjustments to Reconcile Net Income to Net Cash Flows from (Used for) Operating Activities:		
Depreciation and Amortization	34,796	30,657
Deferred Income Taxes	2,821	(22,588)
Amortization of Deferred Gain on Sale-and-Leaseback – Rockport Plant, Unit 2	(4,178)	(4,178)
Allowance for Equity Funds Used During Construction	(382)	(2,956)
Gain on Sale of Lawrenceburg Plant	—	(355,588)
Change in Other Noncurrent Assets	597	(2,594)
Change in Other Noncurrent Liabilities	(682)	(1,453)
Changes in Certain Components of Working Capital:		
Accounts Receivable	7,730	33,493
Fuel, Materials and Supplies	3,671	(411)
Accounts Payable	(1,368)	(28,946)
Accrued Taxes, Net	(5,573)	41,009
Accrued Rent – Rockport Plant, Unit 2	18,464	18,464
Other Current Assets	(3,959)	(7,915)
Other Current Liabilities	(492)	(3,064)
Net Cash Flows from (Used for) Operating Activities	66,614	(38,549)
INVESTING ACTIVITIES		
Construction Expenditures	(18,965)	(55,647)
Change in Advances to Affiliates, Net	(46,627)	(123,151)
Proceeds from Sale of Lawrenceburg Plant	—	726,300
Other Investing Activities	174	(7)
Net Cash Flows from (Used for) Investing Activities	(65,418)	547,495
FINANCING ACTIVITIES		
Capital Contribution Returned to Parent	—	(110,000)
Retirement of Long-term Debt – Nonaffiliated	—	(152,727)
Make Whole Premium on Extinguishment of Long-term Debt	—	(44,884)
Principal Payments for Capital Lease Obligations	(1,212)	(1,335)
Dividends Paid on Common Stock	—	(200,000)
Other Financing Activities	16	—
Net Cash Flows Used for Financing Activities	(1,196)	(508,946)
Net Change in Cash and Cash Equivalents	—	—
Cash and Cash Equivalents at Beginning of Period	—	—
Cash and Cash Equivalents at End of Period	$ —	$ —
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 3,192	$ 5,745
Net Cash Paid for Income Taxes	6,542	99,724
Noncash Acquisitions Under Capital Leases	30	21
Construction Expenditures Included in Current Liabilities as of September 30,	112	196

See Condensed Notes to Condensed Financial Statements beginning on page 7.

INDEX OF CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

Note	Page Number
Significant Accounting Matters	8
New Accounting Pronouncements	9
Commitments, Guarantees and Contingencies	12
Disposition	14
Benefit Plans	15
Fair Value Measurements	16
Income Taxes	17
Financing Activities	19
Revenue From Contracts With Customers	20

1. SIGNIFICANT ACCOUNTING MATTERS

General

The unaudited condensed 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 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, 2018 is not necessarily indicative of results that may be expected for the year ending December 31, 2018. The condensed financial statements are unaudited and should be read in conjunction with the audited 2017 financial statements and notes thereto, which are included in AEGCo's 2017 Annual Report.

Subsequent Events

Management reviewed subsequent events through October 25, 2018, the date that the third quarter 2018 report was available to be issued.

2. NEW ACCOUNTING PRONOUNCEMENTS

During FASB's standard-setting process and upon issuance of final pronouncements, management reviews the new accounting literature to determine its relevance, if any, to AEGCo's business. The following 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 changing 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.

Management adopted ASU 2014-09 effective January 1, 2018, by means of the modified retrospective approach for all contracts. The adoption of ASU 2014-09 did not have a material impact on results of operations, financial position or cash flows. In that regard, the application of the new standard did not cause any significant differences in any individual financial statement line items had those line items been presented in accordance with the guidance that was in effect prior to the adoption of the new standard. Further, given the lack of material impact to the financial statements, the adoption of the new standard did not give rise to any material changes in AEGCo's previously established accounting policies for revenue. See Note 9 - Revenue from Contracts with Customers for additional disclosures required by the new standard.

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 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. In July 2018, the FASB issued ASU 2018-11 "Leases (Topic 842): Targeted Improvements", which provides an optional expedient to adopt the new lease requirements through a cumulative-effect adjustment in the period of adoption. Management plans to apply the new optional transition guidance.

New leasing standard implementation activities to date include the identification of the lease population within the AEP System as well as the sampling of representative lease contracts to analyze accounting treatment under the new accounting guidance. Based upon the completed assessments, management also prepared a gap analysis to outline new disclosure compliance requirements. A lease system was selected after reviewing multiple system options. System implementation activities of core functionality continue in the fourth quarter of 2018. Implementation of reporting functionality designed to meet new disclosure requirements is ongoing.

Management plans to elect certain of the optional 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.
Existing and expired land easements not previously accounted for as leases	Elect optional transition practical expedient to not evaluate under Topic 842 existing or expired land easements that were not previously accounted for as leases under the current leases guidance in Topic 840.

Evaluation of new lease contracts will continue through the fourth quarter. Management expects the new standard to impact financial position and, at this time, cannot estimate the impact. Management does not expect any impact to results of operations or cash flows. Management plans to adopt ASU 2016-02 and its related guidance effective January 1, 2019.

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 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 on 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.

Management adopted ASU 2017-07 effective January 1, 2018. Presentation of the non-service components on a separate line outside of operating income was applied on a retrospective basis, using the amounts disclosed in the benefit plan note for the estimation basis as a practical expedient. Capitalization of only the service cost component was applied on a prospective basis.

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. Among other things, ASU 2017-12: (a) expands the types of transactions eligible for hedge accounting, (b) eliminates the separate measurement and presentation of hedge ineffectiveness, (c) simplifies the requirements around the assessment of hedge effectiveness, (d) provides companies more time to finalize hedge documentation and (e) enhances presentation and disclosure requirements.

Management early adopted ASU 2017-12 in the second quarter of 2018, effective January 1, 2018, by means of a modified retrospective approach. The adoption of ASU 2017-12 did not have an impact on results of operations, financial position or cash flows. Further, given the lack of impact to the financial statements, the adoption of the new standard did not give rise to any material changes in AEGCo’s previously established accounting policies for derivatives and hedging.

ASU 2018-15 “Internal-Use Software: Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract” (ASU 2018-15)

In August 2018, the FASB issued ASU 2018-15 aligning the requirements for capitalizing implementation costs incurred in a cloud computing arrangement (hosting arrangement) that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The new standard requires an entity (customer) in a hosting arrangement that is a service contract to follow the accounting guidance for “Internal-Use Software” to determine which implementation costs to capitalize as an asset related to the service contract and which costs to expense. Capitalized implementation costs of a hosting arrangement that is a service contract should be amortized over the term of the hosting arrangement. The expense related to the capitalized implementation costs should be presented in the same line item in the statement of income as the fees associated with the hosting element (service) of the arrangement. Payments for capitalized implementation costs in the statement of cash flows should be classified in the same manner as payments made for fees associated with the hosting element. Capitalized implementation costs in the statement of financial position should be presented in the same line item that a prepayment for the fees of the associated hosting arrangement would be presented.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2020, with early adoption permitted. The amendments may be applied either retrospectively or prospectively to applicable implementation costs incurred after the date of adoption. Management is analyzing the impact of this new standard and at this time, cannot estimate the impact of adoption on results of operations, financial position or cash flows. Management plans to adopt ASU 2018-15 prospectively, effective January 1, 2020.

3. COMMITMENTS, GUARANTEES AND CONTINGENCIES

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

For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material effect on the financial statements. The Commitments, Guarantees and Contingencies note within AEGCo's 2017 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

AEGCo has $45 million of variable rate Pollution Control Bonds supported by bilateral letters of credit for $45.5 million. The letters of credit mature in July 2019.

Indemnifications and Other Guarantees

Contracts

AEGCo enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of September 30, 2018, there were no material liabilities recorded for any indemnifications.

Master Lease Agreements

AEGCo leases certain equipment under master lease agreements. Under the lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, AEGCo is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of September 30, 2018, the maximum potential loss for these lease agreements was $41 thousand assuming the fair value of the equipment is zero at the end of the lease term.

CONTINGENCIES

Rockport Plant Litigation

In July 2013, the Wilmington Trust Company filed a complaint in the U.S. District Court for the Southern District of New York against AEGCo and I&M alleging that it would be unlawfully burdened by the terms of the modified NSR consent decree after the Rockport Plant, Unit 2 lease expiration in December 2022. The terms of the consent decree allow the installation of environmental emission control equipment, repowering or retirement of the unit. The plaintiffs seek a judgment declaring that the defendants breached the lease, must satisfy obligations related to installation of emission control equipment and indemnify the plaintiffs. The New York court granted a motion to transfer this case to the U.S. District Court for the Southern District of Ohio.

AEGCo and I&M sought and were granted dismissal of certain of the plaintiffs' claims, including claims for compensatory damages, breach of contract, breach of the implied covenant of good faith and fair dealing and indemnification of costs. The court permitted plaintiffs to move forward with their claim that AEGCo and I&M failed to exercise prudent utility practices in the maintenance and operation of Rockport Plant, Unit 2. Plaintiffs voluntarily dismissed the surviving claims with prejudice, and the court issued a final judgment. The plaintiffs subsequently filed an appeal in the U.S. Court of Appeals for the Sixth Circuit on whether the trial court erred in dismissing plaintiffs' claims for breach of contract and breach of the implied covenant of good faith and fair dealing.

In April 2017, the U.S. Court of Appeals for the Sixth Circuit issued an opinion reversing the district court's decisions in part. In June 2017, on rehearing, the court of appeals issued an amended opinion reversing the district court's dismissal of certain of plaintiffs' claims for breach of contract, vacating the denial of the plaintiffs' motion for partial summary judgment and remanding the case to the district court for further proceedings. The amended opinion and judgment affirmed the district court's dismissal of the owners' breach of good faith and fair dealing claim as duplicative of the breach of contract claims and removed the instruction to the district court in the original opinion to enter summary judgment in favor of the owners.

In July 2017, AEP filed a motion with the U.S. District Court for the Southern District of Ohio in the original NSR litigation, seeking to modify the consent decree to eliminate the obligation to install certain future controls at Rockport Plant, Unit 2 if AEP does not acquire ownership of that Unit, and to modify the consent decree in other respects to preserve the environmental benefits of the consent decree. Responsive and supplemental filings have been made by all parties. In November 2017, the district court granted the owners' unopposed motion to stay the lease litigation to afford time for resolution of AEP's motion to modify the consent decree. In September 2018, the district court granted AEP's unopposed motion to stay further proceedings regarding the consent decree to facilitate settlement discussions among the parties to the consent decree.

Management will continue to defend against the claims. Given that the district court dismissed plaintiffs' claims seeking compensatory relief as premature, and that plaintiffs have yet to present a methodology for determining or any analysis supporting any alleged damages, management is unable to determine a range of potential losses that are reasonably possible of occurring.

Rockport Plant, Unit 2 Selective Catalytic Reduction (SCR)

In October 2016, I&M filed an application with the Indiana Utility Regulatory Commission (IURC) for approval of a Certificate of Public Convenience and Necessity (CPCN) to install SCR technology at Rockport Plant, Unit 2. The equipment will allow I&M to reduce emissions of NO_x from Rockport Plant, Unit 2 in order for I&M to continue to operate that unit under current environmental requirements and is expected to be placed in service in May 2020. The estimated cost of the SCR project is $274 million, excluding AFUDC, to be shared equally between I&M and AEGCo. The AEGCo ownership share of the proposed SCR project will be billable under the Rockport UPA to I&M and KPCo and will be subject to future regulatory approval for recovery. In March 2018, the IURC issued an order approving the CPCN and the $274 million estimated cost of the SCR, excluding AFUDC.

In April 2018, a group of intervenors filed a Petition for Reconsideration and Rehearing of the March 2018 IURC order. In June 2018, the IURC denied the Petition for Reconsideration and Rehearing.

4. DISPOSITION

Lawrenceburg Plant

In September 2016, AEP signed a Purchase and Sale Agreement to sell AEGCo's Lawrenceburg Plant as well as other affiliated plants totaling 5,329 MWs of competitive generation assets as one disposal group to a nonaffiliated party. The sale closed in January 2017 for $2.2 billion, of which $726 million related to AEGCo's Lawrenceburg Plant were recorded in Investing Activities on AEGCo's statement of cash flows. The net proceeds from the transaction were $363 million in cash after taxes, repayment of debt associated with this plant including a make whole payment related to the debt and transaction fees. The sale resulted in a pretax gain of $356 million that was recorded in Gain on Sale of Lawrenceburg Plant on AEGCo's statement of income.

5. BENEFIT PLANS

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

Components of Net Periodic Benefit Cost

The following tables provide the components of AEGCo's net periodic benefit cost for the plans:

	Pension Plan		OPEB	
	Three Months Ended September 30,		Three Months Ended September 30,	
	2018	2017	2018	2017
	(in thousands)			
Service Cost	$ 21	$ 19	$ 291	$ 214
Interest Cost	30	36	504	421
Expected Return on Plan Assets	(64)	(62)	(685)	(551)
Amortization of Prior Service Cost (Credit)	—	1	(17)	(17)
Amortization of Net Actuarial Loss	13	15	180	94
Net Periodic Benefit Cost	$ —	$ 9	$ 273	$ 161

	Pension Plan		OPEB	
	Nine Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(in thousands)			
Service Cost	$ 63	$ 57	$ 871	$ 643
Interest Cost	89	110	1,513	1,263
Expected Return on Plan Assets	(191)	(185)	(2,055)	(1,654)
Amortization of Prior Service Cost (Credit)	—	1	(51)	(51)
Amortization of Net Actuarial Loss	39	44	541	282
Net Periodic Benefit Cost	$ —	$ 27	$ 819	$ 483

6. 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.

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 AEGCo's Long-term Debt are summarized in the following table:

	September 30, 2018		December 31, 2017	
	Book Value	**Fair Value**	**Book Value**	**Fair Value**
	(in thousands)			
Long-term Debt	$ 169,973	$ 170,000	$ 169,891	$ 170,000

7. INCOME TAXES

Federal Tax Reform

In December 2017, Tax Reform legislation was signed into law. Tax Reform includes significant changes to the Internal Revenue Code of 1986, as amended, and had a material impact on AEGCo's financial statements in the reporting period of its enactment. Tax Reform lowered the corporate federal income tax rate from 35% to 21%. Tax Reform provisions related to regulated public utilities generally allow for the continued deductibility of interest expense, impact bonus depreciation for certain property acquired and placed in service after September 27, 2017 and continue certain rate normalization requirements for accelerated depreciation benefits.

Provisional Amounts

AEGCo applied Staff Accounting Bulletin 118 (SAB 118), issued by the SEC staff in December 2017, and made reasonable estimates for the measurement and accounting of the effects of Tax Reform which are reflected in the financial statements as provisional amounts based on the best information available. In January 2018, the FASB issued guidance allowing non-public entities to apply SAB 118. SAB 118 provides for up to a one-year period to complete the required analysis and accounting for Tax Reform referred to as the measurement period. While AEGCo was able to make reasonable estimates of the impact of Tax Reform in 2017, the final impact may differ from the recorded provisional amounts to the extent refinements are made to the estimated cumulative differences or as a result of additional guidance or technical corrections that may be issued by the IRS that may impact management's interpretation and assumptions utilized. The measurement period adjustments recorded during the third quarter of 2018 to the provisional amounts recorded were immaterial.

During the third quarter of 2018, the IRS proposed new regulations that reflect changes made by Tax Reform and affect taxpayers with qualified depreciable property acquired and placed in service after September 27, 2017. AEGCo expects to complete the analysis of the provisional items, including analysis of the new regulations proposed by the IRS, during the fourth quarter of 2018.

Impact of Tax Reform During 2018

Effective January 2018, AEGCo updated its current corporate federal income tax rate used in billings to AEP affiliates under the Rockport UPA. AEGCo also reflected the reduced corporate federal income tax rate in Cook Coal Terminal's (CCT) coal transloading services and railcar maintenance services provided to AEP affiliates.

Excess Accumulated Deferred Income Taxes (Excess ADIT)

As reflected in AEGCo's estimated annual ETR for 2018, AEGCo began amortizing the Excess ADIT associated with certain depreciable property subject to rate normalization requirements using the average rate assumption method (ARAM) during the first quarter of 2018. Similar to the reduction in the corporate federal income tax rate discussed above, the benefit associated with the amortization of the Excess ADIT was passed through to AEP affiliates through CCT and Rockport UPA billings.

In addition, with respect to the Excess ADIT balances recorded in Regulatory Liabilities and Deferred Investment Tax Credits that are not subject to rate normalization requirements, AEGCo will work with the FERC to determine the appropriate mechanism, amount and time period to provide these benefits of Tax Reform to customers.

Effective Tax Rates (ETR)

AEGCo's interim ETR reflects the estimated annual ETR for 2018 and 2017, adjusted for tax expense associated with certain discrete items. As previously mentioned, effective January 1, 2018, Tax Reform lowered the corporate tax rate from 35% to 21%. The interim ETR differ from the federal statutory tax rate of 21% and 35% in 2018 and 2017, respectively, primarily due to state income taxes, the amortization of excess accumulated deferred income taxes associated with certain depreciable property using ARAM, tax credits and other book/tax differences which are accounted for on a flow-through basis.

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

Three Months Ended September 30,		Nine Months Ended September 30,	
2018	**2017**	**2018**	**2017**
15.0%	(18.7)%	12.0%	29.8%

Three Months Ended September 30, 2018 Compared to Three Months Ended September 30, 2017

The increase in the ETR was primarily due to consolidated tax savings from Parent, other book/tax differences which are accounted for on a flow-through basis, and the recording of favorable federal income tax adjustments in the third quarter of 2017. This is partially offset due to the change in the corporate federal income tax rate from 35% in 2017 to 21% in 2018 as a result of Tax Reform.

Nine Months Ended September 30, 2018 Compared to Nine Months Ended September 30, 2017

The decrease in the ETR was primarily due to the change in the corporate federal income tax rate from 35% in 2017 to 21% in 2018 as a result of Tax Reform partially offset due to an updated allocation of the $2.2 billion total purchase price among AEGCo's Lawrenceburg and AGR's Darby, Gavin and Waterford plants based on the final purchase price allocation received, which was completed in the second quarter of 2017. This change in estimate resulted in a $29 million decrease in income tax expense in the second quarter of 2017.

Federal and State Income Tax Audit Status

AEGCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011 through 2013 started in April 2014. AEP and 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. To resolve the issue under consideration, AEP and subsidiaries and the IRS exam team agreed to utilize the Fast Track Settlement Program in December 2017. The program was completed in March 2018 and tax years 2014 and 2015 were added to the IRS examination to reflect the impact of the Fast Track changes that were carried forward to 2014 and 2015. In June 2018, AEP settled all outstanding issues under audit for tax years 2011-2013, and the audit was again submitted to the Joint Committee for approval in the third quarter of 2018. The settlement did not materially impact AEGCo's net income, cash flows or financial condition. In the third quarter of 2018, AEP was notified that the IRS would commence an audit of the 2016 tax year in October 2018.

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

8. FINANCING ACTIVITIES

Long-term Debt

AEGCo did not have any long-term debt issuances or retirements during the first nine months of 2018.

Dividend Restrictions

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

AEGCo has credit agreements that contain a covenant that limit its debt to capitalization ratio to 67.5%. The method for calculating outstanding debt and capitalization is contractually defined in the credit agreements.

Corporate Borrowing Program - AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of AEP's subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP's utility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions of the AEP System Utility Money Pool agreement filed with the FERC. The amounts of outstanding loans to the Utility Money Pool as of September 30, 2018 and December 31, 2017 are included in Advances to Affiliates on AEGCo's balance sheets. AEGCo's Utility Money Pool activity and corresponding authorized borrowing limit for the nine months ended September 30, 2018 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, 2018	Authorized Short-Term Borrowing Limit
(in thousands)					
$ —	$ 145,011	$ —	$ 122,436	$ 140,792	$ 200,000

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
2018	—%	—%	2.52%	1.81%	—%	2.19%
2017	1.00%	1.00%	1.49%	0.92%	1.00%	1.21%

9. REVENUE FROM CONTRACTS WITH CUSTOMERS

Disaggregated Revenues from Contracts with Customers

AEGCo's statements of income represent revenues from contracts with customers by type of revenue. AEGCo did not have alternative revenues for the three and nine months ended September 30, 2018.

Performance Obligations

AEGCo has performance obligations as part of its normal course of business. A performance obligation is a promise to transfer a distinct good or service, or a series of distinct goods or services that are substantially the same and have the same pattern of transfer to a customer. The invoice practical expedient within the accounting guidance for "Revenue from Contracts with Customers" allows for the recognition of revenue from performance obligations in the amount of consideration to which there is a right to invoice the customer and when the amount for which there is a right to invoice corresponds directly to the value transferred to the customer.

The purpose of the invoice practical expedient is to depict an entity's measure of progress toward completion of the performance obligation within a contract and can only be applied to performance obligations that are satisfied over time and when the invoice is representative of services provided to date. AEGCo elected to apply the invoice practical expedient to recognize revenue for performance obligations satisfied over time as the invoices from the respective revenue streams are representative of services or goods provided to date to the customer. Performance obligations for AEGCo are summarized as follows:

Wholesale Revenues - Generation Affiliated

AEGCo engages in the generation and wholesale sale of electric power to its affiliates, I&M and KPCo. AEGCo derives operating revenues from the sale of Rockport Plant energy and capacity to I&M and KPCo pursuant to FERC-approved long-term UPAs. Under the UPAs, AEGCo has a performance obligation to supply wholesale generation electricity to I&M and KPCo.

The UPAs provide FERC-approved rate of return on common equity, a return on capital (net of temporary cash investments) and recovery of costs including operation and maintenance, fuel and taxes. Under the terms of the UPAs, AEGCo accumulates all expenses monthly and prepares bills for its affiliates. In the month the expenses are incurred, AEGCo recognizes the billing revenues and establishes a receivable from the affiliated companies. The costs of operating the plants are billed to the affiliates receiving the benefits under the UPAs on a monthly basis. AEGCo's performance obligations under the UPAs are satisfied over time as I&M and KPCo simultaneously receive and consume the wholesale electricity.

Fixed Performance Obligations

As of September 30, 2018, there are no fixed performance obligations related to AEGCo.

Contract Assets and Liabilities

Contract assets are recognized when AEGCo has a right to consideration that is conditional upon the occurrence of an event other than the passage of time, such as future performance under a contract. AEGCo did not have any material contract assets as of September 30, 2018.

When AEGCo receives consideration, or such consideration is unconditionally due from a customer prior to transferring goods or services to the customer under the terms of a sales contract, they recognize a contract liability on the balance sheet in the amount of that consideration. Revenue for such consideration is subsequently recognized in the period or periods in which the remaining performance obligations in the contract are satisfied. AEGCo did not have any material contract liabilities as of September 30, 2018.

Accounts Receivable from Contracts with Customers

Accounts receivable from contracts with customers are presented on AEGCo's balance sheets within the Accounts Receivable - Customers and Accounts Receivable - Affiliated Companies line items. AEGCo's balances for receivables from contracts that are not recognized in accordance with the accounting guidance for "Revenue from Contracts with Customers" included in Accounts Receivable - Customers and Accounts Receivable - Affiliated Companies were not material as of September 30, 2018.

Contract Costs

Contract costs to obtain or fulfill a contract are accounted for under the guidance for "Other Assets and Deferred Costs" and presented as a single asset and neither bifurcated nor reclassified between current and noncurrent assets on AEGCo's balance sheets. Contract costs to acquire a contract are amortized in a manner consistent with the transfer of goods or services to the customer in Other Operation on AEGCo's statements of income. AEGCo did not have material contract costs as of September 30, 2018.