

AEP Texas Central Company and Subsidiaries

2016 Third Quarter Report

Consolidated Financial Statements



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GLOSSARY OF TERMS

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

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.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
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.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
Parent	American Electric Power Company, Inc., the equity owner of AEP subsidiaries within the AEP consolidation.
PUCT	Public Utility Commission of Texas.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
Texas Restructuring Legislation	Legislation enacted in 1999 to restructure the electric utility industry in Texas.
TNC	AEP Texas North Company, an AEP electric utility subsidiary.
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 law.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three and Nine Months Ended September 30, 2016 and 2015
(in thousands)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
REVENUES				
Electric Transmission and Distribution	\$ 314,450	\$ 321,014	\$ 865,831	\$ 871,540
Sales to AEP Affiliates	1,207	1,064	3,585	3,124
Other Revenues	226	1,296	1,484	4,145
TOTAL REVENUES	315,883	323,374	870,900	878,809
EXPENSES				
Other Operation	94,542	95,914	258,695	255,239
Maintenance	10,585	12,470	33,901	37,441
Depreciation and Amortization	95,554	117,884	269,831	311,007
Taxes Other Than Income Taxes	24,859	23,573	66,630	64,569
TOTAL EXPENSES	225,540	249,841	629,057	668,256
OPERATING INCOME	90,343	73,533	241,843	210,553
Other Income (Expense):				
Interest Income	102	39	545	64
Allowance for Equity Funds Used During Construction	1,706	1,338	5,794	4,281
Interest Expense	(29,885)	(31,095)	(90,210)	(95,240)
INCOME BEFORE INCOME TAX EXPENSE	62,266	43,815	157,972	119,658
Income Tax Expense	18,299	15,424	46,124	43,425
NET INCOME	\$ 43,967	\$ 28,391	\$ 111,848	\$ 76,233

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

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

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN
COMMON SHAREHOLDER'S EQUITY
For the Nine Months Ended September 30, 2016 and 2015
(in thousands)
(Unaudited)

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Total</u>
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2014	\$ 55,292	\$ 171,062	\$ 629,861	\$ 856,215
Capital Contribution from Parent		150,000		150,000
Common Stock Dividends			(3,750)	(3,750)
Net Income			76,233	76,233
TOTAL COMMON SHAREHOLDER'S EQUITY - SEPTEMBER 30, 2015	<u>\$ 55,292</u>	<u>\$ 321,062</u>	<u>\$ 702,344</u>	<u>\$ 1,078,698</u>
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2015	\$ 55,292	\$ 321,062	\$ 716,110	\$ 1,092,464
Common Stock Dividends			(7,500)	(7,500)
Net Income			111,848	111,848
TOTAL COMMON SHAREHOLDER'S EQUITY - SEPTEMBER 30, 2016	<u>\$ 55,292</u>	<u>\$ 321,062</u>	<u>\$ 820,458</u>	<u>\$ 1,196,812</u>

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

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

September 30, 2016 and December 31, 2015

(in thousands)

(Unaudited)

	September 30, 2016	December 31, 2015
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 100	\$ 100
Restricted Cash for Securitized Transition Funding	110,829	203,393
Advances to Affiliates	—	124,483
Accounts Receivable:		
Customers	107,595	81,455
Affiliated Companies	8,231	2,727
Accrued Unbilled Revenues	57,248	34,877
Miscellaneous	142	31
Allowance for Uncollectible Accounts	(465)	(1,515)
Total Accounts Receivable	172,751	117,575
Materials and Supplies	37,366	40,356
Risk Management Assets	24	—
Accrued Tax Benefits	5,551	—
Prepayments and Other Current Assets	3,985	2,393
TOTAL CURRENT ASSETS	330,606	488,300
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Transmission	1,876,191	1,722,059
Distribution	2,674,061	2,567,567
Other Property, Plant and Equipment	330,412	306,729
Construction Work in Progress	189,832	211,951
Total Property, Plant and Equipment	5,070,496	4,808,306
Accumulated Depreciation and Amortization	925,975	888,649
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	4,144,521	3,919,657
OTHER NONCURRENT ASSETS		
Regulatory Assets	245,067	245,734
Securitized Transition Assets (September 30, 2016 and December 31, 2015 Amounts Include \$1,147,397 and \$1,297,519, Respectively, Related to Transition Funding)	1,180,097	1,335,926
Long-term Risk Management Assets	11	—
Deferred Charges and Other Noncurrent Assets	41,002	12,549
TOTAL OTHER NONCURRENT ASSETS	1,466,177	1,594,209
TOTAL ASSETS	\$ 5,941,304	\$ 6,002,166

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

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
September 30, 2016 and December 31, 2015
(dollars in thousands)
(Unaudited)

	<u>September 30,</u> <u>2016</u>	<u>December 31,</u> <u>2015</u>
CURRENT LIABILITIES		
Advances from Affiliates	\$ 41,342	\$ —
Accounts Payable:		
General	67,984	70,825
Affiliated Companies	16,962	12,666
Long-term Debt Due Within One Year – Nonaffiliated (September 30, 2016 and December 31, 2015 Amounts Include \$221,906 and \$253,709, Respectively, Related to Transition Funding)	221,906	353,709
Risk Management Liabilities	—	209
Customer Deposits	6,759	12,620
Accrued Taxes	53,545	81,981
Accrued Interest (September 30, 2016 and December 31, 2015 Amounts Include \$13,895 and \$25,335, Respectively, Related to Transition Funding)	36,742	41,320
Other Current Liabilities	47,313	60,960
TOTAL CURRENT LIABILITIES	<u>492,553</u>	<u>634,290</u>
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated (September 30, 2016 and December 31, 2015 Amounts Include \$1,056,829 and \$1,243,495, Respectively, Related to Transition Funding)	2,485,161	2,546,836
Deferred Income Taxes	1,277,571	1,259,143
Regulatory Liabilities and Deferred Investment Tax Credits	467,288	443,984
Deferred Credits and Other Noncurrent Liabilities	21,919	25,449
TOTAL NONCURRENT LIABILITIES	<u>4,251,939</u>	<u>4,275,412</u>
TOTAL LIABILITIES	<u>4,744,492</u>	<u>4,909,702</u>
Rate Matters (Note 3)		
Commitments and Contingencies (Note 4)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – \$25 Per Share:		
Authorized – 12,000,000 Shares		
Outstanding – 2,211,678 Shares	55,292	55,292
Paid-in Capital	321,062	321,062
Retained Earnings	820,458	716,110
TOTAL COMMON SHAREHOLDER'S EQUITY	<u>1,196,812</u>	<u>1,092,464</u>
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	<u>\$ 5,941,304</u>	<u>\$ 6,002,166</u>

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

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2016 and 2015
(in thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2016	2015
OPERATING ACTIVITIES		
Net Income	\$ 111,848	\$ 76,233
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	269,831	311,007
Deferred Income Taxes	7,727	(43,981)
Allowance for Equity Funds Used During Construction	(5,794)	(4,281)
Property Taxes	(9,917)	(9,302)
Change in Other Noncurrent Assets	(20,190)	(20,031)
Change in Other Noncurrent Liabilities	(5,633)	3,884
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	(55,176)	(22,930)
Materials and Supplies	2,990	3,856
Accounts Payable	9,509	(4,936)
Customer Deposits	(5,861)	(3,725)
Accrued Taxes, Net	(33,827)	79,062
Accrued Interest	(4,578)	(9,666)
Other Current Assets	(1,793)	(792)
Other Current Liabilities	(12,209)	(2,530)
Net Cash Flows from Operating Activities	<u>246,927</u>	<u>351,868</u>
INVESTING ACTIVITIES		
Construction Expenditures	(313,469)	(331,111)
Change in Advances to Affiliates, Net	124,483	(177,244)
Change in Restricted Cash for Securitized Transition Funding	92,564	52,571
Proceeds from Sales of Assets	2,873	2,433
Contributions in Aid of Construction	9,965	24,088
Other Investing Activities	(138)	(22)
Net Cash Flows Used for Investing Activities	<u>(83,722)</u>	<u>(429,285)</u>
FINANCING ACTIVITIES		
Capital Contribution from Parent	—	150,000
Issuance of Long-term Debt – Nonaffiliated	124,529	245,702
Change in Advances from Affiliates, Net	41,342	(72,604)
Retirement of Long-term Debt – Nonaffiliated	(320,215)	(240,455)
Principal Payments for Capital Lease Obligations	(1,718)	(1,616)
Dividends Paid on Common Stock	(7,500)	(3,750)
Other Financing Activities	357	140
Net Cash Flows from (Used for) Financing Activities	<u>(163,205)</u>	<u>77,417</u>
Net Change in Cash and Cash Equivalents	—	—
Cash and Cash Equivalents at Beginning of Period	100	100
Cash and Cash Equivalents at End of Period	<u>\$ 100</u>	<u>\$ 100</u>
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 92,426	\$ 100,208
Net Cash Paid for Income Taxes	91,424	20,890
Noncash Acquisitions Under Capital Leases	3,071	1,439
Construction Expenditures Included in Current Liabilities as of September 30,	40,020	42,446

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

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1. SIGNIFICANT ACCOUNTING MATTERS

General

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

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

Investment Tax Credits

Investment tax credits (ITC) were historically accounted for under the flow-through method, except where regulatory commissions reflected ITC in the rate-making process. In the third quarter of 2016, TCC and other AEP subsidiaries changed accounting for the recognition of ITC and elected to apply the preferred deferral methodology. Retrospective application is not necessary for reporting periods prior to 2016 as the financial impact to TCC was immaterial.

Deferred ITC is amortized to income tax expense over the life of the asset. Amortization of deferred ITC begins when the asset is placed into service, except where regulatory commissions reflect ITC in the rate-making process, then amortization begins when the cash tax benefit is recognized.

Subsequent Events

Management reviewed subsequent events through November 1, 2016, the date that the third quarter 2016 report was issued.

2. NEW ACCOUNTING PRONOUNCEMENTS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The new accounting guidance is effective for annual periods beginning after December 15, 2016. Early adoption is permitted in any interim or annual period. Certain provisions require retrospective/modified retrospective transition while others are to be applied prospectively. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption. Management plans to adopt ASU 2016-09 effective January 1, 2017.

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

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

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

3. RATE MATTERS

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

Regulatory Assets Pending Final Regulatory Approval

<u>Noncurrent Regulatory Assets</u>	<u>September 30, 2016</u>	<u>December 31, 2015</u>
	(in thousands)	
<u>Regulatory Assets Currently Earning a Return</u>		
Storm-Related Costs	\$ 25,421	\$ 24,156
<u>Regulatory Assets Currently Not Earning a Return</u>		
Rate Case Expenses	145	145
Total Regulatory Assets Pending Final Regulatory Approval	<u>\$ 25,566</u>	<u>\$ 24,301</u>

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

Distribution Cost Recovery Factor (DCRF)

In July 2016, the PUCT approved a settlement agreement between TCC and intervenors related to TCC's request for a DCRF rider to allow recovery of eligible net distribution investments. The settlement agreement included an annual revenue requirement of \$45 million, effective September 2016. Amounts approved are subject to refund based upon a prudence review of the investments in TCC's next base rate case.

TCC and TNC Merger

In June 2016, TCC and TNC filed applications with the PUCT and FERC that requested approval to merge TCC and TNC into AEP Utilities, Inc. Upon merger, AEP Utilities, Inc. will change its name to AEP Texas Inc. The proposed merger would be effective December 31, 2016. The applications proposed no changes to current TCC and TNC rates. A hearing at the PUCT was held in August 2016. In September 2016, the FERC issued an order approving the merger application. In October 2016, the ALJ issued a proposal for decision that recommends approval of the merger provided certain post-merger conditions are imposed. The conditions recommended by the ALJ include a) the sharing of certain interest rate savings with customers and b) an annual credit to customers of approximately \$630 thousand for savings resulting from an expected reduction in post-merger debt issuance costs, effective until the next base rate case. A decision from the PUCT is expected in the fourth quarter of 2016.

4. COMMITMENTS, GUARANTEES AND CONTINGENCIES

TCC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, TCC'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 TCC 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 TCC's 2015 Annual Report should be read in conjunction with this report.

GUARANTEES

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

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 four uncommitted facilities totaling \$300 million. As of September 30, 2016, TCC's maximum future payment for letters of credit issued under the uncommitted credit facilities was \$2.8 million with a maturity of January 2017.

Indemnifications and Other Guarantees

Contracts

TCC 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, 2016, there were no material liabilities recorded for any indemnifications.

Master Lease Agreements

TCC 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, TCC 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, 2016, the maximum potential loss for these lease agreements was \$6.3 million assuming the fair value of the equipment is zero at the end of the lease term.

5. BENEFIT PLANS

TCC participates in an AEP sponsored qualified pension plan and two unfunded nonqualified pension plans. Substantially all of TCC's employees are covered by the qualified plan or both the qualified and a nonqualified pension plan. TCC 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 TCC's net periodic benefit cost (credit) for the plans for the three and nine months ended September 30, 2016 and 2015:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended September 30,		Three Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Service Cost	\$ 1,429	\$ 1,431	\$ 136	\$ 149
Interest Cost	3,344	3,248	935	872
Expected Return on Plan Assets	(4,608)	(4,530)	(1,717)	(1,817)
Amortization of Prior Service Cost (Credit)	64	66	(1,072)	(1,072)
Amortization of Net Actuarial Loss	1,320	1,693	499	278
Net Periodic Benefit Cost (Credit)	\$ 1,549	\$ 1,908	\$ (1,219)	\$ (1,590)

	Pension Plans		Other Postretirement Benefit Plans	
	Nine Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Service Cost	\$ 4,288	\$ 4,292	\$ 406	\$ 447
Interest Cost	10,029	9,744	2,805	2,614
Expected Return on Plan Assets	(13,824)	(13,588)	(5,150)	(5,450)
Amortization of Prior Service Cost (Credit)	193	198	(3,216)	(3,216)
Amortization of Net Actuarial Loss	3,959	5,078	1,498	835
Net Periodic Benefit Cost (Credit)	\$ 4,645	\$ 5,724	\$ (3,657)	\$ (4,770)

6. BUSINESS SEGMENTS

TCC has one reportable segment, an integrated electricity transmission and distribution business. TCC's other activities are insignificant.

7. DERIVATIVES AND HEDGING

AEPSC is agent for and transacts on behalf of TCC.

Risk Management Strategies

TCC's vehicle fleet is exposed to gasoline and diesel fuel price volatility. TCC utilizes financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. TCC does not hedge all fuel price risk. The gross notional volumes of TCC's outstanding derivative contracts for heating oil and gasoline as of September 30, 2016 and December 31, 2015 were 1 million gallons and 1 million gallons, respectively.

ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND THE IMPACT ON THE FINANCIAL STATEMENTS

According to the accounting guidance for "Derivatives and Hedging," TCC 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, TCC is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the September 30, 2016 and December 31, 2015 balance sheets, TCC had no netting of cash collateral received from third parties against short-term and long-term risk management assets and \$0 and \$269 thousand, respectively, of cash collateral paid to third parties against short-term and long-term risk management liabilities.

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

**Fair Value of Derivative Instruments
September 30, 2016**

<u>Balance Sheet Location</u>	<u>Risk Management Contracts Commodity (a)</u>	<u>Gross Amounts Offset in the Statement of Financial Position (b)</u>	<u>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</u>
		(in thousands)	
Current Risk Management Assets	\$ 77	\$ (53)	\$ 24
Long-term Risk Management Assets	14	(3)	11
Total Assets	<u>91</u>	<u>(56)</u>	<u>35</u>
Current Risk Management Liabilities	53	(53)	—
Long-term Risk Management Liabilities	3	(3)	—
Total Liabilities	<u>56</u>	<u>(56)</u>	<u>—</u>
Total MTM Derivative Contract Net Assets	<u>\$ 35</u>	<u>\$ —</u>	<u>\$ 35</u>

Fair Value of Derivative Instruments
December 31, 2015

Balance Sheet Location	Risk Management Contracts Commodity (a)	Gross Amounts Offset in the Statement of Financial Position (b) (in thousands)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
Current Risk Management Assets	\$ —	\$ —	\$ —
Long-term Risk Management Assets	—	—	—
Total Assets	—	—	—
Current Risk Management Liabilities	478	(269)	209
Long-term Risk Management Liabilities	—	—	—
Total Liabilities	478	(269)	209
Total MTM Derivative Contract Net Assets (Liabilities)	\$ (478)	\$ 269	\$ (209)

- (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 TCC’s activity of derivative risk management contracts for the three and nine months ended September 30, 2016 and 2015:

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

Location of Gain (Loss)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Other Operation Expense	\$ (46)	\$ (105)	\$ (178)	\$ (318)
Maintenance Expense	(47)	(86)	(174)	(275)
Regulatory Assets (a)	55	(230)	478	327
Regulatory Liabilities (a)	35	—	35	—
Total Gain (Loss) on Risk Management Contracts	\$ (3)	\$ (421)	\$ 161	\$ (266)

- (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 TCC’s statements of income. Unrealized and realized gains and losses on derivative instruments not held for trading purposes are included in revenues or expenses on TCC’s statements of income depending on the relevant facts and circumstances. Certain derivatives that economically hedge future commodity risk are recorded in the same expense line item on the statements of income as that of the associated risk. However, unrealized and some realized gains and losses for both trading and non-trading derivative instruments are recorded as regulatory assets (for losses) or regulatory liabilities (for gains), in accordance with the accounting guidance for “Regulated Operations.”

8. FAIR VALUE MEASUREMENTS

Fair Value Hierarchy and Valuation Techniques

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

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

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 TCC’s Long-term Debt as of September 30, 2016 and December 31, 2015 are summarized in the following table:

	<u>September 30, 2016</u>		<u>December 31, 2015</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
		(in thousands)		
Long-term Debt	\$ 2,707,067	\$ 3,055,800	\$ 2,900,545	\$ 3,101,488

Fair Value Measurements of Financial Assets and Liabilities

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

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

Assets:	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u> (in thousands)	<u>Other</u>	<u>Total</u>
Restricted Cash for Securitized Transition Funding (a)	\$ 110,829	\$ —	\$ —	\$ 43	\$ 110,872
<u>Risk Management Assets</u>					
Risk Management Commodity Contracts (b)	—	91	—	(56)	35
Total Assets:	<u>\$ 110,829</u>	<u>\$ 91</u>	<u>\$ —</u>	<u>\$ (13)</u>	<u>\$ 110,907</u>
Liabilities:					
<u>Risk Management Liabilities</u>					
Risk Management Commodity Contracts (b)	<u>\$ —</u>	<u>\$ 56</u>	<u>\$ —</u>	<u>\$ (56)</u>	<u>\$ —</u>

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

Assets:	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u> (in thousands)	<u>Other</u>	<u>Total</u>
Restricted Cash for Securitized Transition Funding (a)	<u>\$ 203,393</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 37</u>	<u>\$ 203,430</u>
Liabilities:					
<u>Risk Management Liabilities</u>					
Risk Management Commodity Contracts (b)	<u>\$ —</u>	<u>\$ 478</u>	<u>\$ —</u>	<u>\$ (269)</u>	<u>\$ 209</u>

- (a) Amounts in "Other" column primarily represent cash deposits with third parties. Level 1 amounts primarily represent investments in money market funds.
- (b) Amounts in "Other" column primarily represent counterparty netting of risk management and hedging contracts and associated cash collateral under the accounting guidance for "Derivatives and Hedging."

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

9. INCOME TAXES

AEP System Tax Allocation Agreement

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

Federal and State Income Tax Audit Status

TCC 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. TCC 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. TCC and other AEP subsidiaries were informed that the IRS expects the Joint Committee to refer 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, TCC 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.

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

State Tax Legislation

In March 2016, the Texas Comptroller of Public Accounts issued clarifying guidance regarding the treatment of transmission and distribution expenses included in the computation of taxable income for purposes of calculating the Texas gross margin tax. The guidance clarified which specific transmission and distribution expenses are included in the computation of the cost of goods sold deduction. This guidance resulted in a net favorable adjustment of \$6 million during the first nine months of 2016 to TCC's net income.

10. FINANCING ACTIVITIES

Long-term Debt

Long-term debt issued, retired and principal payments made during the first nine months of 2016 are shown in the tables below:

Type of Debt	Principal Amount (a)	Interest Rate	Due Date
Issuances:	(in thousands)	(%)	
Other Long-term Debt	\$ 125,000	Variable	2019

(a) Amounts indicated on the statements of cash flows are net of issuance costs and premium or discount and will not tie to the issuance amounts.

Type of Debt	Principal Amount Paid	Interest Rate	Due Date
Retirements and Principal Payments:	(in thousands)	(%)	
Other Long-term Debt	\$ 100,000	Variable	2016
Securitization Bonds	149,080	5.17	2018
Securitization Bonds	44,198	6.25	2016
Securitization Bonds	26,937	0.88	2017

Dividend Restrictions

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

Federal Power Act

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

Leverage Restrictions

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

Corporate Borrowing Program - AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of AEP’s subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP’s utility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions of the AEP System Utility Money Pool agreement filed with the FERC. The amounts of outstanding loans to or borrowings from the Utility Money Pool as of September 30, 2016 and December 31, 2015 are included in Advances to Affiliates and Advances from Affiliates, respectively, on TCC’s balance sheets. TCC’s Utility Money Pool activity and corresponding authorized borrowing limit for the nine months ended September 30, 2016 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	Borrowings from the Utility Money Pool as of September 30, 2016	Authorized Short-Term Borrowing Limit
(in thousands)					
\$ 60,654	\$ 131,145	\$ 32,602	\$ 72,230	\$ 41,342	\$ 250,000

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
2016	0.91%	0.75%	0.83%	0.69%	0.84%	0.73%
2015	0.59%	0.39%	0.47%	0.44%	0.46%	0.46%

11. VARIABLE INTEREST ENTITIES

The accounting guidance for “Variable Interest Entities” is a consolidation model that considers if a company has a controlling financial interest in a VIE. A controlling financial interest will have both (a) the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Entities are required to consolidate a VIE when it is determined that they have a controlling financial interest in a VIE and therefore, are the primary beneficiary of that VIE, as defined by the accounting guidance for “Variable Interest Entities.” In determining whether TCC is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE’s variability TCC absorbs, guarantees of indebtedness, voting rights including kick-out rights, the power to direct the VIE, variable interests held by related parties and other factors. Management believes that significant assumptions and judgments were applied consistently.

Transition Funding was formed for the sole purpose of issuing and servicing securitization bonds related to Texas Restructuring Legislation. Management has concluded that TCC is the primary beneficiary of Transition Funding because TCC has the power to direct the most significant activities of the VIE and TCC’s equity interest could potentially be significant. Therefore, TCC is required to consolidate Transition Funding. The securitized bonds totaled \$1.3 billion and \$1.5 billion as of September 30, 2016 and December 31, 2015, respectively, and are included in Long-term Debt Due Within One Year - Nonaffiliated and Long-term Debt - Nonaffiliated on the balance sheets. Transition Funding has securitized transition assets of \$1.1 billion and \$1.3 billion as of September 30, 2016 and December 31, 2015, respectively, which are presented separately on the face of the balance sheets. The securitized transition assets represent the right to impose and collect Texas true-up costs from customers receiving electric transmission or distribution service from TCC under recovery mechanisms approved by the PUCT. The securitization bonds are payable only from and secured by the securitized transition assets. The bondholders have no recourse to TCC or any other AEP entity. TCC acts as the servicer for Transition Funding’s securitized transition asset and remits all related amounts collected from customers to Transition Funding for interest and principal payments on the securitization bonds and related costs.

The balances below represent the assets and liabilities of Transition Funding that are consolidated. These balances include intercompany transactions that are eliminated upon consolidation.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
VARIABLE INTEREST ENTITIES
September 30, 2016 and December 31, 2015
(in thousands)

<u>ASSETS</u>	<u>Transition Funding</u>	
	<u>2016</u>	<u>2015</u>
Current Assets	\$ 163,541	\$ 234,122
Other Noncurrent Assets (a)	1,210,323	1,365,684
Total Assets	<u>\$ 1,373,864</u>	<u>\$ 1,599,806</u>
 <u>LIABILITIES AND EQUITY</u>		
Current Liabilities	\$ 242,613	\$ 291,735
Noncurrent Liabilities	1,113,151	1,289,996
Equity	18,100	18,075
Total Liabilities and Equity	<u>\$ 1,373,864</u>	<u>\$ 1,599,806</u>

- (a) Includes an intercompany item eliminated in consolidation as of September 30, 2016 and December 31, 2015 of \$62.9 million and \$68.2 million, respectively.

AEPSC provides certain managerial and professional services to AEP's subsidiaries. Parent is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC's cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC's cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. TCC's total billings from AEPSC for the three months ended September 30, 2016 and 2015 were \$21.6 million and \$26.5 million, respectively, and for the nine months ended September 30, 2016 and 2015 were \$65.9 million and \$67.9 million, respectively. The carrying amount of liabilities associated with AEPSC as of September 30, 2016 and December 31, 2015 was \$7.7 million and \$12.1 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.