

AEP Texas North Company and Subsidiary

2013 Annual Report

Audited 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 or Parent	American Electric Power Company, Inc., an electric utility holding company.
AEP System	American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.
AEPEP	AEP Energy Partners, Inc., a subsidiary of AEP dedicated to wholesale marketing and trading, asset management and commercial and industrial sales in the deregulated Texas market.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AFUDC	Allowance for Funds Used During Construction.
AOCI	Accumulated Other Comprehensive Income.
CAA	Clean Air Act.
CO ₂	Carbon dioxide and other greenhouse gases.
CWIP	Construction Work in Progress.
EIS	Energy Insurance Services, Inc., a nonaffiliated captive insurance company and consolidated variable interest entity of AEP.
ERCOT	Electric Reliability Council of Texas regional transmission organization.
ETT	Electric Transmission Texas, LLC, an equity interest joint venture between AEP and MidAmerican Energy Holdings Company Texas Transco, LLC formed to own and operate electric transmission facilities in ERCOT.
Federal EPA	United States Environmental Protection Agency.
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.
IRS	Internal Revenue Service.
MTM	Mark-to-Market.
Nonutility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain nonutility subsidiaries.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
PPA	Power Purchase and Sale Agreement.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
PUCT	Public Utility Commission of Texas.
REP	Texas Retail Electric Provider.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
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.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholder of
AEP Texas North Company:

We have audited the accompanying consolidated financial statements of AEP Texas North Company and subsidiary (the "Company"), which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income (loss), changes in common shareholder's equity, and cash flows for each of the three years in the period ended December 31, 2013, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of AEP Texas North Company and subsidiary as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013 in accordance with accounting principles generally accepted in the United States of America.

Deloitte + Touche LLP

Columbus, Ohio
February 25, 2014

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
For the Years Ended December 31, 2013, 2012 and 2011
(in thousands)

	Years Ended December 31,		
	2013	2012	2011
REVENUES			
Electric Transmission and Distribution	\$ 206,535	\$ 199,677	\$ 201,687
Sales to AEP Affiliates	103,593	85,992	85,420
Other Revenues	1,050	485	513
TOTAL REVENUES	<u>311,178</u>	<u>286,154</u>	<u>287,620</u>
EXPENSES			
Fuel and Other Consumables Used for Electric Generation	55,785	39,402	39,711
Other Operation	82,783	82,563	78,603
Maintenance	26,117	21,240	20,465
Depreciation and Amortization	54,667	53,844	53,721
Taxes Other Than Income Taxes	15,669	18,850	16,869
TOTAL EXPENSES	<u>235,021</u>	<u>215,899</u>	<u>209,369</u>
OPERATING INCOME	76,157	70,255	78,251
Other Income (Expense):			
Other Income	236	53	1,181
Interest Expense	(20,924)	(22,106)	(21,706)
INCOME BEFORE INCOME TAX EXPENSE	55,469	48,202	57,726
Income Tax Expense	18,556	17,513	17,614
NET INCOME	36,913	30,689	40,112
Preferred Stock Dividend Requirements Including Capital Stock Expense	-	-	145
EARNINGS ATTRIBUTABLE TO COMMON STOCK	<u>\$ 36,913</u>	<u>\$ 30,689</u>	<u>\$ 39,967</u>

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

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Years Ended December 31, 2013, 2012 and 2011
(in thousands)

	Years Ended December 31,		
	2013	2012	2011
Net Income	\$ 36,913	\$ 30,689	\$ 40,112
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES			
Cash Flow Hedges, Net of Tax of \$897, \$1,992 and \$3,203 in 2013, 2012 and 2011, Respectively	1,666	(3,700)	(5,949)
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$376, \$252 and \$207 in 2013, 2012 and 2011, Respectively	700	468	(384)
Pension and OPEB Funded Status, Net of Tax of \$1,310, \$754 and \$239 in 2013, 2012 and 2011, Respectively	2,432	1,400	(443)
TOTAL OTHER COMPREHENSIVE INCOME (LOSS)	4,798	(1,832)	(6,776)
TOTAL COMPREHENSIVE INCOME	\$ 41,711	\$ 28,857	\$ 33,336

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY
For the Years Ended December 31, 2013, 2012 and 2011
(in thousands)

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2010	\$ 137,214	\$ 3,440	\$ 183,263	\$ (14,609)	\$ 309,308
Common Stock Dividends			(15,000)		(15,000)
Preferred Stock Dividends			(95)		(95)
Loss on Reacquired Preferred Stock		(164)			(164)
Net Income			40,112		40,112
Other Comprehensive Loss				(6,776)	(6,776)
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2011	<u>137,214</u>	<u>3,276</u>	<u>208,280</u>	<u>(21,385)</u>	<u>327,385</u>
Common Stock Dividends			(20,000)		(20,000)
Net Income			30,689		30,689
Other Comprehensive Loss				(1,832)	(1,832)
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2012	<u>137,214</u>	<u>3,276</u>	<u>218,969</u>	<u>(23,217)</u>	<u>336,242</u>
Common Stock Dividends			(10,000)		(10,000)
Net Income			36,913		36,913
Other Comprehensive Income				4,798	4,798
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2013	<u>\$ 137,214</u>	<u>\$ 3,276</u>	<u>\$ 245,882</u>	<u>\$ (18,419)</u>	<u>\$ 367,953</u>

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
ASSETS
December 31, 2013 and 2012
(in thousands)

	December 31,	
	2013	2012
CURRENT ASSETS		
Advances to Affiliates	\$ 10,177	\$ 10,791
Accounts Receivable:		
Customers	12,460	11,556
Affiliated Companies	16,039	17,457
Accrued Unbilled Revenues	5,483	6,523
Miscellaneous	-	6
Allowance for Uncollectible Accounts	(22)	(305)
Total Accounts Receivable	33,960	35,237
Fuel	3,265	11,814
Materials and Supplies	15,343	15,302
Risk Management Assets	55	16
Accrued Tax Benefits	6,211	-
Prepayments and Other Current Assets	1,987	1,955
TOTAL CURRENT ASSETS	70,998	75,115
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	310,917	309,870
Transmission	540,045	508,716
Distribution	682,766	658,724
Other Property, Plant and Equipment	101,746	95,442
Construction Work in Progress	46,356	31,570
Total Property, Plant and Equipment	1,681,830	1,604,322
Accumulated Depreciation and Amortization	550,657	525,557
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,131,173	1,078,765
OTHER NONCURRENT ASSETS		
Regulatory Assets	47,232	56,366
Deferred Charges and Other Noncurrent Assets	15,511	1,520
TOTAL OTHER NONCURRENT ASSETS	62,743	57,886
TOTAL ASSETS	\$ 1,264,914	\$ 1,211,766

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
December 31, 2013 and 2012

	December 31,	
	2013	2012
	(in thousands)	
CURRENT LIABILITIES		
Advances from Affiliates	\$ 23,533	\$ 50,361
Accounts Payable:		
General	11,661	7,585
Affiliated Companies	15,563	15,098
Long-term Debt Due Within One Year – Nonaffiliated	7	225,006
Risk Management Liabilities	-	14,781
Accrued Taxes	13,115	22,528
Accrued Interest	4,480	5,916
Other Current Liabilities	22,537	15,655
TOTAL CURRENT LIABILITIES	90,896	356,930
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	420,286	145,293
Deferred Income Taxes	148,464	140,473
Regulatory Liabilities and Deferred Investment Tax Credits	181,339	174,426
Oklahoma Purchase Power Agreement	44,944	40,892
Deferred Credits and Other Noncurrent Liabilities	11,032	17,510
TOTAL NONCURRENT LIABILITIES	806,065	518,594
TOTAL LIABILITIES	896,961	875,524
Commitments and Contingencies (Note 4)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – \$25 Per Share:		
Authorized – 7,800,000 Shares		
Outstanding – 5,488,560 Shares	137,214	137,214
Paid-in Capital	3,276	3,276
Retained Earnings	245,882	218,969
Accumulated Other Comprehensive Income (Loss)	(18,419)	(23,217)
TOTAL COMMON SHAREHOLDER'S EQUITY	367,953	336,242
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	\$ 1,264,914	\$ 1,211,766

See Notes to Consolidated Financial Statements beginning on page 9.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2013, 2012 and 2011
(in thousands)

	Years Ended December 31,		
	2013	2012	2011
OPERATING ACTIVITIES			
Net Income	\$ 36,913	\$ 30,689	\$ 40,112
Adjustments to Reconcile Net Income to Net Cash Flows from			
Operating Activities:			
Depreciation and Amortization	54,667	53,844	53,721
Deferred Income Taxes	(3,019)	2,681	12,748
Change in Other Noncurrent Assets	(2,460)	(5,763)	(7,947)
Change in Other Noncurrent Liabilities	(11,905)	1,988	(3,210)
Changes in Certain Components of Working Capital:			
Accounts Receivable, Net	1,540	(5,305)	1,632
Fuel, Materials and Supplies	8,508	(6,725)	(4,269)
Accounts Payable	2,081	3,867	(29,328)
Accrued Taxes, Net	(7,758)	(1,484)	2,616
Other Current Assets	(167)	(1)	338
Other Current Liabilities	4,066	4,674	1,457
Net Cash Flows from Operating Activities	<u>82,466</u>	<u>78,465</u>	<u>67,870</u>
INVESTING ACTIVITIES			
Construction Expenditures	(104,689)	(89,902)	(76,907)
Change in Advances to Affiliates, Net	614	297	(1,606)
Acquisitions of Assets	(292)	(349)	(466)
Proceeds from Sales of Assets	7,306	5,574	3,587
Other Investing Activities	3,148	1,480	-
Net Cash Flows Used for Investing Activities	<u>(93,913)</u>	<u>(82,900)</u>	<u>(75,392)</u>
FINANCING ACTIVITIES			
Issuance of Long-term Debt – Nonaffiliated	273,513	-	-
Change in Advances from Affiliates, Net	(26,828)	24,472	25,889
Retirement of Long-term Debt - Nonaffiliated	(225,006)	(6)	(6)
Retirement Of Cumulative Preferred Stock	-	-	(2,512)
Principal Payments for Capital Lease Obligations	(589)	(666)	(810)
Dividends Paid on Common Stock	(10,000)	(20,000)	(15,000)
Dividends Paid on Cumulative Preferred Stock	-	-	(95)
Other Financing Activities	357	432	36
Net Cash Flows from Financing Activities	<u>11,447</u>	<u>4,232</u>	<u>7,502</u>
Net Decrease in Cash and Cash Equivalents	-	(203)	(20)
Cash and Cash Equivalents at Beginning of Period	-	203	223
Cash and Cash Equivalents at End of Period	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 203</u>
SUPPLEMENTARY INFORMATION			
Cash Paid for Interest, Net of Capitalized Amounts	\$ 18,988	\$ 21,338	\$ 21,513
Net Cash Paid for Income Taxes	27,669	19,398	3,249
Noncash Acquisitions Under Capital Leases	1,338	796	387
Construction Expenditures Included in Current Liabilities as of December 31,	5,472	2,847	4,364

See Notes to Consolidated Financial Statements beginning on page 9.

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1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

As a public utility, TNC engages in the transmission and distribution of electric power to 188,000 retail customers through REPs in its service territory in western and central Texas. TNC consolidates AEP Texas North Generation Company, LLC, its wholly-owned subsidiary.

Under the Texas Restructuring Legislation, TNC exited the generation business and ceased serving retail load. However, TNC continues as part owner in the Oklaunion Plant operated by PSO but has leased its entire portion of the output of the plant through 2027 to a non-utility affiliate.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Rates and Service Regulation

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

The PUCT also regulates TNC's wholesale transmission operations and rates. The FERC claims jurisdiction over retail transmission rates when retail rates are unbundled in connection with restructuring. TNC's retail transmission rates in Texas are unbundled. Although TNC's retail transmission rates in Texas are unbundled, retail transmission rates are regulated, on a cost basis, by the PUCT.

Principles of Consolidation

TNC's consolidated financial statements include TNC and its wholly-owned subsidiary. Intercompany items are eliminated in consolidation. TNC also has a generating unit that is jointly-owned with an affiliated company and nonaffiliated companies. TNC's proportionate share of the operating costs associated with that facility is included in the financial statements and the assets and liabilities are reflected in the balance sheets. See "Oklaunion PPA between TNC and AEP Energy Partners" section within Note 12 for detail of TNC's agreement to sell its portion of the Oklaunion generation to AEPEP. See Note 13 – Variable Interest Entities.

Accounting for the Effects of Cost-Based Regulation

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

Use of Estimates

The preparation of these financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include, but are not limited to, inventory valuation, allowance for doubtful accounts, long-lived asset impairment, unbilled electricity revenue, valuation of long-term energy contracts, the effects of regulation, long-lived asset recovery, storm costs, the effects

of contingencies and certain assumptions made in accounting for pension and postretirement benefits. The estimates and assumptions used are based upon management's evaluation of the relevant facts and circumstances as of the date of the financial statements. Actual results could ultimately differ from those estimates.

Cash and Cash Equivalents

Cash and Cash Equivalents on the statements of cash flows include temporary cash investments with original maturities of three months or less.

Inventory

Fossil fuel inventories are carried at the lower of average cost or market. Materials and supplies inventories are carried at average cost.

Accounts Receivable

Customer accounts receivable primarily includes receivables from REPs and receivables related to other revenue-generating activities.

Revenue is recognized when power is delivered. To the extent that deliveries have occurred but a bill has not been issued, TNC accrues and recognizes, as Accrued Unbilled Revenues on the balance sheets, an estimate of the revenues for deliveries since the last billing.

Allowance for Uncollectible Accounts

TNC records bad debt reserves using the specific identification of receivable balances greater than 120 days delinquent, and for those balances less than 120 days where the collection is doubtful. For miscellaneous accounts receivable, bad debt expense is recorded for all amounts outstanding 180 days or greater at 100%, unless specifically identified. Miscellaneous accounts receivable items open less than 180 days may be reserved using specific identification for bad debt reserves.

Concentrations of Credit Risk and Significant Customers

TNC has significant customers which on a combined basis account for the following percentages of total operating revenues for the years ended December 31 and Accounts Receivable – Customers as of December 31:

Significant Customers of TNC: Centrica and Reliant Energy	2013	2012	2011
Percentage of Operating Revenues	19 %	21 %	23 %
Percentage of Accounts Receivable - Customers	30 %	30 %	36 %

Management monitors credit levels and the financial condition of TNC's customers on a continuing basis to minimize credit risk. The PUCT allows recovery in rates for a reasonable level of bad debt costs. Management believes adequate provision for credit loss has been made in the accompanying financial statements.

Property, Plant and Equipment

Regulated

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

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

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

Nonregulated

The generation operations of TNC generally follow the policies of its rate-regulated operations listed above but with the following exceptions. Property, plant and equipment are stated at fair value at acquisition (or as adjusted for any applicable impairments) plus the original cost of property acquired or constructed since the acquisition, less disposals. Normal and routine retirements from the plant accounts, net of salvage, are charged to accumulated depreciation under the group composite method of depreciation. A gain or loss would be recorded if the retirement is not considered an interim routine replacement. Removal costs are charged to expense.

Allowance for Funds Used During Construction (AFUDC) and Interest Capitalization

For TNC’s regulated operations, AFUDC represents the estimated cost of borrowed and equity funds used to finance construction projects that is capitalized and recovered through depreciation over the service life of regulated electric utility plant. TNC records the equity component of AFUDC in Other Income (Expense) and the debt component of AFUDC as a reduction to Interest Expense. For TNC’s nonregulated operations, interest is capitalized during construction in accordance with the accounting guidance for “Capitalization of Interest.”

Valuation of Nonderivative Financial Instruments

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

Fair Value Measurements of Assets and Liabilities

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

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

Assets in the benefits trusts are classified using the following methods. Equities are classified as Level 1 holdings if they are actively traded on exchanges. Items classified as Level 1 are investments in money market funds, fixed income and equity mutual funds and domestic equity securities. They are valued based on observable inputs primarily unadjusted quoted prices in active markets for identical assets. Items classified as Level 2 are primarily investments in individual fixed income securities and cash equivalents funds. Fixed income securities do not trade on an exchange and do not have an official closing price but their valuation inputs are based on observable market data. Pricing vendors calculate bond valuations using financial models and matrices. The models use observable inputs including yields on benchmark securities, quotes by securities brokers, rating agency actions, discounts or premiums on securities compared to par prices, changes in yields for U.S. Treasury securities, corporate actions by bond issuers, prepayment schedules and histories, economic events and, for certain securities, adjustments to yields to reflect changes in the rate of inflation. Other securities with model-derived valuation inputs that are observable are also classified as Level 2 investments. Investments with unobservable valuation inputs are classified as Level 3 investments. Benefit plan assets included in Level 3 are primarily real estate and private equity investments that are valued using methods requiring judgment including appraisals.

Revenue Recognition

Regulatory Accounting

TNC's financial statements reflect the actions of regulators that can result in the recognition of revenues and expenses in different time periods than enterprises that are not rate-regulated. Regulatory assets (deferred expenses) and regulatory liabilities (deferred revenue reductions or refunds) are recorded to reflect the economic effects of regulation in the same accounting period by matching expenses with their recovery through regulated revenues and by matching income with its passage to customers in cost-based regulated rates.

When regulatory assets are probable of recovery through regulated rates, TNC records them as assets on its balance sheets. TNC tests for probability of recovery at each balance sheet date or whenever new events occur. Examples of new events include the issuance of a regulatory commission order or passage of new legislation. If it is determined that recovery of a regulatory asset is no longer probable, TNC writes off that regulatory asset as a charge against income.

Electricity Supply and Delivery Activities

TNC recognizes revenues from electricity transmission and distribution delivery services. TNC recognizes the revenues on the statements of income upon delivery of the energy to the customer and includes unbilled as well as billed amounts.

Power Purchase and Sale Agreement

TNC recognizes revenue from an affiliate, AEPEP, for a 20-year PPA. TNC recognizes revenues for the fuel, operations and maintenance and all other taxes on a billed basis. Revenue is recognized for the capacity and depreciation billed to AEPEP on a straight-line basis over the term of the PPA as these amounts represent the minimum amount due.

Maintenance

Maintenance costs are expensed as incurred. If it becomes probable that TNC will recover specifically-incurred costs through future rates, a regulatory asset is established to match the expensing of those maintenance costs with their recovery in cost-based regulated revenues.

Income Taxes and Investment Tax Credits

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

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

Investment tax credits are accounted for under the deferral basis and are being amortized over the life of the plant investment.

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

Excise Taxes

As an agent for some state and local governments, TNC collects from customers certain excise taxes levied by those state or local governments on customers. TNC does not recognize these taxes as revenue or expense.

Debt

Gains and losses from the reacquisition of debt used to finance regulated electric utility plants are deferred and amortized over the remaining term of the reacquired debt in accordance with their rate-making treatment unless the debt is refinanced. If the reacquired debt is refinanced, the reacquisition costs attributable to the portions of the business that are subject to cost-based regulatory accounting are generally deferred and amortized over the term of the replacement debt consistent with its recovery in rates.

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

Investments Held in Trust for Future Liabilities

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

Benefit Plans

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

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

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

The investment policy for the pension fund allocates assets based on the funded status of the pension plan. The objective of the asset allocation policy is to reduce the investment volatility of the plan over time. Generally, more of the investment mix will be allocated to fixed income investments as the plan becomes better funded. Assets will be transferred away from equity investments into fixed income investments based on the market value of plan assets compared to the plan's projected benefit obligation. The target asset allocations are as follows:

Pension Plan Assets	Target
Equity	30.0 %
Fixed Income	55.0 %
Other Investments	15.0 %

OPEB Plans Assets	Target
Equity	66.0 %
Fixed Income	33.0 %
Cash	1.0 %

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

For equity investments, the limits are as follows:

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

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

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

For obligations of non-government issuers, the following limitations apply:

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

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

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

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

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

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

Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive income (loss) has two components: net income (loss) and other comprehensive income (loss).

Earnings Per Share (EPS)

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

Subsequent Events

Management reviewed subsequent events through February 25, 2014, the date that TNC's 2013 annual report was issued.

2. COMPREHENSIVE INCOME

Presentation of Comprehensive Income

The following table provides the components of changes in AOCI for the year ended December 31, 2013. All amounts in the following tables are presented net of related income taxes.

**Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Year Ended December 31, 2013**

	Cash Flow Hedges		Pension and OPEB		Total
	Commodity	Interest Rate and Foreign Currency	Amortization of Deferred Costs	Changes in Funded Status	
Balance in AOCI as of December 31, 2012	\$ 13	\$ (9,608)	\$ 1,940	\$ (15,562)	\$ (23,217)
Change in Fair Value Recognized in AOCI	53	339	-	2,432	2,824
Amounts Reclassified from AOCI	(30)	1,304	700	-	1,974
Net Current Period Other					
Comprehensive Income	23	1,643	700	2,432	4,798
Balance in AOCI as of December 31, 2013	<u>\$ 36</u>	<u>\$ (7,965)</u>	<u>\$ 2,640</u>	<u>\$ (13,130)</u>	<u>\$ (18,419)</u>

Reclassifications from Accumulated Other Comprehensive Income

The following table provides details of reclassifications from AOCI for the year ended December 31, 2013.

Reclassifications from Accumulated Other Comprehensive Income (Loss) For the Year Ended December 31, 2013

	Amount of (Gain) Loss Reclassified from AOCI
Gains and Losses on Cash Flow Hedges	(in thousands)
Commodity:	
Other Operation Expense	\$ (12)
Maintenance Expense	(12)
Property, Plant and Equipment	(22)
Subtotal - Commodity	<u>(46)</u>
Interest Rate and Foreign Currency:	
Interest Expense	<u>2,006</u>
Subtotal - Interest Rate and Foreign Currency	<u>2,006</u>
Reclassifications from AOCI, before Income Tax (Expense) Credit	1,960
Income Tax (Expense) Credit	<u>686</u>
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	<u>1,274</u>
Pension and OPEB	
Amortization of Prior Service Cost (Credit)	(61)
Amortization of Actuarial (Gains)/Losses	1,137
Change in Funded Status	<u>-</u>
Reclassifications from AOCI, before Income Tax (Expense) Credit	1,076
Income Tax (Expense) Credit	<u>376</u>
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	<u>700</u>
Total Reclassifications from AOCI, Net of Income Tax (Expense) Credit	<u>\$ 1,974</u>

The following tables provide details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TNC's balance sheets and the reasons for changes in cash flow hedges for the years ended December 31, 2012 and 2011. All amounts in the following tables are presented net of related income taxes.

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
Year Ended December 31, 2012**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
	(in thousands)		
Balance in AOCI as of January 1,	\$ (42)	\$ (5,853)	\$ (5,895)
Changes in Fair Value Recognized in AOCI	67	(3,755)	(3,688)
Amount of (Gain) or Loss Reclassified from AOCI to Statement of Income/within Balance Sheet:			
Other Operation Expense	(4)	-	(4)
Maintenance Expense	(2)	-	(2)
Property, Plant and Equipment	(6)	-	(6)
Balance in AOCI as of December 31,	<u>\$ 13</u>	<u>\$ (9,608)</u>	<u>\$ (9,595)</u>

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
Year Ended December 31, 2011**

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
	(in thousands)		
Balance in AOCI as of January 1,	\$ 54	\$ -	\$ 54
Changes in Fair Value Recognized in AOCI	46	(5,853)	(5,807)
Amount of (Gain) or Loss Reclassified from AOCI to Statement of Income/within Balance Sheet:			
Other Operation Expense	(54)	-	(54)
Maintenance Expense	(32)	-	(32)
Property, Plant and Equipment	(56)	-	(56)
Balance in AOCI as of December 31,	<u>\$ (42)</u>	<u>\$ (5,853)</u>	<u>\$ (5,895)</u>

3. EFFECTS OF REGULATION

Regulatory assets and liabilities are comprised of the following items:

Regulatory Assets:	December 31, 2013 2012		Remaining Recovery Period
	(in thousands)		
Noncurrent Regulatory Assets			
Regulatory assets not yet being recovered pending future proceedings to determine the recovery method and timing:			
<u>Regulatory Assets Currently Not Earning a Return</u>			
Rate Case Expense	\$ 3	\$ 3	
Total Regulatory Assets Not Yet Being Recovered	<u>3</u>	<u>3</u>	
Regulatory assets being recovered:			
<u>Regulatory Assets Currently Earning a Return</u>			
Texas Meter Replacement Costs	12,123	7,354	15 years
Unamortized Loss on Reacquired Debt	2,595	3,226	7 years
Advanced Metering System	372	425	7 years
<u>Regulatory Assets Currently Not Earning a Return</u>			
Pension and OPEB Funded Status	26,127	42,811	11 years
Transmission Cost Recovery Factor	4,200	2,545	1 year
Medicare Subsidy	1,810	-	11 years
Other Regulatory Assets Being Recovered	2	2	various
Total Regulatory Assets Being Recovered	<u>47,229</u>	<u>56,363</u>	
Total Noncurrent Regulatory Assets	<u>\$ 47,232</u>	<u>\$ 56,366</u>	
Regulatory Liabilities:	December 31, 2013 2012		Remaining Refund Period
	(in thousands)		
Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits			
Regulatory liabilities being paid:			
<u>Regulatory Liabilities Currently Paying a Return</u>			
Asset Removal Costs	\$ 146,961	\$ 136,517	(a)
Advanced Metering Infrastructure Surcharge	13,567	17,043	7 years
Excess Earnings	8,806	9,302	18 years
<u>Regulatory Liabilities Currently Not Paying a Return</u>			
Deferred Investment Tax Credits	8,935	9,891	36 years
Income Taxes, Net	2,798	1,449	21 years
Other Regulatory Liabilities Being Paid	272	224	various
Total Regulatory Liabilities Being Paid	<u>181,339</u>	<u>174,426</u>	
Total Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits	<u>\$ 181,339</u>	<u>\$ 174,426</u>	

(a) Relieved as removal costs are incurred.

4. COMMITMENTS, GUARANTEES AND CONTINGENCIES

TNC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, TNC's business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation cannot be predicted. For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material effect on the financial statements.

COMMITMENTS

Construction and Commitments

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

The following table summarizes TNC's actual contractual commitments as of December 31, 2013:

Contractual Commitments	Less Than 1 Year	2-3 Years	4-5 Years	After 5 Years	Total
	(in thousands)				
Construction Contracts for Capital Assets (a)	\$ 2,882	\$ -	\$ -	\$ -	\$ 2,882

(a) Represents only capital assets for which there are signed contracts. Actual payments are dependent upon and may vary significantly based upon the decision to build, regulatory approval schedules, timing and escalation of project costs.

GUARANTEES

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

Indemnifications and Other Guarantees

Contracts

TNC enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of December 31, 2013, there were no material liabilities recorded for any indemnifications.

Lease Obligations

TNC leases certain equipment under master lease agreements. See "Master Lease Agreements" section of Note 10 for disclosure of lease residual value guarantees.

CONTINGENCIES

Insurance and Potential Losses

TNC maintains insurance coverage normal and customary for an electric utility, subject to various deductibles. Insurance coverage includes all risks of physical loss or damage to assets, subject to insurance policy conditions and exclusions. Covered property generally includes power plants, substations, facilities and inventories. Excluded property generally includes transmission and distribution lines, poles and towers. The insurance programs also

generally provide coverage against loss arising from certain claims made by third parties and are in excess of TNC's retentions. Coverage is generally provided by a combination of the protected cell of EIS and/or various industry mutual and/or commercial insurance carriers.

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

Carbon Dioxide Public Nuisance Claims

In October 2009, the Fifth Circuit Court of Appeals reversed a decision by the Federal District Court for the District of Mississippi dismissing state common law nuisance claims in a putative class action by Mississippi residents asserting that CO₂ emissions exacerbated the effects of Hurricane Katrina. The Fifth Circuit held that there was no exclusive commitment of the common law issues raised in plaintiffs' complaint to a coordinate branch of government and that no initial policy determination was required to adjudicate these claims. The court granted petitions for rehearing. An additional recusal left the Fifth Circuit without a quorum to reconsider the decision and the appeal was dismissed, leaving the district court's decision in place. Plaintiffs filed a petition with the U.S. Supreme Court asking the court to remand the case to the Fifth Circuit and reinstate the panel decision. The petition was denied in January 2011. Plaintiffs refiled their complaint in federal district court. The court ordered all defendants to respond to the refiled complaints in October 2011. In March 2012, the court granted the defendants' motion for dismissal on several grounds, including the doctrine of collateral estoppel and the applicable statute of limitations. In May 2013, the U.S. Court of Appeals for the Fifth Circuit affirmed the district court's dismissal of the complaint. The plaintiffs did not appeal to the U.S. Supreme Court.

Alaskan Villages' Claims

In 2008, the Native Village of Kivalina and the City of Kivalina, Alaska filed a lawsuit in Federal Court in the Northern District of California against AEP, AEPSC and 22 other unrelated defendants including oil and gas companies, a coal company and other electric generating companies. The complaint alleges that the defendants' emissions of CO₂ contribute to global warming and constitute a public and private nuisance and that the defendants are acting together. The complaint further alleges that some of the defendants, including AEP, conspired to create a false scientific debate about global warming in order to deceive the public and perpetuate the alleged nuisance. The plaintiffs also allege that the effects of global warming will require the relocation of the village at an alleged cost of \$95 million to \$400 million. In October 2009, the judge dismissed plaintiffs' federal common law claim for nuisance, finding the claim barred by the political question doctrine and by plaintiffs' lack of standing to bring the claim. The judge also dismissed plaintiffs' state law claims without prejudice to refile in state court. In September 2012, the Ninth Circuit Court of Appeals affirmed the trial court's decision, holding that the CAA displaced Kivalina's claims for damages. Plaintiffs filed seeking further review in the U.S. Supreme Court. In May 2013, the U.S. Supreme Court denied the plaintiffs' request for review.

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

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

Superfund addresses clean-up of hazardous substances that have been released to the environment. The Federal EPA administers the clean-up programs. Several states have enacted similar laws. As of December 31, 2013, TNC has been named potentially liable at one site under state law. In the instance where TNC has been named a defendant, disposal or recycling activities were in accordance with the then-applicable laws and regulations. Superfund does not recognize compliance as a defense, but imposes strict liability on parties who fall within its broad statutory categories. Liability has been resolved for a number of sites with no significant effect on net income.

Management evaluates the potential liability for each site separately, but several general statements can be made about potential future liability. Allegations that materials were disposed at a particular site are often unsubstantiated and the quantity of materials deposited at a site can be small and often nonhazardous. Although Superfund liability has been interpreted by the courts as joint and several, typically many parties are named for each site and several of the parties are financially sound enterprises. At present, management's estimates do not anticipate material cleanup costs for identified sites.

5. BENEFIT PLANS

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

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

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

Actuarial Assumptions for Benefit Obligations

The weighted-average assumptions as of December 31 of each year used in the measurement of TNC's benefit obligations are shown in the following table:

<u>Assumptions</u>	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>2013</u>	<u>2012</u>	<u>2013</u>	<u>2012</u>
Discount Rate	4.70 %	3.95 %	4.70 %	3.95 %
Rate of Compensation Increase	4.45 % (a)	4.45 % (a)	NA	NA

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

NA Not applicable.

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

For 2013, the rate of compensation increase assumed varies with the age of the employee, ranging from 3.5% per year to 11.5% per year, with an average increase of 4.45%.

Actuarial Assumptions for Net Periodic Benefit Costs

The weighted-average assumptions as of January 1 of each year used in the measurement of TNC's benefit costs are shown in the following table:

	Pension Plans			Other Postretirement Benefit Plans		
	2013	2012	2011	2013	2012	2011
Discount Rate	3.95 %	4.55 %	5.05 %	3.95 %	4.75 %	5.25 %
Expected Return on Plan Assets	6.50 %	7.25 %	7.75 %	7.00 %	7.25 %	7.50 %
Rate of Compensation Increase	4.45 %	4.45 %	4.40 %	NA	NA	NA

NA Not applicable.

The expected return on plan assets for 2013 was determined by evaluating historical returns, the current investment climate (yield on fixed income securities and other recent investment market indicators), rate of inflation and current prospects for economic growth.

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

Health Care Trend Rates	2013	2012
Initial	6.75 %	7.00 %
Ultimate	5.00 %	5.00 %
Year Ultimate Reached	2020	2020

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

	1% Increase	1% Decrease
	(in thousands)	
Effect on Total Service and Interest Cost		
Components of Net Periodic Postretirement Health Care Benefit Cost	\$ 101	\$ (67)
Effect on the Health Care Component of the Accumulated Postretirement Benefit Obligation	1,378	(1,121)

Significant Concentrations of Risk within Plan Assets

In addition to establishing the target asset allocation of plan assets, the investment policy also places restrictions on securities to limit significant concentrations within plan assets. The investment policy establishes guidelines that govern maximum market exposure, security restrictions, prohibited asset classes, prohibited types of transactions, minimum credit quality, average portfolio credit quality, portfolio duration and concentration limits. The guidelines were established to mitigate the risk of loss due to significant concentrations in any investment. The plans are monitored to control security diversification and ensure compliance with the investment policy. As of December 31, 2013, the assets were invested in compliance with all investment limits. See "Investments Held in Trust for Future Liabilities" section of Note 1 for limit details.

Benefit Plan Obligations, Plan Assets and Funded Status as of December 31, 2013 and 2012

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

	Pension Plans		Other Postretirement Benefit Plans	
	2013	2012	2013	2012
	(in thousands)			
Change in Benefit Obligation				
Benefit Obligation as of January 1,	\$ 105,884	\$ 108,101	\$ 41,542	\$ 50,498
Service Cost	1,602	1,758	408	832
Interest Cost	4,184	4,658	1,595	2,324
Actuarial (Gain) Loss	(3,908)	(138)	(8,119)	2,994
Plan Amendment Prior Service Credit	-	-	-	(12,781)
Benefit Payments	(8,022)	(8,495)	(3,382)	(3,602)
Participant Contributions	-	-	1,061	936
Medicare Subsidy	-	-	218	341
Benefit Obligation as of December 31,	\$ 99,740	\$ 105,884	\$ 33,323	\$ 41,542
Change in Fair Value of Plan Assets				
Fair Value of Plan Assets as of January 1,	\$ 102,808	\$ 97,369	\$ 37,725	\$ 33,523
Actual Gain on Plan Assets	8,537	10,122	5,868	4,837
Company Contributions	134	3,812	-	2,031
Participant Contributions	-	-	1,061	936
Benefit Payments	(8,022)	(8,495)	(3,382)	(3,602)
Fair Value of Plan Assets as of December 31,	\$ 103,457	\$ 102,808	\$ 41,272	\$ 37,725
Funded (Underfunded) Status as of December 31,	\$ 3,717	\$ (3,076)	\$ 7,949	\$ (3,817)

Amounts Recognized on the Balance Sheets as of December 31, 2013 and 2012

	Pension Plans		Other Postretirement Benefit Plans	
	2013	2012	December 31, 2013	2012
	(in thousands)			
Deferred Charges and Other Noncurrent Assets - Prepaid Benefit Costs	\$ 5,171	\$ -	\$ 7,545	\$ -
Other Current Liabilities - Accrued Short-term Benefit Liability	(133)	(129)	-	-
Deferred Credits and Other Noncurrent Liabilities - Accrued Long-term Benefit Liability	(1,321)	(2,947)	404	(3,817)
Funded (Underfunded) Status	\$ 3,717	\$ (3,076)	\$ 7,949	\$ (3,817)

Amounts Included in AOCI and Regulatory Assets as of December 31, 2013 and 2012

Components	Pension Plans		Other Postretirement Benefit Plans	
	December 31,			
	2013	2012	2013	2012
	(in thousands)			
Net Actuarial Loss	\$ 49,512	\$ 59,600	\$ 8,268	\$ 21,152
Prior Service Cost (Credit)	297	405	(15,813)	(17,391)
Recorded as				
Regulatory Assets	\$ 32,004	\$ 39,737	\$ (5,877)	\$ 3,074
Deferred Income Taxes	6,231	7,093	(584)	240
Net of Tax AOCI	11,574	13,175	(1,084)	447

Components of the change in amounts included in AOCI and Regulatory Assets during the years ended December 31, 2013 and 2012 are as follows:

Components	Pension Plans		Other Postretirement Benefit Plans	
	Years Ended December 31,			
	2013	2012	2013	2012
	(in thousands)			
Actuarial (Gain) Loss During the Year	\$ (6,317)	\$ (3,211)	\$ (11,415)	\$ 473
Prior Service Credit	-	-	-	(12,781)
Amortization of Actuarial Loss	(3,771)	(3,130)	(1,469)	(1,287)
Amortization of Prior Service Credit (Cost)	(108)	416	1,578	437
Change for the Year	\$ (10,196)	\$ (5,925)	\$ (11,306)	\$ (13,158)

Pension and Other Postretirement Plans' Assets

The following table presents the classification of pension plan assets within the fair value hierarchy as of December 31, 2013:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in thousands)					
Equities:						
Domestic	\$ 23,973	\$ -	\$ -	\$ -	\$ 23,973	23.2 %
International	11,300	-	-	-	11,300	10.9 %
Real Estate Investment Trusts	1,271	-	-	-	1,271	1.2 %
Common Collective Trust - International	-	214	-	-	214	0.2 %
Subtotal - Equities	36,544	214	-	-	36,758	35.5 %
Fixed Income:						
Common Collective Trust - Debt	-	569	-	-	569	0.5 %
United States Government and Agency Securities	-	8,493	-	-	8,493	8.2 %
Corporate Debt	-	35,136	-	-	35,136	34.0 %
Foreign Debt	-	7,548	-	-	7,548	7.3 %
State and Local Government	-	615	-	-	615	0.6 %
Other - Asset Backed	-	731	-	-	731	0.7 %
Subtotal - Fixed Income	-	53,092	-	-	53,092	51.3 %
Real Estate	-	-	5,232	-	5,232	5.0 %
Alternative Investments	-	-	7,239	-	7,239	7.0 %
Securities Lending	-	772	-	-	772	0.8 %
Securities Lending Collateral (a)	-	-	-	(992)	(992)	(0.9)%
Cash and Cash Equivalents	-	1,067	-	-	1,067	1.0 %
Other - Pending Transactions and Accrued Income (b)	-	-	-	289	289	0.3 %
Total	\$ 36,544	\$ 55,145	\$ 12,471	\$ (703)	\$ 103,457	100.0 %

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

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

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

	Real Estate	Alternative Investments	Total Level 3
Balance as of January 1, 2013	\$ 4,807	\$ 4,282	\$ 9,089
Actual Return on Plan Assets			
Relating to Assets Still Held as of the Reporting Date	608	317	925
Relating to Assets Sold During the Period	-	319	319
Purchases and Sales	(183)	2,321	2,138
Transfers into Level 3	-	-	-
Transfers out of Level 3	-	-	-
Balance as of December 31, 2013	\$ 5,232	\$ 7,239	\$ 12,471

The following table presents the classification of OPEB plan assets within the fair value hierarchy as of December 31, 2013:

<u>Asset Class</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>	<u>Year End Allocation</u>
	(in thousands)					
Equities:						
Domestic	\$ 11,500	\$ -	\$ -	\$ -	\$ 11,500	27.9 %
International	14,952	-	-	-	14,952	36.2 %
Common Collective Trust - Global	-	357	-	-	357	0.9 %
Subtotal - Equities	<u>26,452</u>	<u>357</u>	<u>-</u>	<u>-</u>	<u>26,809</u>	<u>65.0 %</u>
Fixed Income:						
Common Collective Trust - Debt	-	2,135	-	-	2,135	5.2 %
United States Government and Agency Securities	-	1,373	-	-	1,373	3.3 %
Corporate Debt	-	2,674	-	-	2,674	6.5 %
Foreign Debt	-	522	-	-	522	1.2 %
State and Local Government	-	112	-	-	112	0.3 %
Other - Asset Backed	-	197	-	-	197	0.5 %
Subtotal - Fixed Income	<u>-</u>	<u>7,013</u>	<u>-</u>	<u>-</u>	<u>7,013</u>	<u>17.0 %</u>
Trust Owned Life Insurance:						
International Equities	-	322	-	-	322	0.8 %
United States Bonds	-	5,140	-	-	5,140	12.4 %
Cash and Cash Equivalents	1,658	213	-	-	1,871	4.5 %
Other - Pending Transactions and Accrued Income (a)	<u>-</u>	<u>-</u>	<u>-</u>	<u>117</u>	<u>117</u>	<u>0.3 %</u>
Total	<u><u>\$ 28,110</u></u>	<u><u>\$ 13,045</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 117</u></u>	<u><u>\$ 41,272</u></u>	<u><u>100.0 %</u></u>

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

The following table presents the classification of pension plan assets within the fair value hierarchy as of December 31, 2012:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in thousands)					
Equities:						
Domestic	\$ 28,638	\$ -	\$ -	\$ -	\$ 28,638	27.9 %
International	10,876	-	-	-	10,876	10.5 %
Real Estate Investment Trusts	1,983	-	-	-	1,983	1.9 %
Common Collective Trust - International	-	95	-	-	95	0.1 %
Subtotal - Equities	41,497	95	-	-	41,592	40.4 %
Fixed Income:						
Common Collective Trust - Debt United States Government and Agency Securities	-	695	-	-	695	0.7 %
Corporate Debt	-	15,660	-	-	15,660	15.2 %
Foreign Debt	-	27,040	-	-	27,040	26.3 %
State and Local Government	-	4,349	-	-	4,349	4.2 %
Other - Asset Backed	-	963	-	-	963	0.9 %
Subtotal - Fixed Income	-	49,487	-	-	49,487	48.1 %
Real Estate	-	-	4,807	-	4,807	4.7 %
Alternative Investments	-	-	4,282	-	4,282	4.2 %
Securities Lending	-	1,759	-	-	1,759	1.7 %
Securities Lending Collateral (a)	-	-	-	(1,989)	(1,989)	(1.9)%
Cash and Cash Equivalents	-	2,753	-	-	2,753	2.7 %
Other - Pending Transactions and Accrued Income (b)	-	-	-	117	117	0.1 %
Total	\$ 41,497	\$ 54,094	\$ 9,089	\$ (1,872)	\$ 102,808	100.0 %

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

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

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

	Corporate Debt	Real Estate	Alternative Investments	Total Level 3
	(in thousands)			
Balance as of January 1, 2012	\$ 144	\$ 3,696	\$ 3,628	\$ 7,468
Actual Return on Plan Assets				
Relating to Assets Still Held as of the Reporting Date	-	588	186	774
Relating to Assets Sold During the Period	(51)	-	91	40
Purchases and Sales	(93)	523	377	807
Transfers into Level 3	-	-	-	-
Transfers out of Level 3	-	-	-	-
Balance as of December 31, 2012	\$ -	\$ 4,807	\$ 4,282	\$ 9,089

The following table presents the classification of OPEB plan assets within the fair value hierarchy as of December 31, 2012:

Asset Class	Level 1	Level 2	Level 3	Other	Total	Year End Allocation
	(in thousands)					
Equities:						
Domestic	\$ 10,153	\$ -	\$ -	\$ -	\$ 10,153	26.9 %
International	12,139	-	-	-	12,139	32.2 %
Subtotal - Equities	22,292	-	-	-	22,292	59.1 %
Fixed Income:						
Common Collective Trust - Debt	-	1,745	-	-	1,745	4.6 %
United States Government and Agency Securities	-	1,978	-	-	1,978	5.2 %
Corporate Debt	-	3,725	-	-	3,725	9.9 %
Foreign Debt	-	630	-	-	630	1.7 %
State and Local Government	-	175	-	-	175	0.5 %
Other - Asset Backed	-	236	-	-	236	0.6 %
Subtotal - Fixed Income	-	8,489	-	-	8,489	22.5 %
Trust Owned Life Insurance:						
International Equities	-	1,240	-	-	1,240	3.3 %
United States Bonds	-	3,912	-	-	3,912	10.3 %
Cash and Cash Equivalents	1,493	274	-	-	1,767	4.7 %
Other - Pending Transactions and Accrued Income (a)	-	-	-	25	25	0.1 %
Total	\$ 23,785	\$ 13,915	\$ -	\$ 25	\$ 37,725	100.0 %

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

Determination of Pension Expense

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

The accumulated benefit obligation for the pension plans is as follows:

Accumulated Benefit Obligation	December 31,	
	2013	2012
	(in thousands)	
Qualified Pension Plan	\$ 95,351	\$ 102,635
Nonqualified Pension Plan	1,454	1,427
Total	\$ 96,805	\$ 104,062

For the underfunded pension plan that had an accumulated benefit obligation in excess of plan assets, the projected benefit obligation, accumulated benefit obligation and fair value of plan assets of these plans as of December 31, 2013 and 2012 were as follows:

	Underfunded Pension Plan	
	2013	2012
	(in thousands)	
Projected Benefit Obligation	\$ 1,454	\$ 1,427
Accumulated Benefit Obligation	\$ 1,454	\$ 1,427
Fair Value of Plan Assets	-	-
Underfunded Accumulated Benefit Obligation	\$ (1,454)	\$ (1,427)

Estimated Future Benefit Payments and Contributions

TNC expects contributions and payments for the pension plans of \$133 thousand during 2014. The estimated contributions to the pension trust are at least the minimum amount required by the Employee Retirement Income Security Act and additional discretionary contributions may also be made to maintain the funded status of the plan.

The table below reflects the total benefits expected to be paid from the plan or from TNC's assets. The payments include the participants' contributions to the plan for their share of the cost. In November 2012, changes to the retiree medical coverage were announced. Effective for retirements after December 2012, contributions to retiree medical coverage were capped reducing exposure to future medical cost inflation. Effective for employees hired after December 2013, retiree medical coverage will not be provided. The impact of the changes is reflected in the Benefit Plan Obligation table as plan amendments. Future benefit payments are dependent on the number of employees retiring, whether the retiring employees elect to receive pension benefits as annuities or as lump sum distributions, future integration of the benefit plans with changes to Medicare and other legislation, future levels of interest rates and variances in actuarial results. The estimated payments for pension benefits and OPEB are as follows:

	Estimated Payments	
	Pension Plans	Other Postretirement Benefit Plans
	(in thousands)	
2014	\$ 9,230	\$ 3,424
2015	8,508	3,523
2016	8,838	3,664
2017	9,163	3,808
2018	8,651	3,751
Years 2019 to 2023, in Total	42,485	19,461

Components of Net Periodic Benefit Cost

The following table provides the components of net periodic benefit cost (credit) for the years ended December 31, 2013, 2012 and 2011:

	Pension Plans			Other Postretirement Benefit Plans		
	Years Ended December 31,					
	2013	2012	2011	2013	2012	2011
	(in thousands)					
Service Cost	\$ 1,602	\$ 1,758	\$ 1,689	\$ 408	\$ 832	\$ 768
Interest Cost	4,184	4,658	5,149	1,595	2,324	2,456
Expected Return on Plan Assets	(6,128)	(7,049)	(7,043)	(2,572)	(2,390)	(2,565)
Amortization of Prior Service Cost (Credit)	108	(416)	(420)	(1,578)	(437)	(20)
Amortization of Net Actuarial Loss	3,771	3,130	2,641	1,469	1,287	635
Net Periodic Benefit Cost (Credit)	3,537	2,081	2,016	(678)	1,616	1,274
Capitalized Portion	(1,744)	(993)	(861)	334	(771)	(544)
Net Periodic Benefit Cost (Credit) Recognized in Expense	\$ 1,793	\$ 1,088	\$ 1,155	\$ (344)	\$ 845	\$ 730

Estimated amounts expected to be amortized to net periodic benefit costs (credits) and the impact on the balance sheet during 2014 are shown in the following table:

Components	Pension Plans	Other Postretirement Benefit Plans
	(in thousands)	
Net Actuarial Loss	\$ 2,563	\$ 468
Prior Service Cost (Credit)	108	(1,577)
Total Estimated 2014 Amortization	\$ 2,671	\$ (1,109)
Expected to be Recorded as		
Regulatory Asset	\$ 2,078	\$ (1,134)
Deferred Income Taxes	208	9
Net of Tax AOCI	385	16
Total	\$ 2,671	\$ (1,109)

American Electric Power System Retirement Savings Plan

TNC participates in an AEP sponsored defined contribution retirement savings plan, the American Electric Power System Retirement Savings Plan, for substantially all employees. This qualified plan offers participants an opportunity to contribute a portion of their pay, includes features under Section 401(k) of the Internal Revenue Code and provides for matching contributions. The matching contributions to the plan are 100% of the first 1% of eligible employee contributions and 70% of the next 5% of contributions. The cost for matching contributions totaled \$1.1 million in 2013, \$1.1 million in 2012 and \$1 million in 2011.

6. BUSINESS SEGMENTS

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

7. DERIVATIVES AND HEDGING

Cash Flow Hedging Strategies

TNC's vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEPSC, on behalf of TNC, enters into financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. Not all fuel price risk exposure is hedged. The gross notional volumes of TNC's outstanding derivative contracts for heating oil and gasoline as of December 31, 2013 and 2012 were 392 thousand gallons and 379 thousand gallons, respectively.

AEPSC, on behalf of TNC, enters into a variety of interest rate derivative transactions in order to manage interest rate risk exposure. Some interest rate derivative transactions effectively modify exposure to interest rate risk by converting a portion of floating-rate debt to a fixed rate. AEPSC, on behalf of TNC, also enters into interest rate derivative contracts to manage interest rate exposure related to future borrowings of fixed-rate debt. The forecasted fixed-rate debt offerings have a high probability of occurrence as the proceeds will be used to fund existing debt maturities and projected capital expenditures. TNC does not hedge all interest rate exposure. As of December 31, 2013, TNC did not have any outstanding derivative contracts for interest rate hedges. The gross notional volume of TNC's outstanding derivative contracts for interest rate hedges as of 2012 was \$125 million.

According to the accounting guidance for "Derivatives and Hedging," TNC reflects the fair values of derivative instruments subject to netting agreements with the same counterparty net of related cash collateral. For certain risk management contracts, TNC is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the December 31, 2013 and 2012 balance sheets, TNC had no netting of cash collateral received from third parties against short-term and long-term risk management assets and cash collateral paid to third parties against short-term and long-term risk liabilities.

The following tables represent the gross fair value impact of TNC's derivative activity on the balance sheets as of December 31, 2013 and 2012:

**Fair Value of Derivative Instruments
December 31, 2013**

<u>Balance Sheet Location</u>	<u>Hedging Contracts</u>		<u>Gross Amounts of Risk Management Assets/ Liabilities Recognized</u>	<u>Gross Amounts Offset in the Statement of Financial Position (b)</u>	<u>Net Amounts of Asset/Liabilities Presented in the Statement of Financial Position (c)</u>
	<u>Commodity (a)</u>	<u>Interest Rate (a)</u>			
	(in thousands)				
Current Risk Management Assets	\$ 55	\$ -	\$ 55	\$ -	\$ 55
Long-term Risk Management Assets	-	-	-	-	-
Total Assets	<u>55</u>	<u>-</u>	<u>55</u>	<u>-</u>	<u>55</u>
Current Risk Management Liabilities	-	-	-	-	-
Long-term Risk Management Liabilities	-	-	-	-	-
Total Liabilities	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total MTM Derivative Contract Net Assets (Liabilities)	<u>\$ 55</u>	<u>\$ -</u>	<u>\$ 55</u>	<u>\$ -</u>	<u>\$ 55</u>

**Fair Value of Derivative Instruments
December 31, 2012**

<u>Balance Sheet Location</u>	<u>Hedging Contracts</u>		<u>Gross Amounts of Risk Management Assets/ Liabilities Recognized</u>	<u>Gross Amounts Offset in the Statement of Financial Position (b)</u>	<u>Net Amounts of Asset/Liabilities Presented in the Statement of Financial Position (c)</u>
	<u>Commodity (a)</u>	<u>Interest Rate (a)</u>			
	(in thousands)				
Current Risk Management Assets	\$ 27	\$ -	\$ 27	\$ (11)	\$ 16
Long-term Risk Management Assets	-	-	-	-	-
Total Assets	<u>27</u>	<u>-</u>	<u>27</u>	<u>(11)</u>	<u>16</u>
Current Risk Management Liabilities	11	14,781	14,792	(11)	14,781
Long-term Risk Management Liabilities	-	-	-	-	-
Total Liabilities	<u>11</u>	<u>14,781</u>	<u>14,792</u>	<u>(11)</u>	<u>14,781</u>
Total MTM Derivative Contract Net Assets (Liabilities)	<u>\$ 16</u>	<u>\$ (14,781)</u>	<u>\$ (14,765)</u>	<u>\$ -</u>	<u>\$ (14,765)</u>

- (a) Derivative instruments within these categories 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.

Accounting for Cash Flow Hedging Strategies

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

TNC reclassifies gains and losses on heating oil and gasoline derivative contracts designated as cash flow hedges from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Other Operation expense, Maintenance expense or Depreciation and Amortization expense, as it relates to capital projects, on its statements of income. During 2013, 2012 and 2011, TNC designated heating oil and gasoline derivatives as cash flow hedges.

TNC reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Interest Expense on its statements of income in those periods in which hedged interest payments occur. During 2013, 2012 and 2011, TNC designated interest rate derivatives as cash flow hedges.

During 2013, 2012 and 2011, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies discussed above.

For details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TNC's balance sheets and the reasons for changes in cash flow hedges, see Note 2.

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TNC's balance sheets as of December 31, 2013 and 2012 were:

Impact of Cash Flow Hedges on the Balance Sheet December 31, 2013

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
		(in thousands)	
Hedging Assets (a)	\$ 55	\$ -	\$ 55
Hedging Liabilities (a)	-	-	-
AOCI Gain (Loss) Net of Tax	36	(7,965)	(7,929)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	36	(869)	(833)

Impact of Cash Flow Hedges on the Balance Sheet December 31, 2012

	<u>Commodity</u>	<u>Interest Rate</u>	<u>Total</u>
		(in thousands)	
Hedging Assets (a)	\$ 16	\$ -	\$ 16
Hedging Liabilities (a)	-	14,781	14,781
AOCI Gain (Loss) Net of Tax	13	(9,608)	(9,595)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	13	(921)	(908)

- (a) Hedging Assets and Hedging Liabilities are included in Risk Management Assets and Liabilities on TNC's balance sheets.

The actual amounts that TNC reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ from the estimate above due to market price changes. As of December 31, 2013, the maximum length of time that TNC is hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions was 12 months.

TNC's interest rate hedging liabilities have cross-default provisions that could be triggered if there was a non-performance event by Parent or the obligor under outstanding debt or a third party obligation in excess of \$50 million. As of December 31, 2013, TNC had no liabilities for contracts with cross-default provisions prior to contractual netting arrangements. As of December 31, 2012, TNC had \$15 million of liabilities for contracts with cross-default provisions prior to contractual netting arrangements.

8. FAIR VALUE MEASUREMENTS

Fair Value Measurements of Long-term Debt

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

The book values and fair values of TNC's Long-term Debt as of December 31, 2013 and 2012 are summarized in the following table:

	December 31,			
	2013		2012	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 420,293	\$ 419,622	\$ 370,299	\$ 414,547

Fair Value Measurements of Financial Assets and Liabilities

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

The following tables set forth, by level within the fair value hierarchy, TNC’s financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2013 and 2012. 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 December 31, 2013

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Risk Management Assets					
<hr/>					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 55	\$ -	\$ -	\$ 55

Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2012

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
Risk Management Assets					
<hr/>					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 27	\$ -	\$ (11)	\$ 16
Risk Management Liabilities					
<hr/>					
Cash Flow Hedges:					
Commodity Hedges (a)	\$ -	\$ 11	\$ -	\$ (11)	\$ -
Interest Rate/Foreign Currency Hedges	-	14,781	-	-	14,781
Total Risk Management Liabilities	<u>\$ -</u>	<u>\$ 14,792</u>	<u>\$ -</u>	<u>\$ (11)</u>	<u>\$ 14,781</u>

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

As of December 31, 2013, TNC had no liabilities measured at fair value on a recurring basis.

There have been no transfers between Level 1 and Level 2 during the years ended December 31, 2013, 2012 and 2011.

9. INCOME TAXES

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

	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Income Tax Expense (Credit):			
Current	\$ 22,531	\$ 15,817	\$ 5,886
Deferred	(3,019)	2,681	12,748
Deferred Investment Tax Credits	(956)	(985)	(1,020)
Income Tax Expense	<u>\$ 18,556</u>	<u>\$ 17,513</u>	<u>\$ 17,614</u>

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

	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Net Income	\$ 36,913	\$ 30,689	\$ 40,112
Income Tax Expense	18,556	17,513	17,614
Pretax Income	<u>\$ 55,469</u>	<u>\$ 48,202</u>	<u>\$ 57,726</u>
Income Taxes on Pretax Income at Statutory Rate (35%)	\$ 19,414	\$ 16,871	\$ 20,204
Increase (Decrease) in Income Taxes resulting from the following items:			
Depreciation	(169)	(173)	(269)
Investment Tax Credits, Net	(956)	(985)	(1,020)
State and Local Income Taxes, Net	1,499	851	(115)
Other	(1,232)	949	(1,186)
Income Tax Expense	<u>\$ 18,556</u>	<u>\$ 17,513</u>	<u>\$ 17,614</u>
Effective Income Tax Rate	33.5 %	36.3 %	30.5 %

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

	December 31,	
	2013	2012
	(in thousands)	
Deferred Tax Assets	\$ 37,394	\$ 42,944
Deferred Tax Liabilities	(184,969)	(182,441)
Net Deferred Tax Liabilities	<u>\$ (147,575)</u>	<u>\$ (139,497)</u>
Property Related Temporary Differences	\$ (156,550)	\$ (150,772)
Amounts Due from Customers for Future Federal Income Taxes	980	507
Deferred State Income Taxes	(884)	(956)
Deferred Income Taxes on Other Comprehensive Loss	9,917	12,501
Regulatory Assets	(13,232)	(16,379)
Deferred Revenues	15,730	14,312
All Other, Net	(3,536)	1,290
Net Deferred Tax Liabilities	<u>\$ (147,575)</u>	<u>\$ (139,497)</u>

AEP System Tax Allocation Agreement

TNC joins in the filing of a consolidated federal income tax return with its affiliates in the AEP System. The allocation of the AEP System's current consolidated federal income tax to the AEP System companies allocates the benefit of current tax losses to the AEP System companies giving rise to such losses in determining their current tax

expense. The tax benefit of the Parent is allocated to its subsidiaries with taxable income. With the exception of the loss of the Parent, the method of allocation reflects a separate return result for each company in the consolidated group.

Federal and State Income Tax Audit Status

TNC and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. TNC and other AEP subsidiaries completed the examination of the years 2007 and 2008 in April 2011 and settled all outstanding issues on appeal for the years 2001 through 2006 in October 2011. The settlements did not materially impact TNC's and other AEP subsidiaries' net income, cash flows or financial condition. The IRS examination of years 2009 and 2010 started in October 2011 and was completed in the second quarter of 2013. Cash flows were negatively impacted by \$8 million with the payment of the previously accrued taxes. Although the outcome of tax audits is uncertain, in management's opinion, adequate provisions for federal income taxes have been made for potential liabilities resulting from such matters. In addition, TNC accrues interest on these uncertain tax positions. Management is not aware of any issues for open tax years that upon final resolution are expected to materially impact net income.

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

Tax Credit Carryforward

As of December 31, 2013, TNC had unused federal income tax credits of \$77 thousand. If these credits are not utilized, the federal general business tax credits will expire in the years 2029 through 2032.

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

Uncertain Tax Positions

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

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

	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Interest Expense	\$ 407	\$ 45	\$ 44
Interest Income	-	-	955
Reversal of Prior Period Interest Expense	-	118	779

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

	December 31,	
	2013	2012
	(in thousands)	
Accrual for Receipt of Interest	\$ 70	\$ 74
Accrual for Payment of Interest Penalties	188	165

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

	<u>2013</u>	<u>2012</u>	<u>2011</u>
		(in thousands)	
Balance as of January 1,	\$ 919	\$ 596	\$ 1,903
Increase - Tax Positions Taken During a Prior Period	-	374	659
Decrease - Tax Positions Taken During a Prior Period	(23)	(25)	(715)
Increase - Tax Positions Taken During the Current Year	115	-	-
Decrease - Tax Positions Taken During the Current Year	-	-	-
Increase - Settlements with Taxing Authorities	-	-	321
Decrease - Settlements with Taxing Authorities	-	-	-
Decrease - Lapse of the Applicable Statute of Limitations	-	(26)	(1,572)
Balance as of December 31,	<u>\$ 1,011</u>	<u>\$ 919</u>	<u>\$ 596</u>

The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate is \$473 thousand, \$398 thousand and \$277 thousand for 2013, 2012 and 2011, respectively. Management believes there will be no significant net increase or decrease in unrecognized tax benefits within 12 months of the reporting date.

Federal Tax Legislation

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

Federal Tax Regulations

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

10. LEASES

Leases of property, plant and equipment are for remaining periods up to 10 years and require payments of related property taxes, maintenance and operating costs. The majority of the leases have purchase or renewal options and will be renewed or replaced by other leases.

Lease rentals for both operating and capital leases are generally charged to Other Operation and Maintenance expense in accordance with rate-making treatment for regulated operations. The components of rental costs are as follows:

<u>Lease Rental Costs</u>	Years Ended December 31,		
	<u>2013</u>	<u>2012</u>	<u>2011</u>
		(in thousands)	
Net Lease Expense on Operating Leases	\$ 1,917	\$ 1,938	\$ 2,342
Amortization of Capital Leases	588	666	810
Interest on Capital Leases	58	93	145
Total Lease Rental Costs	<u>\$ 2,563</u>	<u>\$ 2,697</u>	<u>\$ 3,297</u>

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

	December 31,	
	2013	2012
(in thousands)		
Property, Plant and Equipment Under Capital Leases		
Total Property, Plant and Equipment Under Capital Leases – Other	\$ 3,139	\$ 1,938
Accumulated Amortization	1,005	560
Net Property, Plant and Equipment Under Capital Leases	\$ 2,134	\$ 1,378
Obligations Under Capital Leases		
Noncurrent Liability	\$ 1,554	\$ 926
Liability Due Within One Year	580	452
Total Obligations Under Capital Leases	\$ 2,134	\$ 1,378

Future minimum lease payments consisted of the following as of December 31, 2013:

Future Minimum Lease Payments	Noncancelable	
	Capital Leases	Operating Leases
(in thousands)		
2014	\$ 646	\$ 1,670
2015	500	1,445
2016	432	1,115
2017	380	907
2018	227	538
Later Years	167	1,263
Total Future Minimum Lease Payments	2,352	\$ 6,938
Less Estimated Interest Element	218	
Estimated Present Value of Future Minimum Lease Payments	\$ 2,134	

Master Lease Agreements

TNC leases certain equipment under master lease agreements. Under the lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, TNC is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of December 31, 2013, the maximum potential loss for these lease agreements was approximately \$1 million assuming the fair value of the equipment is zero at the end of the lease term.

11. FINANCING ACTIVITIES

Preferred Stock

In December 2011, TNC redeemed all of its outstanding preferred stock with a par value of \$2.3 million at a premium, resulting in a \$50 thousand loss, which is included in Preferred Stock Dividend Requirements Including Capital Stock Expense on TNC's statement of income.

Number of Shares Redeemed for the Year Ended December 31, 2011	
Series	
4.40%	23,481

Long-term Debt

There are certain limitations on establishing liens against TNC's assets under its indentures. None of the long-term debt obligations of TNC have been guaranteed or secured by AEP or any of its affiliates.

The following details long-term debt outstanding as of December 31, 2013 and 2012:

Type of Debt	Maturity	Weighted	Interest Rate Ranges as of		Outstanding as of		
		Average	Interest rate as of	December 31,	December 31,	December 31,	December 31,
			December 31,	2013	2012	2013	2012
			2013	2013	2012	(in thousands)	
Senior Unsecured Notes	2013-2043	4.57%	3.09%-6.76%	5.50%-6.76%	\$ 300,000	\$ 325,000	
Pollution Control Bonds (a)	2020	4.45%	4.45%	4.45%	44,310	44,310	
Other Long-term Debt (b)	2016-2059	1.78%	1.742%-4.50%	4.50%	75,983	989	
Total Long-term Debt Outstanding					420,293	370,299	
Long-term Debt Due Within One Year					7	225,006	
Long-term Debt					<u>\$ 420,286</u>	<u>\$ 145,293</u>	

(a) Insurance policies support certain series.

(b) In 2013, TNC issued a \$75 million three-year credit facility to be used for general corporate purposes.

Long-term debt outstanding as of December 31, 2013 is payable as follows:

	2014	2015	2016	2017	2018	After	Total
	(in thousands)						
Principal Amount	\$ 7	\$ 7	\$ 75,007	\$ 8	\$ 30,008	\$ 315,256	\$ 420,293
Total Long-term Debt Outstanding							<u>\$ 420,293</u>

Dividend Restrictions

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

Federal Power Act

The Federal Power Act prohibits TNC from participating "in the making or paying of any dividends of such public utility from any funds properly included in capital account." The term "capital account" is not defined in the Federal Power Act or its regulations. Management understands "capital account" to mean the book value of the common stock. This restriction does not limit the ability of TNC to pay dividends out of retained earnings.

Leverage Restrictions

Pursuant to the credit agreement leverage restrictions, TNC must maintain a percentage of debt to total capitalization at a level that does not exceed 67.5%. As of December 31, 2013, \$69 million of TNC's retained earnings have restrictions related to the payment of dividends to Parent.

Money Pool – AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of AEP's subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP's utility subsidiaries, and a Nonutility Money Pool, which funds a majority of AEP's nonutility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions of the AEP System Utility Money

Pool agreement filed with the FERC. The amounts of outstanding borrowings from the Utility Money Pool as of December 31, 2013 and 2012 are included in Advances from Affiliates on TNC's balance sheets. TNC's Utility Money Pool activity and corresponding authorized borrowing limit for the years ended December 31, 2013 and 2012 are described in the following table:

<u>Year</u>	<u>Maximum Borrowings from the Utility Money Pool</u>	<u>Maximum Loans to the Utility Money Pool</u>	<u>Average Borrowings from the Utility Money Pool</u>	<u>Average Loans to the Utility Money Pool</u>	<u>Borrowings from the Utility Money Pool as of December 31,</u>	<u>Authorized Short-Term Borrowing Limit</u>
(in thousands)						
2013	\$ 102,565	\$ 131,243	\$ 59,783	\$ 131,243	\$ 23,533	\$ 250,000
2012	57,994	-	43,893	-	50,361	250,000

The activity in the above table does not include short-term lending activity of TNC's wholly-owned subsidiary, AEP Texas North Generation Company LLC (TNGC), which is a participant in the Nonutility Money Pool. The amounts of outstanding loans to the Nonutility Money Pool as of December 31, 2013 and 2012 are included in Advances to Affiliates on TNC's balance sheets. For the years ended December 31, 2013 and 2012, TNGC had the following activity in the Nonutility Money Pool:

<u>Year</u>	<u>Maximum Borrowings from the Nonutility Money Pool</u>	<u>Maximum Loans to the Nonutility Money Pool</u>	<u>Average Borrowings from the Nonutility Money Pool</u>	<u>Average Loans to the Nonutility Money Pool</u>	<u>Loans to the Nonutility Money Pool as of December 31,</u>
(in thousands)					
2013	\$ -	\$ 10,792	\$ -	\$ 10,434	\$ 10,177
2012	-	11,088	-	10,750	10,791

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the years ended December 31, 2013, 2012 and 2011 are summarized in the following table:

<u>Years Ended December 31,</u>	<u>Maximum Interest Rate for Funds Borrowed from the Utility Money Pool</u>	<u>Minimum Interest Rate for Funds Borrowed from the Utility Money Pool</u>	<u>Maximum Interest Rate for Funds Loaned to the Utility Money Pool</u>	<u>Minimum Interest Rate for Funds Loaned to the Utility Money Pool</u>	<u>Average Interest Rate for Funds Borrowed from the Utility Money Pool</u>	<u>Average Interest Rate for Funds Loaned to the Utility Money Pool</u>
2013	0.43 %	0.24 %	0.36 %	0.36 %	0.34 %	0.36 %
2012	0.56 %	0.39 %	- %	- %	0.46 %	- %
2011	0.56 %	0.06 %	- %	- %	0.33 %	- %

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Nonutility Money Pool for the years ended December 31, 2013, 2012 and 2011 are summarized in the following table:

<u>Years Ended December 31,</u>	<u>Maximum Interest Rate for Funds Borrowed from the Nonutility Money Pool</u>	<u>Minimum Interest Rate for Funds Borrowed from the Nonutility Money Pool</u>	<u>Maximum Interest Rate for Funds Loaned to the Nonutility Money Pool</u>	<u>Minimum Interest Rate for Funds Loaned to the Nonutility Money Pool</u>	<u>Average Interest Rate for Funds Borrowed from the Nonutility Money Pool</u>	<u>Average Interest Rate for Funds Loaned to the Nonutility Money Pool</u>
2013	- %	- %	0.43 %	0.24 %	- %	0.33 %
2012	- %	- %	0.56 %	0.39 %	- %	0.47 %
2011	- %	- %	0.58 %	0.36 %	- %	0.45 %

Interest expense and interest income related to the Utility Money Pool are included in Interest Expense and Interest Income, respectively, in TNC's statements of income. For amounts borrowed from and advanced to the Utility Money Pool, TNC incurred the following amounts of interest expense and earned the following amounts of interest income, respectively, for the years ended December 31, 2013, 2012 and 2011:

	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Interest Expense	\$ 243	\$ 206	\$ 115
Interest Income	37	-	-

Interest expense and interest income related to the Nonutility Money Pool are included in Interest Expense and Interest Income, respectively, in TNC's statements of income. For amounts borrowed from and advanced to the Nonutility Money Pool, TNC incurred the following amounts of interest expense and earned the following amounts of interest income, respectively, for the years ended December 31, 2013, 2012 and 2011:

	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Interest Expense	\$ -	\$ -	\$ -
Interest Income	35	51	50

12. RELATED PARTY TRANSACTIONS

For other related party transactions, also see "AEP System Tax Allocation Agreement" section of Note 9 and "Money Pool – AEP System" section of Note 11.

Affiliated Revenues

The following table shows the revenues derived from direct sales to affiliates and other revenues for the years ended December 31, 2013, 2012 and 2011:

Related Party Revenues	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Direct Sales to AEPEP Affiliate	\$ 98,808	\$ 81,375	\$ 81,015
Other Revenues	4,785	4,617	4,405
Total Affiliated Revenues	\$ 103,593	\$ 85,992	\$ 85,420

The above summarized related party revenues are reported in Sales to AEP Affiliates on TNC's statements of income.

ERCOT Transmission Cost of Service

TNC's net revenues allocated pursuant to the PUCT-approved ERCOT protocols for the years ended December 31, 2013, 2012 and 2011 were \$2.1 million, \$2.1 million and \$2.1 million, respectively. The net revenues are recorded in Sales to AEP Affiliates on TNC's statements of income.

ERCOT Transmission Service Charges

Pursuant to an order from the PUCT, ETT bills TNC for its ERCOT wholesale transmission services. ETT billed TNC \$2.5 million, \$1.6 million and \$1 million for transmission services in 2013, 2012 and 2011, respectively. The billings are recorded in Other Operation expenses on TNC's statements of income.

Oklauion PPA between TNC and AEP Energy Partners (AEPEP)

On January 1, 2007, TNC began a PPA with an affiliate, AEPEP, whereby TNC agrees to sell AEPEP 100% of TNC's capacity and associated energy from its undivided interest (54.69%) in the Oklaunion Plant. This PPA is effective through December 2027. AEPEP is to pay TNC for the capacity and associated energy delivered to the delivery point, the sum of fuel, operation and maintenance, depreciation, capacity and all taxes other than federal income taxes applicable. A portion of the payment is fixed and is payable regardless of the level of output. There are no penalties if TNC fails to maintain a minimum availability level or exceeds a maximum heat rate level. The PPA was approved by the FERC. TNC recognizes revenues for the fuel, operations and maintenance and all other taxes as-billed. Revenue is recognized for the capacity and depreciation billed to AEPEP, on a straight-line basis over the term of the PPA as these represent the minimum payments due.

TNC recorded revenue of \$99 million, \$81 million and \$81 million from AEPEP for the years ended December 31, 2013, 2012 and 2011, respectively. These amounts are included in Sales to AEP Affiliates on TNC's statements of income.

Sales and Purchases of Property

TNC had affiliated sales and purchases of electric property individually amounting to \$100 thousand or more and sales and purchases of meters and transformers. There were no gains or losses recorded on the transactions. The following table shows the sales and purchases, recorded at net book value, for the years ended December 31, 2013, 2012 and 2011:

	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Sales	\$ 6,977	\$ 4,149	\$ 3,584
Purchases	1,515	2,486	2,140

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

Intercompany Billings

TNC performs certain utility services for other AEP subsidiaries when necessary or practical. The costs of these services are billed on a direct-charge basis, whenever possible, or on reasonable basis of proration for services that benefit multiple companies. The billings for services are made at cost and include no compensation for the use of equity capital.

13. VARIABLE INTEREST ENTITIES

The accounting guidance for "Variable Interest Entities" is a consolidation model that considers if a company has a controlling financial interest in a VIE. A controlling financial interest will have both (a) the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Entities are required to consolidate a VIE when it is determined that they have a controlling financial interest in a VIE and therefore, are the primary beneficiary of that VIE, as defined by the accounting guidance for "Variable Interest Entities." In determining whether TNC is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE's variability TNC absorbs, guarantees of indebtedness, voting rights including kick-out rights, the power to direct the VIE, variable interests held by related parties and other factors. Management believes that significant assumptions and judgments were applied consistently. TNC is not the primary beneficiary of any VIE and has not provided financial or other support to any VIE that was not previously contractually required.

AEPSC provides certain managerial and professional services to AEP's subsidiaries. AEP is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC's cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances

its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC's cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. TNC's total billings from AEPSC for the years ended December 31, 2013, 2012 and 2011 were \$26 million, \$26 million and \$24 million, respectively. The carrying amount of liabilities associated with AEPSC as of December 31, 2013 and 2012 was \$3 million and \$4 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

14. PROPERTY, PLANT AND EQUIPMENT

Depreciation

TNC provides for depreciation of Property, Plant and Equipment on a straight-line basis over the estimated useful lives of property, generally using composite rates by functional class. The following tables provide TNC's annual property information:

2013		Regulated			Nonregulated			
Functional Class of Property	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite	Depreciable Life Ranges	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite	Depreciable Life Ranges
			Depreciation Rate				Depreciation Rate	
		(in thousands)		(in years)	(in thousands)		(in years)	
Generation	\$ -	\$ -	NA	NA	\$ 310,917	\$ 165,511	2.6%	60
Transmission	540,045	117,470	2.7%	45-75	-	-	NA	NA
Distribution	682,766	203,106	3.8%	28-70	-	-	NA	NA
CWIP	40,978	(2,231)	NM	NM	5,378	18	NM	NM
Other	100,731	66,377	7.5%	10-50	1,015	406	NM	NM
Total	\$ 1,364,520	\$ 384,722			\$ 317,310	\$ 165,935		

2012		Regulated			Nonregulated			
Functional Class of Property	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite	Depreciable Life Ranges	Property, Plant and Equipment	Accumulated Depreciation	Annual Composite	Depreciable Life Ranges
			Depreciation Rate				Depreciation Rate	
		(in thousands)		(in years)	(in thousands)		(in years)	
Generation	\$ -	\$ -	NA	NA	\$ 309,870	\$ 158,637	2.6%	60
Transmission	508,716	111,707	2.8%	45-75	-	-	NA	NA
Distribution	658,724	190,628	3.9%	28-70	-	-	NA	NA
CWIP	28,964	(2,125)	NM	NM	2,606	70	NM	NM
Other	94,424	66,245	6.9%	10-50	1,018	395	NM	NM
Total	\$ 1,290,828	\$ 366,455			\$ 313,494	\$ 159,102		

2011	Regulated		Nonregulated	
Functional Class of Property	Annual Composite	Depreciable Life Ranges	Annual Composite	Depreciable Life Ranges
	Depreciation Rate		Depreciation Rate	
		(in years)		(in years)
Generation	NA	NA	2.6%	20-49
Transmission	2.7%	45-75	NA	NA
Distribution	4.0%	28-70	NA	NA
CWIP	NM	NM	NM	NM
Other	9.3%	NM	NM	NM

NA Not applicable.
NM Not meaningful.

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

Asset Retirement Obligations (ARO)

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

The following is a reconciliation of the 2013 and 2012 aggregate carrying amounts of ARO for TNC:

Year	ARO as of January 1,	Accretion Expense	Liabilities Incurred	Liabilities Settled	Revisions in		ARO as of December 31,
					Cash Flow Estimates		
(in thousands)							
2013	\$ 1,631	\$ 96	\$ -	\$ (425)	\$ 13		1,315
2012	1,622	96	-	(87)	-		1,631

Allowance for Funds Used During Construction (AFUDC) and Interest Capitalization

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

	Years Ended December 31,		
	2013	2012	2011
(in thousands)			
Allowance for Equity Funds Used During Construction	\$ 244	\$ (3)	\$ 177
Allowance for Borrowed Funds Used During Construction	332	104	237

Jointly-owned Electric Facilities

TNC has a 54.7% ownership share of Unit No. 1 at the Oklaunion Generating Station. In addition to TNC, the Oklaunion Generating Station is jointly-owned by PSO and various nonaffiliated companies. Using its own financing, each participating company is obligated to pay its share of the costs in the same proportion as its ownership interest. TNC’s proportionate share of the operating costs associated with this facility is included in its statements of income and the investment and accumulated depreciation are reflected in its balance sheets under Property, Plant and Equipment as follows:

	Fuel Type	Percent of Ownership	Utility Plant in Service	Construction		Accumulated Depreciation
				Work in Progress		
(in thousands)						
TNC's Share as of December 31, 2013						
Oklaunion Generating Station, Unit 1 (a)	Coal	54.7 %	\$ 310,917	\$ 5,390	\$	165,511
TNC's Share as of December 31, 2012						
Oklaunion Generating Station, Unit 1 (a)	Coal	54.7 %	\$ 309,870	\$ 2,606	\$	158,638

(a) Operated by PSO.

15. SUSTAINABLE COST REDUCTIONS

In April 2012, management initiated a process to identify strategic repositioning opportunities and efficiencies that will result in sustainable cost savings. Management selected a consulting firm to facilitate an organizational and process evaluation and a second firm to evaluate current employee benefit programs. The process resulted in involuntary severances and is expected to be completed by the end of the first quarter of 2013. The severance program provides two weeks of base pay for every year of service along with other severance benefits.

TNC recorded a charge of \$1.5 million to Other Operation expense in 2012 primarily related to severance benefits as a result of the sustainable cost reductions initiative. In addition, the sustainable cost reduction activity for the year ended December 31, 2013 is described in the following table:

<u>Balance as of</u> <u>December 31, 2012</u>	<u>Expense</u> <u>Allocation from</u> <u>AEPSC</u>	<u>Incurred</u>	<u>Settled</u>	<u>Adjustments</u>	<u>Remaining</u> <u>Balance as of</u> <u>December 31, 2013</u>
\$ 371	\$ 36	\$ -	\$ (167)	\$ (236)	\$ 4
(in thousands)					

These expenses, net of adjustments, relate primarily to severance benefits and are included primarily in Other Operation expense on the statements of income. The remaining liability is included in Other Current Liabilities on the balance sheets. Management does not expect additional costs to be incurred related to this initiative.

16. UNAUDITED QUARTERLY FINANCIAL INFORMATION

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

	<u>2013 Quarterly Periods Ended</u>			
	<u>March 31</u>	<u>June 30</u>	<u>September 30</u>	<u>December 31</u>
	(in thousands)			
Total Revenues	\$ 73,513	\$ 78,023	\$ 81,462	\$ 78,180
Operating Income	19,683	17,701	21,038	17,735
Net Income	8,808	8,382	10,652	9,071
	<u>2012 Quarterly Periods Ended</u>			
	<u>March 31</u>	<u>June 30</u>	<u>September 30</u>	<u>December 31</u>
	(in thousands)			
Total Revenues	\$ 65,806	\$ 71,697	\$ 76,745	\$ 71,906
Operating Income	16,186	19,344	20,538	14,187
Net Income	7,808	9,218	9,998	3,665

There were no significant events in 2013 and 2012.