# AEP Texas Central Company
# and Subsidiaries

2014 First Quarter Report

Consolidated Financial Statements

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## GLOSSARY OF TERMS

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

| Term | Meaning |
|---|---|
| AEP 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. |
| AEPSC | American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries. |
| AOCI | Accumulated Other Comprehensive Income. |
| ASU | Accounting Standards Update. |
| FASB | Financial Accounting Standards Board. |
| FERC | Federal Energy Regulatory Commission. |
| FTR | Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices. |
| GAAP | Accounting Principles Generally Accepted in the United States of America. |
| IRS | Internal Revenue Service. |
| MTM | Mark-to-Market. |
| OPEB | Other Postretirement Benefit Plans. |
| OTC | Over the counter. |
| PUCT | Public Utility Commission of Texas. |
| Risk Management Contracts | Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges. |
| TCC | AEP Texas Central Company, an AEP electric utility subsidiary. |
| Texas Restructuring Legislation | Legislation enacted in 1999 to restructure the electric utility industry in Texas. |
| Transition Funding | AEP Texas Central Transition Funding I LLC, AEP Texas Central Transition Funding II LLC and AEP Texas Central Transition Funding III LLC, wholly-owned subsidiaries of TCC and consolidated variable interest entities formed for the purpose of issuing and servicing securitization bonds related to Texas restructuring law. |
| Utility Money Pool | Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries. |
| VIE | Variable Interest Entity. |

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**
**For the Three Months Ended March 31, 2014 and 2013**
**(in thousands)**
**(Unaudited)**

| | Three Months Ended March 31, 2014 | 2013 |
|---|---|---|
| **REVENUES** | | |
| Electric Transmission and Distribution | $ 257,338 | $ 224,961 |
| Sales to AEP Affiliates | 989 | 976 |
| Other Revenues | 758 | 641 |
| **TOTAL REVENUES** | 259,085 | 226,578 |
| **EXPENSES** | | |
| Other Operation | 68,159 | 60,297 |
| Maintenance | 10,883 | 8,862 |
| Depreciation and Amortization | 88,042 | 75,094 |
| Taxes Other Than Income Taxes | 19,127 | 14,538 |
| **TOTAL EXPENSES** | 186,211 | 158,791 |
| **OPERATING INCOME** | 72,874 | 67,787 |
| **Other Income (Expense):** | | |
| Interest Income | 2 | 13 |
| Allowance for Equity Funds Used During Construction | 860 | 92 |
| Interest Expense | (32,437) | (35,900) |
| **INCOME BEFORE INCOME TAX EXPENSE** | 41,299 | 31,992 |
| Income Tax Expense | 14,789 | 11,901 |
| **NET INCOME** | $ 26,510 | $ 20,091 |

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

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

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**
**For the Three Months Ended March 31, 2014 and 2013**
**(in thousands)**
**(Unaudited)**

| | Three Months Ended March 31, 2014 | Three Months Ended March 31, 2013 |
|---|---|---|
| Net Income | $ 26,510 | $ 20,091 |
| **OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES** | | |
| Cash Flow Hedges, Net of Tax of $40 and $22 in 2014 and 2013, Respectively | (75) | 40 |
| **TOTAL COMPREHENSIVE INCOME** | $ 26,435 | $ 20,131 |

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

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY**
**For the Three Months Ended March 31, 2014 and 2013**
**(in thousands)**
**(Unaudited)**

| | Common Stock | Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|---|---|---|---|---|---|
| **TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2012** | $ 55,292 | $ 171,062 | $ 431,632 | $ 29 | $ 658,015 |
| Common Stock Dividends | | | (1,250) | | (1,250) |
| Net Income | | | 20,091 | | 20,091 |
| Other Comprehensive Income | | | | 40 | 40 |
| **TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2013** | $ 55,292 | $ 171,062 | $ 450,473 | $ 69 | $ 676,896 |
| **TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2013** | $ 55,292 | $ 171,062 | $ 531,930 | $ 75 | $ 758,359 |
| Common Stock Dividends | | | (1,250) | | (1,250) |
| Net Income | | | 26,510 | | 26,510 |
| Other Comprehensive Loss | | | | (75) | (75) |
| **TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2014** | $ 55,292 | $ 171,062 | $ 557,190 | $ - | $ 783,544 |

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

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**ASSETS**
**March 31, 2014 and December 31, 2013**
**(in thousands)**
**(Unaudited)**

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| **CURRENT ASSETS** | | |
| Cash and Cash Equivalents | $ 126 | $ 154 |
| Restricted Cash for Securitized Transition Funding | 129,227 | 196,859 |
| Accounts Receivable: | | |
| Customers | 86,441 | 81,191 |
| Affiliated Companies | 5,125 | 5,279 |
| Accrued Unbilled Revenues | 36,584 | 37,327 |
| Miscellaneous | 2,145 | 72 |
| Allowance for Uncollectible Accounts | (178) | (204) |
| Total Accounts Receivable | 130,117 | 123,665 |
| Materials and Supplies | 42,005 | 40,976 |
| Risk Management Assets | 48 | 115 |
| Prepayments and Other Current Assets | 2,330 | 14,880 |
| **TOTAL CURRENT ASSETS** | 303,853 | 376,649 |
| **PROPERTY, PLANT AND EQUIPMENT** | | |
| Electric: | | |
| Transmission | 1,311,847 | 1,297,710 |
| Distribution | 2,286,456 | 2,258,828 |
| Other Property, Plant and Equipment | 295,031 | 289,483 |
| Construction Work in Progress | 228,445 | 175,742 |
| **Total Property, Plant and Equipment** | 4,121,779 | 4,021,763 |
| Accumulated Depreciation and Amortization | 835,674 | 818,391 |
| **TOTAL PROPERTY, PLANT AND EQUIPMENT – NET** | 3,286,105 | 3,203,372 |
| **OTHER NONCURRENT ASSETS** | | |
| Regulatory Assets | 258,104 | 254,467 |
| Securitized Transition Assets (March 31, 2014 and December 31, 2013 Amounts Include $1,765,333 and $1,819,456, Respectively, Related to Transition Funding) | 1,816,607 | 1,872,144 |
| Deferred Charges and Other Noncurrent Assets | 72,996 | 47,741 |
| **TOTAL OTHER NONCURRENT ASSETS** | 2,147,707 | 2,174,352 |
| **TOTAL ASSETS** | $ 5,737,665 | $ 5,754,373 |

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

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**LIABILITIES AND COMMON SHAREHOLDER'S EQUITY**
**March 31, 2014 and December 31, 2013**
**(dollars in thousands)**
**(Unaudited)**

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| **CURRENT LIABILITIES** | | |
| Advances from Affiliates | $ 178,866 | $ 105,538 |
| Accounts Payable: | | |
| General | 67,031 | 71,330 |
| Affiliated Companies | 13,846 | 14,411 |
| Long-term Debt Due Within One Year – Nonaffiliated (March 31, 2014 and December 31, 2013 Amounts Include $265,663 and $258,099, Respectively, Related to Transition Funding) | 265,663 | 258,099 |
| Customer Deposits | 17,601 | 17,713 |
| Accrued Taxes | 63,215 | 35,947 |
| Accrued Interest (March 31, 2014 and December 31, 2013 Amounts Include $20,735 and $36,489, Respectively, Related to Transition Funding) | 33,247 | 47,524 |
| Other Current Liabilities | 42,183 | 40,772 |
| **TOTAL CURRENT LIABILITIES** | 681,652 | 591,334 |
| **NONCURRENT LIABILITIES** | | |
| Long-term Debt – Nonaffiliated (March 31, 2014 and December 31, 2013 Amounts Include $1,659,966 and $1,779,686, Respectively, Related to Transition Funding) | 2,523,797 | 2,643,503 |
| Deferred Income Taxes | 1,273,655 | 1,288,726 |
| Regulatory Liabilities and Deferred Investment Tax Credits | 451,804 | 451,553 |
| Deferred Credits and Other Noncurrent Liabilities | 23,213 | 20,898 |
| **TOTAL NONCURRENT LIABILITIES** | 4,272,469 | 4,404,680 |
| **TOTAL LIABILITIES** | 4,954,121 | 4,996,014 |
| Rate Matters (Note 4) | | |
| Commitments and Contingencies (Note 5) | | |
| **COMMON SHAREHOLDER’S EQUITY** | | |
| Common Stock – Par Value – $25 Per Share: | | |
| Authorized – 12,000,000 Shares | | |
| Outstanding – 2,211,678 Shares | 55,292 | 55,292 |
| Paid-in Capital | 171,062 | 171,062 |
| Retained Earnings | 557,190 | 531,930 |
| Accumulated Other Comprehensive Income (Loss) | - | 75 |
| **TOTAL COMMON SHAREHOLDER’S EQUITY** | 783,544 | 758,359 |
| **TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY** | $ 5,737,665 | $ 5,754,373 |

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

## AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
## For the Three Months Ended March 31, 2014 and 2013
## (in thousands)
## (Unaudited)

| | Three Months Ended March 31, 2014 | 2013 |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| **Net Income** | $ 26,510 | $ 20,091 |
| **Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:** | | |
| Depreciation and Amortization | 88,042 | 75,094 |
| Deferred Income Taxes | (15,053) | 2,969 |
| Allowance for Equity Funds Used During Construction | (860) | (92) |
| Property Taxes | (25,110) | (19,563) |
| Change in Other Noncurrent Assets | (5,244) | (4,476) |
| Change in Other Noncurrent Liabilities | (489) | 4,970 |
| **Changes in Certain Components of Working Capital:** | | |
| Accounts Receivable, Net | (6,452) | 853 |
| Materials and Supplies | (1,029) | (1,158) |
| Accounts Payable | 4,748 | (3,726) |
| Customer Deposits | (112) | (1,069) |
| Accrued Taxes, Net | 40,109 | 14,091 |
| Accrued Interest | (14,277) | (16,505) |
| Other Current Assets | (511) | (846) |
| Other Current Liabilities | (9,106) | (10,202) |
| **Net Cash Flows from Operating Activities** | 81,166 | 60,431 |
| **INVESTING ACTIVITIES** | | |
| Construction Expenditures | (116,645) | (80,084) |
| Change in Restricted Cash for Securitized Transition Funding | 67,632 | 76,054 |
| Proceeds from Sales of Assets | 2,474 | 2,427 |
| Other Investing Activities | 5,580 | (553) |
| **Net Cash Flows Used for Investing Activities** | (40,959) | (2,156) |
| **FINANCING ACTIVITIES** | | |
| Change in Advances from Affiliates, Net | 73,328 | 48,295 |
| Retirement of Long-term Debt – Nonaffiliated | (112,174) | (105,020) |
| Principal Payments for Capital Lease Obligations | (488) | (373) |
| Dividends Paid on Common Stock | (1,250) | (1,250) |
| Other Financing Activities | 349 | 938 |
| **Net Cash Flows Used for Financing Activities** | (40,235) | (57,410) |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | (28) | 865 |
| **Cash and Cash Equivalents at Beginning of Period** | 154 | 100 |
| **Cash and Cash Equivalents at End of Period** | $ 126 | $ 965 |
| **SUPPLEMENTARY INFORMATION** | | |
| Cash Paid for Interest, Net of Capitalized Amounts | $ 44,975 | $ 49,925 |
| Noncash Acquisitions Under Capital Leases | 1,190 | 1,237 |
| Construction Expenditures Included in Current Liabilities as of March 31, | 36,308 | 20,300 |

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

**INDEX OF CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

## 1. SIGNIFICANT ACCOUNTING MATTERS

### *General*

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

In the opinion of management, the unaudited condensed consolidated interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three months ended March 31, 2014 is not necessarily indicative of results that may be expected for the year ending December 31, 2014. The condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2013 financial statements and notes thereto, which are included in TCC's 2013 Annual Report.

Management reviewed subsequent events through April 25, 2014, the date that the first quarter 2014 report was issued.

## 2. NEW ACCOUNTING PRONOUNCEMENT

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

### *ASU 2014-08 "Presentation of Financial Statements and Property, Plant and Equipment" (ASU 2014-08)*

In April 2014, the FASB issued ASU 2014-08 changing the presentation of discontinued operations on the statements of income and other requirements for reporting discontinued operations. Under the new standard, a disposal of a component or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results when the component meets the criteria to be classified as held for sale or is disposed. The amendments in this update also require additional disclosures about discontinued operations and disposal of an individually significant component of an entity that does not qualify for discontinued operations. This standard must be prospectively applied to all reporting periods presented in financial reports issued after the effective date. Early adoption is permitted for disposals that have not been reported in financial statements previously issued or available for issuance.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2014. If applicable, this standard will change the presentation of financial statements but will not affect the calculation of net income, comprehensive income or earnings per share. Management plans to adopt ASU 2014-08 effective January 1, 2015.

## 3. COMPREHENSIVE INCOME

*Presentation of Comprehensive Income*

The following tables provide the components of changes in AOCI for the three months ended March 31, 2014 and 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 Three Months Ended March 31, 2014**

| | Cash Flow Hedges | | |
|---|---|---|---|
| | Commodity | Interest Rate and Foreign Currency | Total |
| | | (in thousands) | |
| **Balance in AOCI as of December 31, 2013** | $ 75 | $ - | $ 75 |
| Change in Fair Value Recognized in AOCI | - | - | - |
| Amounts Reclassified from AOCI | (75) | - | (75) |
| Net Current Period Other Comprehensive Income | (75) | - | (75) |
| **Balance in AOCI as of March 31, 2014** | $ - | $ - | $ - |

**Changes in Accumulated Other Comprehensive Income (Loss) by Component**
**For the Three Months Ended March 31, 2013**

| | Cash Flow Hedges | | |
|---|---|---|---|
| | Commodity | Interest Rate and Foreign Currency | Total |
| | | (in thousands) | |
| **Balance in AOCI as of December 31, 2012** | $ 29 | $ - | $ 29 |
| Change in Fair Value Recognized in AOCI | 61 | - | 61 |
| Amounts Reclassified from AOCI | (21) | - | (21) |
| Net Current Period Other Comprehensive Income | 40 | - | 40 |
| **Balance in AOCI as of March 31, 2013** | $ 69 | $ - | $ 69 |

***Reclassifications Out of Accumulated Other Comprehensive Income***

The following table provides details of reclassifications from AOCI for the three months ended March 31, 2014 and 2013.

**Reclassifications from Accumulated Other Comprehensive Income (Loss)**
**For the Three Months Ended March 31, 2014 and 2013**

| | Amount of (Gain) Loss Reclassified from AOCI | |
|---|---|---|
| | Three Months Ended March 31, | |
| | 2014 | 2013 |
| **Gains and Losses on Cash Flow Hedges** | (in thousands) | |
| Commodity: | | |
| Other Operation Expense | $ (9) | $ (11) |
| Maintenance Expense | (8) | (8) |
| Property, Plant and Equipment | (12) | (13) |
| Regulatory Assets/(Liabilities), Net (a) | (86) | - |
| Subtotal - Commodity | (115) | (32) |
| | | |
| Interest Rate and Foreign Currency: | | |
| Interest Expense | - | - |
| Subtotal - Interest Rate and Foreign Currency | - | - |
| | | |
| Reclassifications from AOCI, before Income Tax (Expense) Credit | (115) | (32) |
| Income Tax (Expense) Credit | (40) | (11) |
| **Total Reclassifications from AOCI, Net of Income Tax (Expense) Credit** | $ (75) | $ (21) |

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

## 4. RATE MATTERS

As discussed in TCC's 2013 Annual Report, TCC is involved in rate and regulatory proceedings at the FERC and the PUCT. The Rate Matters note within TCC's 2013 Annual Report should be read in conjunction with this report to gain a complete understanding of material rate matters still pending that could impact net income, cash flows and possibly financial condition. The following discusses ratemaking developments in 2014 and updates TCC's 2013 Annual Report.

***Regulatory Assets Not Yet Being Recovered***

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| **Noncurrent Regulatory Assets** | (in thousands) | |
| **Regulatory assets not yet being recovered pending future proceedings:** | | |
| | | |
| Regulatory Assets Currently Earning a Return | | |
| Storm Related Costs | $ 21,241 | $ 21,566 |
| Regulatory Assets Currently Not Earning a Return | | |
| Rate Case Expenses | 145 | 145 |
| **Total Regulatory Assets Not Yet Being Recovered** | $ 21,386 | $ 21,711 |

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

## 5. COMMITMENTS, GUARANTEES AND CONTINGENCIES

TCC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, TCC's business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation 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. The Commitments, Guarantees and Contingencies note within TCC's 2013 Annual Report should be read in conjunction with this report.

### GUARANTEES

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

#### *Indemnifications and Other Guarantees*

*Contracts*

TCC enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of March 31, 2014, there were no material liabilities recorded for any indemnifications.

*Master Lease Agreements*

TCC leases certain equipment under master lease agreements. Under the lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, TCC is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of March 31, 2014, the maximum potential loss for these lease agreements was approximately $2.6 million assuming the fair value of the equipment is zero at the end of the lease term.

## 6. BENEFIT PLANS

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

#### *Components of Net Periodic Benefit Cost*

The following table provides the components of TCC's net periodic benefit cost (credit) for the plans for the three months ended March 31, 2014 and 2013:

| | Pension Plans | | Other Postretirement Benefit Plans | |
|---|---|---|---|---|
| | Three Months Ended March 31, | | Three Months Ended March 31, | |
| | 2014 | 2013 | 2014 | 2013 |
| | (in thousands) | | | |
| Service Cost | $ 1,127 | $ 1,211 | $ 179 | $ 295 |
| Interest Cost | 3,604 | 3,316 | 1,034 | 1,103 |
| Expected Return on Plan Assets | (4,366) | (4,702) | (1,831) | (1,781) |
| Amortization of Prior Service Cost (Credit) | 80 | 80 | (1,072) | (1,072) |
| Amortization of Net Actuarial Loss | 2,026 | 2,988 | 322 | 1,017 |
| **Net Periodic Benefit Cost (Credit)** | $ 2,471 | $ 2,893 | $ (1,368) | $ (438) |

## 7. <u>BUSINESS SEGMENTS</u>

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

## 8. <u>DERIVATIVES AND HEDGING</u>

***Risk Management Strategies***

TCC's vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEPSC, on behalf of TCC, enters into financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. For disclosure purposes, these contracts were included with other hedging activities as "Commodity" as of December 31, 2013. As of March 31, 2014, these contracts will be grouped as "Commodity" with other risk management activities. TCC does not hedge all fuel price risk. The gross notional volumes of TCC's outstanding derivative contracts for heating oil and gasoline as of March 31, 2014 and December 31, 2013 were 574 thousand gallons and 789 thousand gallons, respectively.

According to the accounting guidance for "Derivatives and Hedging," TCC reflects the fair values of derivative instruments subject to netting agreements with the same counterparty net of related cash collateral. For certain risk management contracts, TCC is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the March 31, 2014 condensed balance sheet, TCC netted $2 thousand of cash collateral received from third parties against short-term and long-term risk management assets. For the December 31, 2013 condensed balance sheet, TCC 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 management liabilities.

The following tables represent the gross fair value impact of TCC's derivative activity on the condensed balance sheets as of March 31, 2014 and December 31, 2013:

**Fair Value of Derivative Instruments**
**March 31, 2014**

| Balance Sheet Location | Risk Management Contracts Commodity (a) | Hedging Contracts Commodity (a) | Gross Amounts of Risk Management Assets/ Liabilities Recognized | Gross Amounts Offset in the Statement of Financial Position (b) | Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c) |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| Current Risk Management Assets | $ 54 | $ - | $ 54 | $ (6) | $ 48 |
| Long-term Risk Management Assets | - | - | - | - | - |
| **Total Assets** | 54 | - | 54 | (6) | 48 |
| Current Risk Management Liabilities | 4 | - | 4 | (4) | - |
| Long-term Risk Management Liabilities | - | - | - | - | - |
| **Total Liabilities** | 4 | - | 4 | (4) | - |
| **Total MTM Derivative Contract Net Assets (Liabilities)** | $ 50 | $ - | $ 50 | $ (2) | $ 48 |

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

| Balance Sheet Location | Risk Management Contracts Commodity (a) | Hedging Contracts Commodity (a) | Gross Amounts of Risk Management Assets/ Liabilities Recognized | Gross Amounts Offset in the Statement of Financial Position (b) | Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c) |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| Current Risk Management Assets | $ - | $ 115 | $ 115 | $ - | $ 115 |
| Long-term Risk Management Assets | - | - | - | - | - |
| **Total Assets** | - | 115 | 115 | - | 115 |
| Current Risk Management Liabilities | - | - | - | - | - |
| Long-term Risk Management Liabilities | - | - | - | - | - |
| **Total Liabilities** | - | - | - | - | - |
| **Total MTM Derivative Contract Net Assets (Liabilities)** | $ - | $ 115 | $ 115 | $ - | $ 115 |

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

The table below presents TCC's activity of derivative risk management contracts for the three months ended March 31, 2014 and 2013:

**Amount of Gain (Loss) Recognized on**
**Risk Management Contracts**
**For the Three Months Ended March 31, 2014 and 2013**

| Location of Gain | 2014 | 2013 |
|---|---|---|
| | (in thousands) | |
| Regulatory Liabilities (a) | $ 50 | $ - |

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

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

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

For contracts that have not been designated as part of a hedging relationship, the accounting for changes in fair value depends on whether the derivative instrument is held for trading purposes. Unrealized and realized gains and losses on derivative instruments held for trading purposes are included in revenues on a net basis on TCC's condensed statements of income. Unrealized and realized gains and losses on derivative instruments not held for trading purposes are included in revenues or expenses on TCC's condensed statements of income depending on the relevant facts and circumstances. However, unrealized and some realized gains and losses for both trading and non-trading derivative instruments are recorded as regulatory assets (for losses) or regulatory liabilities (for gains), in accordance with the accounting guidance for "Regulated Operations."

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

For cash flow hedges (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), TCC 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 condensed balance sheets until the period the hedged item affects Net Income. TCC records hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains).

TCC reclassifies gains and losses on heating oil and gasoline derivative contracts designated as cash flow hedges from Accumulated Other Comprehensive Income (Loss) on its condensed balance sheets into Other Operation expense, Maintenance expense or Depreciation and Amortization expense, as it relates to capital projects, on its condensed statements of income. TCC discontinued cash flow hedge accounting for these derivative contracts effective March 31, 2014. During the three months ended March 31, 2013, TCC designated heating oil and gasoline derivatives as cash flow hedges.

For details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TCC's condensed balance sheets and the reasons for changes in cash flow hedges for the three months ended March 31, 2014 and 2013, see Note 3.

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TCC's condensed balance sheets as of March 31, 2014 and December 31, 2013 were:

**Impact of Cash Flow Hedges on the Condensed Balance Sheet**
**March 31, 2014 and December 31, 2013**

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| | (in thousands) | |
| Hedging Assets (a) | $ - | $ 115 |
| Hedging Liabilities (a) | - | - |
| AOCI Gain (Loss) Net of Tax | - | 75 |
| Portion Expected to be Reclassified to Net Income During the Next Twelve Months | - | 75 |

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

The actual amounts that TCC reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ from the estimate above due to market price changes. As of March 31, 2014, TCC is not hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions.

## 9. FAIR VALUE MEASUREMENTS

### *Fair Value Hierarchy and Valuation Techniques*

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

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

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

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

The book values and fair values of TCC's Long-term Debt as of March 31, 2014 and December 31, 2013 are summarized in the following table:

| | March 31, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| | Book Value | Fair Value | Book Value | Fair Value |
| | (in thousands) | | | |
| Long-term Debt | $ 2,789,460 | $ 2,798,493 | $ 2,901,602 | $ 3,054,309 |

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

The following tables set forth, by level within the fair value hierarchy, TCC's financial assets and liabilities that were accounted for at fair value on a recurring basis as of March 31, 2014 and December 31, 2013. 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**
**March 31, 2014**

| | Level 1 | Level 2 | Level 3 | Other | Total |
|---|---|---|---|---|---|
| **Assets:** | | | (in thousands) | | |
| Restricted Cash for Securitized Transition Funding (a) | $ 129,227 | $ - | $ - | $ 6 | $ 129,233 |
| **Risk Management Assets** | | | | | |
| Risk Management Commodity Contracts (b) | - | 54 | - | (6) | 48 |
| **Total Assets** | $ 129,227 | $ 54 | $ - | $ - | $ 129,281 |
| **Liabilities:** | | | | | |
| **Risk Management Liabilities** | | | | | |
| Risk Management Commodity Contracts (b) | $ - | $ 4 | $ - | $ (4) | $ - |

**Assets and Liabilities Measured at Fair Value on a Recurring Basis**
**December 31, 2013**

| | Level 1 | Level 2 | Level 3 | Other | Total |
|---|---|---|---|---|---|
| **Assets:** | | | (in thousands) | | |
| Restricted Cash for Securitized Transition Funding (a) | $ 196,859 | $ - | $ - | $ 6 | $ 196,865 |
| **Risk Management Assets** | | | | | |
| Cash Flow Hedges: | | | | | |
| Commodity Hedges (b) | - | 115 | - | - | 115 |
| **Total Assets** | $ 196,859 | $ 115 | $ - | $ 6 | $ 196,980 |

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

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

There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2014 and 2013.

## 10. INCOME TAXES

***AEP System Tax Allocation Agreement***

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

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

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 in 2013 by $11 million with the payment of the previously accrued taxes. The IRS examination of years 2011 and 2012 started in April 2014. Although the outcome of tax audits is uncertain, in management's opinion, adequate provisions for federal income taxes have been made for potential liabilities resulting from such matters. In addition, TCC accrues interest on these uncertain tax positions. Management is not aware of any issues for open tax years that upon final resolution are expected to materially impact net income.

TCC and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns. TCC and other AEP subsidiaries are currently under examination in several state and local jurisdictions. However, it is possible that previously filed tax returns have positions that may be challenged by these tax authorities. Management believes that adequate provisions for income taxes have been made for potential liabilities resulting from such challenges and that the ultimate resolution of these audits will not materially impact net income. TCC is no longer subject to state or local income tax examinations by tax authorities for years before 2008.

## 11. FINANCING ACTIVITIES

***Long-term Debt***

Long-term debt principal payments made during the first three months of 2014 are shown in the table below:

| Type of Debt | Principal Amount Paid | Interest Rate | Due Date |
|---|---|---|---|
| | (in thousands) | (%) | |
| Securitization Bonds | $ 72,461 | 5.09 | 2015 |
| Securitization Bonds | 39,713 | 6.25 | 2016 |

***Dividend Restrictions***

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

*Federal Power Act*

The Federal Power Act prohibits TCC from participating "in the making or paying of any dividends of such public utility from any funds properly included in capital account." 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 TCC to pay dividends out of retained earnings.

*Leverage Restrictions*

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

***Utility 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. 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 March 31, 2014 and December 31, 2013 are included in Advances from Affiliates on TCC's condensed balance sheets. TCC's Utility Money Pool activity and corresponding authorized borrowing limit for the three months ended March 31, 2014 are described in the following table:

| Maximum Borrowings from the Utility Money Pool | Maximum Loans to the Utility Money Pool | Average Borrowings from the Utility Money Pool | Average Loans to the Utility Money Pool | Borrowings from the Utility Money Pool as of March 31, 2014 | Authorized Short-Term Borrowing Limit |
|---|---|---|---|---|---|
| | | (in thousands) | | | |
| $ 183,206 | $ - | $ 152,086 | $ - | $ 178,866 | $ 250,000 |

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the three months ended March 31, 2014 and 2013 are summarized in the following table:

| Three Months Ended March 31, | Maximum Interest Rate for Funds Borrowed from the Utility Money Pool | Minimum Interest Rate for Funds Borrowed from the Utility Money Pool | Maximum Interest Rate for Funds Loaned to the Utility Money Pool | Minimum Interest Rate for Funds Loaned to the Utility Money Pool | Average Interest Rate for Funds Borrowed from the Utility Money Pool | Average Interest Rate for Funds Loaned to the Utility Money Pool |
|---|---|---|---|---|---|---|
| 2014 | 0.33 % | 0.28 % | - % | - % | 0.31 % | - % |
| 2013 | 0.43 % | 0.35 % | - % | - % | 0.37 % | - % |

## 12. VARIABLE INTEREST ENTITIES

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

AEP Texas Central Transition Funding I LLC, AEP Texas Central Transition Funding II LLC and AEP Texas Central Transition Funding III LLC, wholly-owned subsidiaries of TCC, (collectively Transition Funding) were formed for the sole purpose of issuing and servicing securitization bonds related to Texas Restructuring Legislation. Management has concluded that TCC is the primary beneficiary of Transition Funding because TCC has the power to direct the most significant activities of the VIE and TCC's equity interest could potentially be significant. Therefore, TCC is required to consolidate Transition Funding. The securitized bonds totaled $2 billion and $2 billion as of March 31, 2014 and December 31, 2013, respectively, and are included in current and long-term debt on the condensed balance sheets. Transition Funding has securitized transition assets of $1.8 billion and $1.9 billion as of March 31, 2014 and December 31, 2013, respectively, which are presented separately on the face of the condensed balance sheets. The securitized transition assets represent the right to impose and collect Texas true-up costs from customers receiving electric transmission or distribution service from TCC under recovery mechanisms approved by the PUCT. The securitization bonds are payable only from and secured by the securitized transition assets. The bondholders have no recourse to TCC or any other AEP entity. TCC acts as the servicer for Transition Funding's securitized transition asset and remits all related amounts collected from customers to Transition Funding for interest and principal payments on the securitization bonds and related costs.

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

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**VARIABLE INTEREST ENTITIES**
**March 31, 2014 and December 31, 2013**
**(in thousands)**

| | Transition Funding | |
|---|---|---|
| **ASSETS** | **2014** | **2013** |
| Current Assets | $ 165,848 | $ 232,533 |
| Other Noncurrent Assets (a) | 1,861,037 | 1,917,548 |
| **Total Assets** | $ 2,026,885 | $ 2,150,081 |
| **LIABILITIES AND EQUITY** | | |
| Current Liabilities | $ 304,088 | $ 312,369 |
| Noncurrent Liabilities | 1,704,731 | 1,819,649 |
| Equity | 18,066 | 18,063 |
| **Total Liabilities and Equity** | $ 2,026,885 | $ 2,150,081 |

(a) Includes an intercompany item eliminated in consolidation as of March 31, 2014 and December 31, 2013 of $81 million and $82 million, respectively.

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. TCC's total billings from AEPSC for the three months ended March 31, 2014 and 2013 were $20 million and $15 million, respectively. The carrying amount of liabilities associated with AEPSC as of March 31, 2014 and December 31, 2013 was $8 million and $9 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.