AEP Texas North Company
and Subsidiary

2016 First Quarter Report

Consolidated Financial Statements

AEP AMERICAN® ELECTRIC POWER

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GLOSSARY OF TERMS

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

Term	Meaning
AEP	American Electric Power Company, Inc., an investor-owned electric public utility holding company which includes American Electric Power Company, Inc. (Parent) and majority owned consolidated subsidiaries and consolidated affiliates.
AEP System	American Electric Power System, an electric system, owned and operated by AEP subsidiaries.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AOCI	Accumulated Other Comprehensive Income.
ASU	Accounting Standards Update.
FASB	Financial Accounting Standards Board.
FERC	Federal Energy Regulatory Commission.
FTR	Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices.
GAAP	Accounting Principles Generally Accepted in the United States of America.
IRS	Internal Revenue Service.
MTM	Mark-to-Market.
Nonutility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain nonutility subsidiaries.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
Parent	American Electric Power Company, Inc., the equity owner of AEP subsidiaries within the AEP consolidation.
PUCT	Public Utility Commission of Texas.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
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.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three Months Ended March 31, 2016 and 2015
(in thousands)
(Unaudited)

	Three Months Ended March 31, 2016	2015
REVENUES		
Electric Transmission and Distribution	$ 56,099	$ 57,080
Sales to AEP Affiliates	15,141	22,080
Other Revenues	332	179
TOTAL REVENUES	71,572	79,339
EXPENSES		
Fuel and Other Consumables Used for Electric Generation	3,483	8,104
Other Operation	25,221	24,136
Maintenance	5,630	9,968
Depreciation and Amortization	13,241	14,476
Taxes Other Than Income Taxes	4,982	4,824
TOTAL EXPENSES	52,557	61,508
OPERATING INCOME	19,015	17,831
Other Income (Expense):		
Other Income	965	51
Interest Expense	(5,676)	(4,900)
INCOME BEFORE INCOME TAX EXPENSE	14,304	12,982
Income Tax Expense	3,937	4,464
NET INCOME	$ 10,367	$ 8,518

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

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

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Three Months Ended March 31, 2016 and 2015
(in thousands)
(Unaudited)

	Three Months Ended March 31, 2016	2015
Net Income	$ 10,367	$ 8,518
OTHER COMPREHENSIVE INCOME, NET OF TAXES		
Cash Flow Hedges, Net of Tax of $117 and $117 in 2016 and 2015, Respectively	218	217
Amortization of Pension and OPEB Deferred Costs, Net of Tax of $36 and $41 in 2016 and 2015, Respectively	67	76
TOTAL OTHER COMPREHENSIVE INCOME	285	293
TOTAL COMPREHENSIVE INCOME	$ 10,652	$ 8,811

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

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN
COMMON SHAREHOLDER'S EQUITY
For the Three Months Ended March 31, 2016 and 2015
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2014	$ 137,214	$ 3,276	$ 249,195	$ (17,595)	$ 372,090
Common Stock Dividends			(6,000)		(6,000)
Net Income			8,518		8,518
Other Comprehensive Income				293	293
TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2015	$ 137,214	$ 3,276	$ 251,713	$ (17,302)	$ 374,901
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2015	$ 137,214	$ 28,276	$ 251,459	$ (16,276)	$ 400,673
Common Stock Dividends			(6,000)		(6,000)
Net Income			10,367		10,367
Other Comprehensive Income				285	285
TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2016	$ 137,214	$ 28,276	$ 255,826	$ (15,991)	$ 405,325

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

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
ASSETS
March 31, 2016 and December 31, 2015
(in thousands)
(Unaudited)

	March 31, 2016	December 31, 2015
CURRENT ASSETS		
Advances to Affiliates	$ 8,651	$ 23,112
Accounts Receivable:		
Customers	12,722	13,265
Affiliated Companies	12,169	6,693
Accrued Unbilled Revenues	7,916	8,472
Miscellaneous	1,174	916
Allowance for Uncollectible Accounts	(366)	(355)
Total Accounts Receivable	33,615	28,991
Fuel	8,600	10,205
Materials and Supplies	14,171	14,184
Accrued Tax Benefits	5,712	6,240
Prepayments and Other Current Assets	723	961
TOTAL CURRENT ASSETS	71,472	83,693
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	346,312	342,542
Transmission	656,433	630,759
Distribution	784,199	776,057
Other Property, Plant and Equipment	106,620	101,012
Construction Work in Progress	71,091	78,308
Total Property, Plant and Equipment	1,964,655	1,928,678
Accumulated Depreciation and Amortization	599,923	591,910
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,364,732	1,336,768
OTHER NONCURRENT ASSETS		
Regulatory Assets	59,655	55,730
Deferred Charges and Other Noncurrent Assets	62,854	37,300
TOTAL OTHER NONCURRENT ASSETS	122,509	93,030
TOTAL ASSETS	$ 1,558,713	$ 1,513,491

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

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
March 31, 2016 and December 31, 2015
(Unaudited)

	March 31, 2016	December 31, 2015
	(in thousands)	
CURRENT LIABILITIES		
Advances from Affiliates	$ 20,230	$ —
Accounts Payable:		
General	20,736	27,402
Affiliated Companies	10,406	11,277
Long-term Debt Due Within One Year – Nonaffiliated	75,007	75,007
Risk Management Liabilities	112	111
Accrued Taxes	18,356	15,269
Accrued Interest	5,554	5,281
Other Current Liabilities	10,725	14,189
TOTAL CURRENT LIABILITIES	161,126	148,536
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	468,273	468,158
Deferred Income Taxes	230,010	205,617
Regulatory Liabilities and Deferred Investment Tax Credits	197,037	193,127
Oklaunion Purchase Power Agreement	50,547	50,217
Deferred Credits and Other Noncurrent Liabilities	46,395	47,163
TOTAL NONCURRENT LIABILITIES	992,262	964,282
TOTAL LIABILITIES	1,153,388	1,112,818
Rate Matters (Note 4)		
Commitments and Contingencies (Note 5)		
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	28,276	28,276
Retained Earnings	255,826	251,459
Accumulated Other Comprehensive Income (Loss)	(15,991)	(16,276)
TOTAL COMMON SHAREHOLDER'S EQUITY	405,325	400,673
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	$ 1,558,713	$ 1,513,491

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

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Three Months Ended March 31, 2016 and 2015
(in thousands)
(Unaudited)

	Three Months Ended March 31, 2016	2015
OPERATING ACTIVITIES		
Net Income	$ 10,367	$ 8,518
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	13,241	14,476
Deferred Income Taxes	9,815	2,131
Property Taxes	(11,332)	(10,202)
Change in Other Noncurrent Assets	(2,471)	577
Change in Other Noncurrent Liabilities	(630)	(1,544)
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	(4,624)	989
Fuel, Materials and Supplies	1,618	2,656
Accounts Payable	(2,474)	(172)
Accrued Taxes, Net	3,615	5,237
Other Current Assets	(120)	(783)
Other Current Liabilities	(3,199)	(2,626)
Net Cash Flows from Operating Activities	13,806	19,257
INVESTING ACTIVITIES		
Construction Expenditures	(43,539)	(34,930)
Change in Advances to Affiliates, Net	14,461	289
Proceeds from Sales of Assets	949	687
Other Investing Activities	(25)	694
Net Cash Flows Used for Investing Activities	(28,154)	(33,260)
FINANCING ACTIVITIES		
Change in Advances from Affiliates, Net	20,230	20,060
Retirement of Long-term Debt – Nonaffiliated	(2)	(2)
Principal Payments for Capital Lease Obligations	(199)	(206)
Dividends Paid on Common Stock	(6,000)	(6,000)
Other Financing Activities	319	151
Net Cash Flows from Financing Activities	14,348	14,003
Net Change in Cash and Cash Equivalents	—	—
Cash and Cash Equivalents at Beginning of Period	—	—
Cash and Cash Equivalents at End of Period	$ —	$ —
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 5,040	$ 4,057
Net Cash Paid (Received) for Income Taxes	(5,193)	—
Noncash Acquisitions Under Capital Leases	1,419	237
Construction Expenditures Included in Current Liabilities as of March 31,	14,968	12,387

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, 2016 is not necessarily indicative of results that may be expected for the year ending December 31, 2016. The condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2015 financial statements and notes thereto, which are included in TNC's 2015 Annual Report.

Management reviewed subsequent events through April 28, 2016, the date that the first quarter 2016 report was issued.

2. NEW ACCOUNTING PRONOUNCEMENTS

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

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

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

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

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

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

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

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

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

ASU 2016-02 "Accounting for Leases" (ASU 2016-02)

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

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

ASU 2016-09 "Compensation – Stock Compensation" (ASU 2016-09)

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

The new accounting guidance is effective for annual periods beginning after December 15, 2016. Early adoption is permitted in any interim or annual period. Certain provisions require retrospective/modified retrospective transition while others are to be applied prospectively. Management plans to adopt ASU 2016-09 effective January 1, 2017.

3. COMPREHENSIVE INCOME

Presentation of Comprehensive Income

The following tables provide the components of changes in AOCI and details of reclassifications from AOCI for the three months ended March 31, 2016 and 2015. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 6 for additional details.

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Three Months Ended March 31, 2016

	Cash Flow Hedges Interest Rate and Foreign Currency	Pension and OPEB	Total
	(in thousands)		
Balance in AOCI as of December 31, 2015	$ (6,229)	$ (10,047)	$ (16,276)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	334	—	334
Amortization of Prior Service Cost (Credit)	—	(17)	(17)
Amortization of Actuarial (Gains)/Losses	—	120	120
Reclassifications from AOCI, before Income Tax (Expense) Credit	334	103	437
Income Tax (Expense) Credit	116	36	152
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	218	67	285
Net Current Period Other Comprehensive Income (Loss)	218	67	285
Balance in AOCI as of March 31, 2016	$ (6,011)	$ (9,980)	$ (15,991)

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Three Months Ended March 31, 2015

	Cash Flow Hedges Interest Rate and Foreign Currency	Pension and OPEB	Total
	(in thousands)		
Balance in AOCI as of December 31, 2014	$ (7,097)	$ (10,498)	$ (17,595)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	334	—	334
Amortization of Prior Service Cost (Credit)	—	(17)	(17)
Amortization of Actuarial (Gains)/Losses	—	133	133
Reclassifications from AOCI, before Income Tax (Expense) Credit	334	116	450
Income Tax (Expense) Credit	117	40	157
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	217	76	293
Net Current Period Other Comprehensive Income (Loss)	217	76	293
Balance in AOCI as of March 31, 2015	$ (6,880)	$ (10,422)	$ (17,302)

4. RATE MATTERS

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

Regulatory Assets Pending Final Regulatory Approval

Noncurrent Regulatory Assets	March 31, 2016	December 31, 2015
	(in thousands)	
Regulatory Assets Currently Not Earning a Return		
Rate Case Expenses	$ 3	$ 3
Total Regulatory Assets Pending Final Regulatory Approval	$ 3	$ 3

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

TNC Distribution Cost Recovery Factor (DCRF)

In April 2016, TNC filed a request with the PUCT for approval of a DCRF rider to allow recovery of eligible net distribution investments. The request included a revenue requirement of $16 million to be effective September 2016. Amounts approved would be subject to refund based upon a prudence review of the investments in TNC's next base rate case. If any of these costs are not recoverable, it could reduce future net income and cash flows and impact financial condition.

5. 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 against TNC cannot be predicted. Management accrues contingent liabilities only when management concludes that it is both probable that a liability has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. When management determines that it is not probable, but rather reasonably possible that a liability has been incurred at the date of the financial statements, management discloses such contingencies and the possible loss or range of loss if such estimate can be made. Any estimated range is based on currently available information and involves elements of judgment and significant uncertainties. Any estimated range of possible loss may not represent the maximum possible loss exposure. Circumstances change over time and actual results may vary significantly from estimates.

For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material effect on the financial statements. The Commitments, Guarantees and Contingencies note within TNC's 2015 Annual Report should be read in conjunction with this report.

GUARANTEES

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

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 March 31, 2016, there were no material liabilities recorded for any indemnifications.

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 March 31, 2016, the maximum potential loss for these lease agreements was $2.6 million assuming the fair value of the equipment is zero at the end of the lease term.

6. BENEFIT PLANS

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.

Components of Net Periodic Benefit Cost

The following table provides the components of TNC's net periodic benefit cost (credit) for the plans for the three months ended March 31, 2016 and 2015:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended March 31,		Three Months Ended March 31,	
	2016	2015	2016	2015
	(in thousands)			
Service Cost	$ 453	$ 461	$ 42	$ 47
Interest Cost	1,078	1,020	347	316
Expected Return on Plan Assets	(1,460)	(1,457)	(639)	(658)
Amortization of Prior Service Cost (Credit)	22	23	(394)	(394)
Amortization of Net Actuarial Loss	431	538	186	101
Net Periodic Benefit Cost (Credit)	$ 524	$ 585	$ (458)	$ (588)

7. BUSINESS SEGMENTS

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

8. DERIVATIVES AND HEDGING

AEPSC is agent for and transacts on behalf of TNC.

Risk Management Strategies

TNC's vehicle fleet is exposed to gasoline and diesel fuel price volatility. TNC utilizes financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. TNC does not hedge all fuel price risk. The gross notional volumes of TNC's outstanding derivative contracts for heating oil and gasoline as of March 31, 2016 and December 31, 2015 were 491 thousand gallons and 516 thousand gallons, respectively.

Cash Flow Hedging Strategies

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

ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND THE IMPACT ON THE FINANCIAL STATEMENTS

According to the accounting guidance for "Derivatives and Hedging," 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 March 31, 2016 and December 31, 2015 condensed balance sheets, TNC had no netting of cash collateral received from third parties against short-term and long-term risk management assets and $76 thousand and $143 thousand, respectively, of cash collateral paid to third parties against short-term and long-term risk management liabilities.

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

Fair Value of Derivative Instruments
March 31, 2016

Balance Sheet Location	Risk Management Contracts Commodity (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
		(in thousands)	
Current Risk Management Assets	$ —	$ —	$ —
Long-term Risk Management Assets	—	—	—
Total Assets	—	—	—
Current Risk Management Liabilities	188	(76)	112
Long-term Risk Management Liabilities	—	—	—
Total Liabilities	188	(76)	112
Total MTM Derivative Contract Net Assets (Liabilities)	$ (188)	$ 76	$ (112)

Fair Value of Derivative Instruments
December 31, 2015

Balance Sheet Location	Risk Management Contracts Commodity (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
		(in thousands)	
Current Risk Management Assets	$ —	$ —	$ —
Long-term Risk Management Assets	—	—	—
Total Assets	—	—	—
Current Risk Management Liabilities	254	(143)	111
Long-term Risk Management Liabilities	—	—	—
Total Liabilities	254	(143)	111
Total MTM Derivative Contract Net Assets (Liabilities)	$ (254)	$ 143	$ (111)

(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 TNC's activity of derivative risk management contracts for the three months ended March 31, 2016 and 2015:

Amount of Gain (Loss) Recognized on
Risk Management Contracts

Location of Gain (Loss)	Three Months Ended March 31, 2016	2015
	(in thousands)	
Other Operation Expense	$ (72)	$ (106)
Maintenance Expense	(77)	(72)
Regulatory Assets (a)	65	94
Regulatory Liabilities (a)	—	—
Total Loss on Risk Management Contracts	$ (84)	$ (84)

(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.

TNC'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 TNC'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 TNC's condensed statements of income depending on the relevant facts and circumstances. Certain derivatives that economically hedge future commodity risk are recorded in the same expense line item on the condensed statements of income as that of the associated risk. However, unrealized and some realized gains and losses for both trading and non-trading derivative instruments are recorded as regulatory assets (for losses) or regulatory liabilities (for gains), in accordance with the accounting guidance for "Regulated Operations."

Accounting for Cash Flow Hedging Strategies

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

TNC reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its condensed balance sheets into Interest Expense on its condensed statements of income in those periods in which hedged interest payments occur. During the three months ended March 31, 2016 and 2015, TNC did not apply cash flow hedging to outstanding interest rate derivatives.

During the three months ended March 31, 2016 and 2015, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies discussed above.

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

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TNC's condensed balance sheets as of March 31, 2016 and December 31, 2015 were:

Impact of Cash Flow Hedges on the Condensed Balance Sheets

	Interest Rate	
	March 31, 2016	**December 31, 2015**
	(in thousands)	
Hedging Assets (a)	$ —	$ —
Hedging Liabilities (a)	—	—
AOCI Loss Net of Tax	(6,011)	(6,229)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(869)	(869)

(a) Hedging Assets and Hedging Liabilities are included in Risk Management Assets and Liabilities on TNC's condensed 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 March 31, 2016, TNC 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. AEPSC's market risk oversight staff independently monitors risk policies, procedures and risk levels and provides members of the Commercial Operations Risk Committee (Regulated Risk Committee) various reports regarding compliance with policies, limits and procedures. The Regulated Risk Committee consists of AEPSC's Chief Operating Officer, Chief Financial Officer, Executive Vice President of Generation, Senior Vice President of Commercial Operations and Chief Risk Officer.

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

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 March 31, 2016 and December 31, 2015 are summarized in the following table:

	March 31, 2016		December 31, 2015	
	Book Value	Fair Value	Book Value	Fair Value
	(in thousands)			
Long-term Debt	$ 543,280	$ 588,092	$ 543,165	$ 566,317

__Fair Value Measurements of Financial Assets and Liabilities__

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

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

Liabilities:	**Level 1**	**Level 2**	**Level 3**	**Other**	**Total**
			(in thousands)		
Risk Management Liabilities					
Risk Management Commodity Contracts (a)	$ —	$ 188	$ —	$ (76)	$ 112

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

Liabilities:	**Level 1**	**Level 2**	**Level 3**	**Other**	**Total**
			(in thousands)		
Risk Management Liabilities					
Risk Management Commodity Contracts (a)	$ —	$ 254	$ —	$ (143)	$ 111

(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 March 31, 2016 and December 31, 2015, TNC had no assets 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, 2016 and 2015.

10. INCOME TAXES

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. The IRS examination of years 2011, 2012 and 2013 started in April 2014. TNC and other AEP subsidiaries received a Revenue Agents Report in April 2016, completing the 2011 through 2013 audit cycle indicating an agreed upon audit. 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. 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.

State Tax Legislation

In March 2016, the Texas Comptroller of Public Accounts issued clarifying guidance regarding the treatment of transmission and distribution expenses included in the computation of taxable income for purposes of calculating the Texas gross margins tax. The guidance clarified which specific transmission and distribution expenses are included in the computation of the cost of goods sold deduction. This guidance resulted in a net favorable adjustment of $1 million to TNC's net income.

11. FINANCING ACTIVITIES

Long-term Debt

Long-term debt principal payments made during the first three months of 2016 are shown in the table below:

Type of Debt	Principal Amount Paid (in thousands)	Interest Rate (%)	Due Date
Other Long-term Debt	$ 2	4.50	2059

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." 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%.

Corporate Borrowing Program – AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of AEP's subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP's utility subsidiaries, and a Nonutility Money Pool, which funds a majority of AEP's nonutility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions of the AEP System Utility Money Pool agreement filed with the FERC. The amounts of outstanding loans to (borrowings from) the Utility Money Pool as of March 31, 2016 and December 31, 2015 are included in Advances to Affiliates and Advances from Affiliates, respectively, on TNC's balance sheets. TNC's Utility Money Pool activity and corresponding authorized borrowing limit for the three months ended March 31, 2016 are described in the following table:

Maximum Borrowings from the Utility Money Pool	Maximum Loans to the Utility Money Pool	Average Borrowings from the Utility Money Pool	Average Loans to the Utility Money Pool	Borrowings from the Utility Money Pool as of March 31, 2016	Authorized Short-Term Borrowing Limit
		(in thousands)			
$ 30,762	$ 14,394	$ 21,098	$ 4,024	$ 20,230	$ 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 March 31, 2016 and December 31, 2015 are included in Advances to Affiliates on TNC's condensed balance sheets. For the three months ended March 31, 2016, TNGC had the following activity in the Nonutility Money Pool:

Maximum Borrowings from the Nonutility Money Pool	Maximum Loans to the Nonutility Money Pool	Average Borrowings from the Nonutility Money Pool	Average Loans to the Nonutility Money Pool	Loans to the Nonutility Money Pool as of March 31, 2016
		(in thousands)		
$ —	$ 8,719	$ —	$ 8,475	$ 8,651

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, 2016 and 2015 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
2016	0.83%	0.69%	0.82%	0.69%	0.74%	0.76%
2015	0.59%	0.39%	—%	—%	0.46%	—%

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Nonutility Money Pool for the three months ended March 31, 2016 and 2015 are summarized in the following table:

Three Months Ended March 31,	Maximum Interest Rate for Funds Borrowed from the Nonutility Money Pool	Minimum Interest Rate for Funds Borrowed from the Nonutility Money Pool	Maximum Interest Rate for Funds Loaned to the Nonutility Money Pool	Minimum Interest Rate for Funds Loaned to the Nonutility Money Pool	Average Interest Rate for Funds Borrowed from the Nonutility Money Pool	Average Interest Rate for Funds Loaned to the Nonutility Money Pool
2016	—%	—%	0.83%	0.69%	—%	0.73%
2015	—%	—%	0.59%	0.39%	—%	0.46%

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 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. Parent is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC's cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC's cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. TNC's total billings from AEPSC for the three months ended March 31, 2016 and 2015 were $9.7 million and $8 million, respectively. The carrying amount of liabilities associated with AEPSC as of March 31, 2016 and December 31, 2015 was $3.1 million and $4.5 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.