Accounting Policy/Procedure

Policy/Procedure Title	Accounting for Allowance for Funds Used During Construction and Capitalized Interest	Date	7/29/13

Purpose

This accounting policy / procedure memo serves to update and replace AEP Accounting Bulletin 1, "Accounting for Allowance for Funds Used During Construction." This document outlines AEP's procedures for computing and capitalizing allowance for funds used during construction and capitalized interest. Additionally, the underlying principles governing the accounting for this construction cost factor are presented.

This policy / procedure document may not be released to parties outside AEP without the approval of the Chief Accounting Officer.

Policy/Procedure Statement

I. Summary of Principles Permitting Allowance for Funds Used During Construction (AFUDC) and Capitalized Interest

A. FERC Uniform System of Accounts
Effective January 1, 1977, the FERC ordered new accounting procedures for AFUDC (Order No. 561 issued February 2, 1977).

AFUDC as provided in the Uniform System of Accounts is a two-part allowance. It includes:

1. An allowance for other funds used during construction, which includes the cost of common equity and preferred stock when so used, and;

2. An allowance for borrowed funds used during construction, which includes the cost of short-term debt and long-term debt when so used.

AFUDC is capitalized on the company's books by charging Account 107, Construction Work in Progress, as a component of construction cost and crediting Other Income, Account 419.1 – Allowance for Other Funds Used During Construction and/or crediting Interest Charges, Account 432 – Allowance for Borrowed Funds Used During Construction – Credit, as appropriate.

B. Generally Accepted Accounting Principles
Capitalization of Interest
Accounting Standards Codification (ASC) 835-20, Capitalization of Interest, permits capitalization of interest by all entities; however, such costs are limited to actual interest expense incurred for borrowed funds, imputed interest on certain payables and interest related to capital leases. AEP applies capitalized interest to its non-regulated subsidiaries in accordance with ASC 835-20.

The capitalization period begins when expenditures for the asset have been made, activities necessary to get the asset ready for its intended use are in progress, and interest cost is being incurred. Interest capitalization continues as long as those three conditions are present. If substantially all activities related to the construction of the asset are suspended, interest capitalization should cease until activities are resumed.

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The amount capitalized in an accounting period is determined by applying the capitalization rate to the average amount of accumulated expenditures for the asset during the period. The capitalization rates are the prior month's weighted average debt cost for the applicable AEP subsidiary. The total amount of interest cost capitalized in an accounting period should not exceed the total amount of interest cost incurred in that period.

The capitalization period ends when the asset is substantially complete and ready for its intended use.

ASC 835-20 recognizes that regulated entities capitalize both a cost of debt and a cost of equity capital during the construction period in accordance with ASC 980-835.

AFUDC
ASC 980-835, Regulated Operations, Interest, addresses cases where a regulator requires an entity to capitalize the cost of financing construction as financed partially by borrowings and partially by equity (AFUDC). In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets shall be capitalized for financial reporting purposes instead of the amount of interest that would be capitalized in accordance with ASC 835-20.

AEP applies AFUDC to its regulated subsidiaries in accordance with ASC 980-835. The prior month's weighted average debt cost and equity cost for the applicable AEP subsidiary are used to determine the AFUDC rate.

With the exception of the rate calculation, procedures to apply capital interest are the same as used for AFUDC unless indicated.

II. Rate for Computing AFUDC

A. Authorization of Rate for Computing AFUDC
The FERC has granted permission to utilities to calculate the AFUDC rate on a monthly basis instead of annually as specified in Electric Plant Instruction No. 3, Item 17. This change enables a utility to calculate AFUDC using the maximum allowed rate on a monthly basis and avoids the need for a retroactive adjustment of AFUDC to the maximum allowed rate.

AEP uses the monthly methodology for calculating AFUDC rates. The balances for long-term debt, preferred stock, common stock and construction work in progress are the actual book balances at the end of the prior month. The interest rate for long-term debt and the cost rate for preferred stock are based on the prior month's costs. The cost rate for common stock is the rate of return granted common equity in the last approved rate proceeding. The balance for short-term debt is the average daily balance for the prior month and the related interest rate is the average rate for the prior month.

B. Formula and Elements for Computing the Monthly Maximum Allowable Rate
Separate monthly rates for each company are developed using the formula and elements for the computation of AFUDC as contained in Electric Plant Instruction No. 3, Item 17, of the Uniform System of Accounts adjusted for the requirements of FERC Accounting Release AR-13 effective May 1, 1983. The formula and elements are as follows:

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$$Ai = s\left(\frac{S}{W}\right) + d\left(\frac{D}{D+P+C}\right)\left(1 - \frac{S}{W}\right)$$

$$Ae = \left[1 - \frac{S}{W}\right]\left[p\left(\frac{P}{D+P+C}\right) + c\left(\frac{C}{D+P+C}\right)\right]$$

Ai = Gross allowance for borrowed funds used during construction rate
Ae = Allowance for other funds used during construction rate
S = Average short-term debt
s = Short-term debt interest rate
D = Long-term debt (including use-restricted debt)
d = Long-term debt interest rate (including rate of use-restricted debt)
P = Preferred stock
p = Preferred stock cost rate
C = Common equity
c = Common equity cost rate
W = Average balance in construction work in progress plus nuclear fuel in process of refinement, conversion, enrichment and fabrication, less asset retirement costs related to plant under construction

The rate for computing AFUDC as outlined above represents a maximum monthly, simple interest rate which cannot be exceeded without prior Commission approval.

C. Compounding of AFUDC
In Order No. 561, FERC noted that compounding of AFUDC would be permitted, but no more frequently than semiannually.

AEP uses a compounded rate for AFUDC based on semiannual compounding. The rate is developed and applied to construction on a monthly basis.

III. Charges Exempt from Application of AFUDC

AFUDC is to be applied on all construction expenditures with the following exceptions:

1. Meter and transformer blanket work orders.

2. Electric plant purchased.

3. Most work orders with a general plant work order type (general plant work orders mapped to account 397, communication equipment, have AFUDC applied to construction expenditures).

4. Work orders for acquiring land and land rights where new facilities are not being constructed on the land. See Item VI, below.

5. Any portion of construction work in progress which should be excluded from the application of AFUDC as a consequence of compensatory rate relief.

6. Ongoing landfill preparation activities where work may be done intermittently over several years.

7. Certain charge types such as unvouchered liabilities and billing credits.

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IV. Method for Accruing AFUDC

AFUDC is to be computed by applying the applicable monthly rate to the previous month's closing balance in the work order (including AFUDC), plus one-half ($^1/_2$) of the current month's additions, less any unpaid retained percentages under contracts and any unpaid invoices included therein.

The computed base multiplied by the applicable monthly rate equals the AFUDC for the current month that is to be charged to the work order.

V. Period for Capitalization of AFUDC

A. Commencement

1. FERC Interpretation
FERC Accounting Release AR-5 (Revised) effective February 20, 1968 states that; "Interest during construction may be capitalized starting from the date that construction costs are continuously incurred on a planned progressive basis." Release AR-5 also states that; "No interest should be accrued during the period of interrupted construction unless the company can justify the interruption as being reasonable under the circumstances."

2. AEP System Implementation
AFUDC is to be capitalized, in accordance with the instructions contained in this policy / procedure memo, commencing with the month of the first charges to an eligible work order.

In the case of interrupted construction a project must meet the criteria specified in the AEP Work Order Suspension Policy to be considered eligible for suspension. Suspended work orders cease accruing AFUDC from the month the work order is suspended until the month the work order is reopened.

The accrual of AFUDC will automatically cease if a work order has no direct charges (labor, material, outside services, etc.) for a period exceeding 6 months.

B. Cessation

1. FERC Interpretation
FERC Accounting Release AR-5 (Revised) states that; "Capitalization of interest stops when the facilities have been tested and are placed in or ready for service. This would include those portions of construction projects completed and put into service although the project is not fully completed."

2. AEP System Implementation
The cessation of AFUDC is dependent upon the month of the in-service date of the facilities as reported in accordance with AEP's In Service Procedure.

The in-service date shall correspond to the first commitment to permanent use of the facilities in the performance of their intended functions (e.g., when electrical equipment is energized and permanently connection to the system). Temporary or limited operations for testing or for construction purposes are not construed as in-service.

A half-month of AFUDC will be calculated in the in-service month. If an in-service date is reported after the fact, any AFUDC calculated after the in-service month will be automatically reversed in the current month.

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VI. AFUDC Applied to Land and Land Rights

The accrual of AFUDC on expenditures for land and land rights shall begin at the commencement of the related construction project.

AFUDC on land and land rights is part of the cost of constructing a new facility, and as such, these costs should be capitalized as part of the construction cost of the facility to be recovered through depreciation rather than as part of the cost of the land which is not depreciated. Accordingly AFUDC accrued on the cost of land and land rights shall be transferred to the related construction project as part of the cost of the facility constructed. This transfer will be made when the facility being constructed is placed in-service.