Indiana & Michigan Electric Company

ANNUAL REPORT 1978

AMERICAN ELECTRIC POWER SYSTEM

8001040 660

The Company's Annual Report (Form 10-K) to the Securities and Exchange Commission will be available on or about March 31, 1979 to shareowners upon their written request and at no cost. Please address such requests to:

Mr. H. D. Post
Assistant Treasurer
American Electric Power
Service Corporation
2 Broadway
New York, N. Y. 10004

Transfer Agent of Cumulative Preferred Stock

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Registrar of Cumulative Preferred Stock

Irving Trust Company 1 Wall Street, New York, N. Y. 10015

Contents

Background of the Company

INDIANA & MICHIGAN ELECTRIC COMPANY (the Company) is a subsidiary of American Electric Power Company, Inc. (AEP) and is engaged in the generation, purchase, transmission, and distribution of electric power. The Company was organized under the laws of Indiana on February 21, 1925, and is also authorized to transact business in Michigan and West Virginia. Its principal executive offices are in Fort Wayne, Indiana.

Indiana & Michigan Power Company, the generating subsidiary of the Company, was formed in 1971 to own, complete the construction of, and operate the Donald C. Cook Nuclear Plant (the Nuclear Plant). Unit No. 1 of the Nuclear Plant was placed in commercial operation on August 23, 1975. Unit No. 2 was placed in commercial operation on July 1, 1978. The subsidiary sells all of the plant's generation to the parent for distribution to the latter's customers.

The Company serves 231 communities and approximately 437,000 customers in a 7,740-square-mile area of northern and eastern Indiana and a portion of southwestern Michigan. This area has an estimated population of 1,566,000. Among the principal industries served are manufacturers of automobiles, trucks, automotive parts, aircraft parts, steel, ferrous and nonferrous castings, farm machinery, machine tools, electric motors, electric transformers, electric wire and cable, glass, textiles, rubber products, food products and electronic components. In addition, the Company supplies wholesale electric power to other electric utilities, municipalities, and cooperatives.

The Company's generating plants and important load centers are interconnected by a high-voltage transmission network. This network in turn is interconnected either directly or indirectly with the following other AEP System companies to form a single major integrated power system: Appalachian Power Company, Kentucky Power Company, Kingsport Power Company, Michigan Power Company, Ohio Power Company, and Wheeling Electric Company. The Company is also interconnected with the following other utilities: Central Illinois Public Service Company, The Cincinnati Gas & Electric Company, Consumers Power Company, Commonwealth Edison Company, Illinois Power Company, Indiana-Kentucky Electric Corporation (a subsidiary of Ohio Valley Electric Corporation), Indianapolis Power & Light Company, Northern Indiana Public Service Company, and Public Service Company of Indiana, Inc.

Consolidated Summary of Operations

	Year Ended December 31,				
	1978	1977	1976	1975	1974
			(In Thousands)		
OPERATING REVENUES—ELECTRIC	$603,480	$512,824	$416,193	$363,355	$287,606
OPERATING EXPENSES:					
Operation:					
Fuel for Electric Generation	125,277	74,052	70,127	55,775	55,216
Purchased and Interchange Power (Net)	116,308	144,833	126,712	121,194	111,161
Other	60,001	44,706	40,251	37,800	27,959
Maintenance	32,724	28,452	20,140	17,078	17,747
Depreciation	59,844	48,824	47,852	32,734	24,853
Taxes, Other Than Income Taxes	26,432	23,408	18,920	14,015	10,956
Federal and State Income Taxes	23,060	18,149	(8,625)	6,026	(3,086)
Total Operating Expenses	443,646	382,424	315,377	284,622	244,806
OPERATING INCOME	159,834	130,400	100,816	78,733	42,800
OTHER INCOME AND DEDUCTIONS:					
Allowance for Funds Used During Construction	—	—	28,874(a)	45,482(a)	59,454(a)
Allowance for Other Funds Used During Construction	27,974	26,889	—	—	—
Miscellaneous Nonoperating Income Less Deductions	1,040	952	718	135	1,537
Total Other Income and Deductions	29,014	27,841	29,592	45,617	60,991
INCOME BEFORE INTEREST CHARGES	188,848	158,241	130,408	124,350	103,791
INTEREST CHARGES:					
Total Interest Charges	96,648	80,772	76,534	70,822	70,388
Allowance for Borrowed Funds Used During Construction (Credit)	(22,627)	(19,651)	—	—	—
Net Interest Charges	74,021	61,121	76,534	70,822	70,388
CONSOLIDATED INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGES	114,827	97,120	53,874	53,528	33,403
NON-RECURRING CUMULATIVE EFFECT OF ACCOUNTING CHANGES (Net of $603,000 Applicable Taxes)	—	—	—	—	8,151
CONSOLIDATED NET INCOME	$114,827	$ 97,120	$ 53,874	$ 53,528	$ 41,554

(a) Not reclassified into debt and equity components since allocation based on then existing capital structure would not necessarily be comparable to allocation under the FERC formula used after 1976.

Management's Comments on Consolidated Summary of Operations

The amounts shown in the Consolidated Summary of Operations and discussed below reflect only the results of past operations and are not intended as any representation as to the results of operations for any future period. Reference is made to the consolidated financial statements, related notes, and Operating Statistics and Balance Sheet Data for additional information concerning results of operations.

Operating Revenues—Electric

Electric operating revenues increased by $96,631,000 (23%) in 1977 over 1976 and by $90,656,000 (18%) in 1978 over 1977. Factors associated with the increases and related estimated amounts are as follows:

	Increase (Decrease)	
	1977 vs. 1976	1978 vs. 1977
	(In Millions)	
Base Rates and Fuel Cost Adjustments	$109.3	$ 53.8
Sales Volume	(21.2)	51.1
Sales Mix	8.2	(14.2)
Other Operating Revenues	0.3	—
Overall Increase	$ 96.6	$ 90.7

The increase in operating revenues in 1977 over 1976 was primarily attributable to rate increases placed in effect during 1976 and 1977 and to the recovery of increased fuel costs pursuant to the Company's fuel-adjustment clauses. Growth in operating revenues during 1977 was limited due to a 17% decrease in kilowatt-hour sales for resale. The increase in operating revenues in 1978 over 1977 reflected a 29% increase in kilowatt-hour sales for resale, the recovery of increased fuel costs, and rate increases placed in effect during 1977 and 1978. Conservation measures by some customers have tended to limit the growth of operating revenues in both 1977 and 1978.

Operating Expenses

Fuel for electric generation increased in 1977 over 1976 by $3,925,000 (6%) and in 1978 over 1977 by $51,225,000 (69%). Factors relating to these increases and the related estimated amounts are shown below:

	Increase (Decrease)			
	1977 vs. 1976			
	(In Millions)			
	Coal	Oil	Nuclear	Total
Cost of Fuel Consumed	$ 5.1	$ 4.1	$ 2.4	$11.6
Generation Level and Fuel Mix	(2.8)	1.0	(5.9)	(7.7)
Overall Increase (Decrease)	$ 2.3	$ 5.1	$(3.5)	$ 3.9

	1978 vs. 1977			
	(In Millions)			
	Coal	Oil	Nuclear	Total
Cost of Fuel Consumed	$23.7	$ 4.4	$ 3.3	$31.4
Generation Level and Fuel Mix	(2.2)	5.7	16.3	19.8
Overall Increase	$21.5	$10.1	$19.6	$51.2

The cost of fossil fuel consumed increased significantly in 1977 and 1978. The increase in 1977 was affected by there having been a refund of approximately $4,000,000 to the Company in settlement of litigation with a supplier of fuel oil. (Such amount was recorded as a reduction to fuel for electric generation for 1976 and is reflected in the increase shown above in the cost of oil in 1977 from 1976.) A decrease in the quantity of nuclear fuel consumed in 1977 was related to the planned outage of Unit No. 1 of the Nuclear Plant for refueling. The increase in 1978 also reflected the placing of Unit No. 2 of the Nuclear Plant in commercial operation during July. The utilization of the relatively more expensive fuel oil (to conserve coal supplies) to generate electricity during the coal miners' strike which ended in March 1978 contributed to the increase in 1978 over 1977.

The purchased and interchange power increase of $18,121,000 (14%) in 1977 and decrease of $28,525,000 (20%) in 1978 primarily reflect the utilization of the Nuclear Plant as described above.

Other operation expense increased by $15,295,000 (34%) in 1978 over 1977 mainly due to higher costs of labor, materials, supplies, and services, and was also affected by test generation prior to, and increased generation due to, placing of Unit No. 2 of the Nuclear Plant into commercial operation.

The increase in maintenance expense in 1977 over 1976 of $8,312,000 (41%) was associated with cer-

MANAGEMENT'S COMMENTS ON CONSOLIDATED SUMMARY OF OPERATIONS (Concluded)

tain increased maintenance activity in 1977 which had previously been deferred and with higher labor cost and increased costs of materials, supplies, and services as regards power production maintenance. Maintenance expense increased by $4,272,000 (15%) in 1978 over 1977 largely because of increasing cost levels and increased power plant, transmission and distribution maintenance activities.

The increase in depreciation expense in 1978 over 1977 of $11,020,000 (23%) was chiefly due to the placing of Unit No. 2 of the Nuclear Plant and certain environmental protection facilities at the Company's Tanners Creek Plant in commercial operation.

Taxes, other than income taxes increased by $4,488,000 (24%) in 1977. This was due to increases in utility plant in service and the completion in 1976 of the amortization (approximating $3,000,000 for that year) of certain deferred credits associated with property taxes which had been deferred pursuant to regulatory authorization. The increase in taxes, other than income taxes in 1978 over 1977 of $3,024,000 (13%) was largely attributable to increased Indiana Property Tax resulting from greater assessed valuation of property, increased Indiana Gross Income Tax attributable to increased applicable revenues, and to Michigan Single Business Tax pertaining to the Generating Subsidiary.

Information concerning Federal income taxes (including a reconciliation of actual Federal income taxes to such taxes computed at statutory rates) is shown in Note 3 of Notes to Consolidated Financial statements.

Allowance for Funds Used During Construction

The allowance for funds used during construction (AFUDC), including the portion shown as a credit to interest charges, increased by $17,666,000 (61%) in 1977. This increase was related to an increased amount invested in construction (including Unit No. 2 of the Nuclear Plant and precipitator installation projects at two of the Company's plants) and to the effect of the Generating Subsidiary's compounding AFUDC beginning in 1977.

Interest Charges

In 1978, total interest charges increased by $15,876,000 (20%) over 1977; this was related to additional long-term debt outstanding.

Auditors' Opinion

To the Shareowners and the Board of Directors of
Indiana & Michigan Electric Company

We have examined the balance sheets of Indiana & Michigan Electric Company and its generating subsidiary, Indiana & Michigan Power Company, consolidated, as of December 31, 1978 and 1977 and the related statements of consolidated income, retained earnings and sources of funds for plant and property additions for the respective years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in paragraphs three and five of Note 2 of Notes to Consolidated Financial Statements, the Company is collecting certain wholesale revenues subject to possible refund and has been incurring charges for interchange power subject to refund by its affiliated interchange power suppliers. An initial decision in the interchange power proceeding in February 1978, could, if sustained, result in substantial refunds to the Company. In addition, the Company is involved in antitrust matters discussed in paragraphs three and five of Note 10 of Notes to Consolidated Financial Statements.

In our opinion, subject to the effect on the financial statements identified above of such adjustments, if any, as might have been required had the outcome of the rate and antitrust matters referred to in the preceding paragraph been known, such financial statements present fairly the financial position of the above companies, consolidated, as of December 31, 1978 and 1977 and the results of their operations and their sources of funds for plant and property additions for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Deloitte Haskins & Sells

New York, New York
February 19, 1979 (March 2, 1979
as to paragraph five of Note 10 of Notes
to Consolidated Financial Statements)

Consolidated Statement of Income

	Year Ended December 31, 1978	1977
	(In Thousands)	
OPERATING REVENUES—ELECTRIC (Notes 1 and 2)	$603,480	$512,824
OPERATING EXPENSES:		
Operation:		
Fuel for Electric Generation	125,277	74,052
Purchased and Interchange Power (Net) (Notes 2 and 9)	116,308	144,833
Other	60,001	44,706
Maintenance (Note 1)	32,724	28,452
Depreciation (Note 1)	59,844	48,824
Taxes, Other Than Income Taxes (Note 9)	26,432	23,408
State Income Taxes	(378)	704
Federal Income Taxes (Notes 1 and 3)	23,438	17,445
Total Operating Expenses	443,646	382,424
OPERATING INCOME	159,834	130,400
OTHER INCOME AND DEDUCTIONS (Notes 1 and 3):		
Allowance for Other Funds Used During Construction	27,974	26,889
Miscellaneous Nonoperating Income Less Deductions	1,040	952
Total Other Income and Deductions	29,014	27,841
INCOME BEFORE INTEREST CHARGES	188,848	158,241
INTEREST CHARGES:		
Interest on Long-term Debt	89,397	73,188
Interest on Short-term Debt	5,964	6,697
Miscellaneous Interest Charges (Note 1)	1,287	887
Total Interest Charges	96,648	80,772
Allowance for Borrowed Funds Used During Construction (Credit) (Note 1)	(22,627)	(19,651)
Net Interest Charges	74,021	61,121
CONSOLIDATED NET INCOME	$114,827	$ 97,120

See Notes to Consolidated Financial Statements.

Consolidated Balance Sheet

	December 31, 1978	December 31, 1977
	(In Thousands)	
ASSETS AND OTHER DEBITS		
ELECTRIC UTILITY PLANT (Note 1):		
Production	$1,345,070	$ 864,902
Transmission	421,644	401,562
Distribution	257,186	244,103
General and Miscellaneous (includes Nuclear Fuel)	68,209	40,965
Construction Work in Progress	305,136	555,500
Total Electric Utility Plant	2,397,245	2,107,032
Less Accumulated Provision for Depreciation	410,520	358,826
Electric Utility Plant, Less Provision	1,986,725	1,748,206
OTHER PROPERTY AND INVESTMENTS (Notes 1 and 4)	170,299	137,421
CURRENT ASSETS:		
Cash (Note 8)	21,264	54,735
Special Deposits and Working Funds	6,750	24,065
Temporary Cash Investments (at cost, which approximates market)	—	8,494
Accounts Receivable:		
Customers	46,277	38,052
Associated Companies	7,511	9,382
Miscellaneous	4,498	4,968
Accumulated Provision for Uncollectible Accounts	(299)	(221)
Materials and Supplies (at average cost or less):		
Construction and Operation Materials and Supplies	12,783	11,468
Fuel	16,112	17,320
Accrued Utility Revenues	13,811	18,149
Prepayments and Other Current Assets	3,467	4,322
Total Current Assets	132,174	190,734
DEFERRED DEBITS:		
Unamortized Debt Expense (Note 1)	3,143	2,172
Property Taxes	1,422	1,450
Deferred Collection of Fuel Costs (Note 2)	1,584	1,655
Other Work in Progress	9,010	4,780
Other Deferred Debits	45,606	36,521
Total Deferred Debits	60,765	46,578
Total	$2,349,963	$2,122,939

See Notes to Consolidated Financial Statements.

LIABILITIES AND OTHER CREDITS

	December 31, 1978	December 31, 1977
	(In Thousands)	
CAPITALIZATION:		
Common Stock—No Par Value (Note 5):		
Authorized—2,500,000 Shares		
Outstanding—1,400,000 Shares	$ 56,584	$ 56,584
Premium on Capital Stock (Note 5)	381	381
Other Paid-in Capital (Note 5)	470,228	410,228
Retained Earnings (Note 6)	136,829	104,566
Total Common Shareowner's Equity	664,022	571,759
Cumulative Preferred Stock (Note 7)	227,000	187,000
Long-term Debt (less portion due within one year) (Note 8)	1,043,090	977,062
Total Capitalization (less long-term debt due within one year)	1,934,112	1,735,821
CURRENT LIABILITIES:		
Long-term Debt Due Within One Year (Note 8)	7,536	61,421
Short-term Debt (Note 8):		
Notes Payable to Banks	69,490	49,650
Commercial Paper	55,450	52,200
Accounts Payable:		
General	50,460	19,650
Associated Companies	15,305	16,306
Dividends Declared:		
Common Stock	14,252	11,360
Cumulative Preferred Stock	4,754	3,854
Customer Deposits	1,909	1,739
Taxes Accrued	20,005	18,804
Interest Accrued	18,338	19,041
Other Current Liabilities	16,439	16,653
Total Current Liabilities	273,938	270,678
COMMITMENTS AND CONTINGENCIES (Note 10)		
DEFERRED CREDITS AND OPERATING RESERVES:		
Deferred Income Taxes (Note 1)	120,921	102,143
Deferred Investment Tax Credits (Notes 1 and 3)	8,503	10,785
Other Deferred Credits and Operating Reserves	12,489	3,512
Total Deferred Credits and Operating Reserves	141,913	116,440
Total	$2,349,963	$2,122,939

Consolidated Statement of Sources of Funds for Plant and Property Additions

	Year Ended December 31, 1978	1977
	(In Thousands)	
Funds from Operations:		
Consolidated Net Income	$114,827	$ 97,120
Principal Non-fund Charges (Credits) to Income:		
Depreciation	59,853	48,837
Provision for Deferred Income Taxes (Net)	18,779	13,535
Deferred Investment Tax Credits (Net)	3,423	5,038
Allowance for Other Funds Used During Construction	(27,974)	(26,889)
Other (Net)	506	72
Total Funds from Operations	169,414	137,713
Funds from Financings:		
Issuances and Contributions:		
Long-term Debt	369,839	135,391
Cumulative Preferred Stock	38,486	38,120
Capital Contributions from Parent Company	60,000	58,000
Short-term Debt (Net)	23,090	—
Total	491,415	231,511
Less—Retirements:		
Long-term Debt	357,877	10,873
Short-term Debt (Net)	—	46,163
Net Funds from Financings	133,538	174,475
Dividends on Common Stock	(62,692)	(52,920)
Dividends on Cumulative Preferred Stock	(18,357)	(14,041)
Sales of Property	42,416	97,311
Other Changes (Net)	(13,675)	(4,523)
Decrease (Increase) in Working Capital (Excluding Short-term Debt and Long-term Debt Due Within One Year) (a)	92,615	(61,061)
Total	$343,259	$276,954
Plant and Property Additions:		
Gross Additions to Utility Plant	$340,209	$272,433
Gross Other Additions	31,024	31,410
Total Gross Additions	371,233	303,843
Allowance for Other Funds Used During Construction	(27,974)	(26,889)
Total	$343,259	$276,954
(a) Represented by decrease (increase) as follows:		
Cash and Cash Items	$ 59,280	$(30,020)
Accounts Receivable	(5,806)	(3,534)
Materials and Supplies	(107)	(5,851)
Accounts Payable	29,809	(11,096)
Taxes Accrued	1,201	(1,087)
Other (Net)	8,238	(9,473)
	$ 92,615	$(61,061)

See Notes to Consolidated Financial Statements.

Consolidated Statement of Retained Earnings

	December 31, 1978	December 31, 1977
	(In Thousands)	
Balance at Beginning of Year	$104,566	$ 76,286
Consolidated Net Income	114,827	97,120
Total	219,393	173,406
Deductions:		
Cash Dividends Declared:		
Common Stock	62,692	52,920
Cumulative Preferred Stock:		
4⅛ % Series	495	495
4.56% Series	273	273
4.12% Series	165	165
7.08% Series	2,124	2,124
7.76% Series	2,716	2,716
8.68% Series	2,604	2,604
12 % Series	3,600	3,600
$2.15 Series	3,440	2,064
$2.25 Series	2,940	—
Total Cash Dividends Declared	81,049	66,961
Capital Stock Expense	1,515	1,879
Total Deductions	82,564	68,840
Balance at End of Year (Note 6)	$136,829	$104,566

See Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

1. Significant Accounting Policies:

The common stock of the Company is wholly owned by American Electric Power Company, Inc. (AEP). The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary Indiana & Michigan Power Company (the Generating Subsidiary). The Generating Subsidiary was formed to own, complete construction of and operate the Donald C. Cook Nuclear Plant, the first unit of which has been in commercial operation since 1975 and the second unit of which was placed in commercial operation during July 1978. Significant intercompany items have been eliminated in consolidation. A minor inactive subsidiary has not been consolidated.

The accounting and rates of the Company and the Generating Subsidiary are subject in certain respects to the requirements of state regulatory bodies and in certain respects to the requirements of the Federal Energy Regulatory Commission (FERC). The consolidated financial statements have been prepared, with full reservation of legal rights, on the basis of the accounts which are maintained for FERC purposes.

Utility Plant, Other Property and Investments and Depreciation

Electric utility plant is stated at original cost. Generally, the plant of the Company and the Generating Subsidiary is subject to first mortgage liens.

The companies capitalize, as a construction cost, an allowance for funds used during construction, an item not representing cash income, which is defined in the applicable regulatory systems of accounts as the net cost of borrowed funds used for construction purposes and a reasonable rate on other funds when so used. The respective composite rates used by the Company and the Generating Subsidiary were increased to 10.5% and 10.2%, respectively, during 1978 (effective January 1) from 8.5% used by both companies in 1977, (applied by the Company on an annual basis and by the Generating Subsidiary on a semiannual compound basis).

The companies provide for depreciation on a straight-line basis over the estimated useful lives of the property. The current provisions are determined largely with the use of functional composite rates as follows:

Functional Class of Property	Composite Annual Rate
Production:	
Steam—Nuclear	4.0%
Steam—Fossil-fired	3.1%
Transmission	2.9%
Distribution	3.3%
General	3.5%

Income is charged with the costs of labor, materials, supervision, and other costs incurred in maintaining the properties. Property accounts are charged with costs of betterments and major replacements of property, and the accumulated provisions for depreciation are charged with retirements, together with removal costs less salvage.

Nonutility property, other property investments, and other investments are generally stated at cost.

Income Taxes

Deferred Federal income taxes, reduced where applicable by investment tax credits, are provided by the Company and the Generating Subsidiary generally to the extent that such amounts are allowed for rate-making purposes. On October 1, 1978, the Company and its Generating Subsidiary expanded deferred tax accounting to additional timing differences pursuant to an order of the Public Service Commission of Indiana.

The Company and the Generating Subsidiary practice deferral accounting for the effect of tax reductions resulting from the application of investment tax credits to provisions for current and certain deferred Federal income taxes. The deferred investment tax credit applicable to current Federal income taxes payable is amortized over 30 years.

Pension Plan

The Company and the Generating Subsidiary participate with other companies in the AEP System in a trusteed plan to provide pensions for all employees, subject to certain eligibility requirements. The plan was previously contributory on the part of employees, but as of January 1, 1978, required employee contributions were eliminated as to substantially all employees. The pension plan conforms to the Employee Retirement Income Security Act of 1974 (ERISA).

Pension costs for the years ended December 31, 1978 and 1977 were approximately $2,624,000 and $2,170,000, respectively, representing the cost of currently accruing benefits. There were no unfunded prior service costs as of December 31, 1978. Effective January 1, 1979, benefits of the plan were modified. The change resulted in unfunded prior service costs of approximately $1,970,000, which will be amortized over 30 years. The plan may be modified or terminated at any time, subject to limitations of labor agreements.

Employees Savings Plan

The Company and the Generating Subsidiary participate with other AEP System companies in a trusteed savings plan which became effective January 1, 1978 and is available to employees who have met eligibility requirements. The savings plan conforms to the applicable provisions of ERISA. Each employer contributes

to the plan an amount equal to 50% of its employee-participants' contributions up to 6% of their regular compensation. Benefits to participating employees are based solely upon amounts contributed to the participants' accounts. By its nature the plan is fully funded at all times. The cost of the plan for the year ended December 31, 1978 totaled $607,000.

Other

The Company accrues unbilled revenues for services rendered subsequent to the last billing cycle through month-end.

Miscellaneous nonoperating income for the years ended December 31, 1978 and 1977 includes gains amounting to $261,000 and $306,000, respectively, on certain long-term debt reacquired.

Debt discount or premium and debt expense are being amortized over the lives of the related debt issues and the amortization thereof is included within miscellaneous interest charges.

2. Operating Revenues and Operating Expenses:

The Company has collected retail revenues under final orders of the Public Service Commission of Indiana which became effective in February 1977 and September 1978. The 1977 order has been appealed to a court of appeals and certain parties have initiated proceedings looking toward an appeal from the 1978 order.

In September 1978, FERC ordered that the Company refund approximately $3,000,000 to a municipal customer. The Company recorded the refund in the third quarter of 1978. The effect of such refund on prior periods was not material.

Revenues collected by the Company from wholesale rate increases placed into effect subject to possible refund (exclusive of the amount refunded as described above) are estimated as follows:

	(In Thousands)
1978	$20,777
1977	16,439
Prior to 1977	5,224
Total	$42,440

See Note 10 for information with respect to an antitrust decision enjoining the Company from charging certain wholesale rates.

Commencing in June 1975, operating expenses include the effect of changes in rates charged for interchange power transactions between the Company and other companies in the AEP System. The effect of such changes was to increase the charges to the Company, subject to possible refund by its interchange power suppliers, by the following estimated amounts:

	(In Thousands)
1978	$ 24,981
1977	27,968
Prior to 1977	50,368
Total	$103,317

On February 23, 1978, an administrative law judge of FERC issued an initial decision ordering one of the affiliated interchange power suppliers to make certain refunds, after recomputing interchange charges for the period subsequent to June 1975 on the basis of the interconnection agreement in effect prior to that date, but excluding from such calculations as member capacity, in the case of the Company, the capacity owned by the Generating Subsidiary and, in the case of another member of the System, the capacity owned by its generating subsidiary. If the change is finally ordered by FERC, the Company could become entitled to refunds in a substantial amount. Certain intervenors have urged that changes be made in the interconnection agreement, which would have the opposite effect, increasing the amounts payable by the Company. The AEP System subsidiaries, including the Company, have filed a brief which urges that the action of the administrative law judge be revised so as to sustain the original amounts charged, but cannot predict the final outcome of the proceeding or the effect thereof on the Company.

Operating revenues derived from domestic governmental entities represent approximately 8% and 10% of total operating revenues for 1978 and 1977, respectively. Operating revenues derived from a certain wholesale customer represent approximately 12% and 7% of total operating revenues for 1978 and 1977, respectively.

In 1978 the Company received approval of the Public Service Commission of Indiana to collect, over a five-year period ending in 1983, substantially all of its deferred fuel costs.

3. Federal Income Taxes:

The details of Federal income taxes are as follows:

	Year Ended December 31, 1978	Year Ended December 31, 1977
	(In Thousands)	
Charged (Credited) to Operating Expenses:		
Current Federal Income Taxes (Net)	$1,357	$(1,128)
Deferred Federal Income Taxes (Net)	18,658	13,535
Deferred Investment Tax Credits (Net)	3,423	5,038
Total	23,438	17,445
Charged to Other Income and Deductions	936(a)	537
Total Federal Income Taxes	$24,374	$17,982

(a) Includes deferred income taxes of $121,000.

The consolidated effective Federal income tax rates were less than the statutory rates for the years 1978 and 1977. The following is a reconciliation of the differences between the amount of Federal income tax expense reported in the Consolidated Statement of Income and the amount of Federal income taxes computed by multiplying consolidated net income before Federal income taxes by the statutory tax rate.

	Year Ended December 31, 1978	Year Ended December 31, 1977
	(In Thousands)	
Consolidated Net Income	$114,827	$ 97,120
Federal Income Taxes	24,374	17,982
Pre-Tax Book Income	$139,201	$115,102
Federal Income Tax on Pre-Tax Book Income at Statutory Rate of 48%	$ 66,816	$ 55,249
Increase (Decrease) in Federal Income Taxes Resulting from:		
Excess of Tax over Book Depreciation	(19,691)	(16,080)
Allowance for Funds Used During Construction and Items Capitalized on the Books but Deducted for Tax Purposes	(25,853)	(24,005)
Mine Development and Exploration Expense	(4,680)	(1,962)
Provision for Revenue Refunds	(888)	(2,912)
Amortization of Pollution Control Facilities	(4,080)	(1,609)
Miscellaneous Items	109	(5,633)
Federal Income Tax on Current-Year Taxable Income (Separate-Return Basis)	11,733	3,048
Reduction Due to System Consolidation	(11,733)	(3,048)
Minimum Tax on Preference Items	650	18
Currently Payable	650	18
Adjustments of Prior-Year Accruals (Net)	(276)	(774)
Adjustments for Tax Losses (a):		
Federal Income Taxes	7,503	68
Investment Tax Credit	(5,705)	97
Current Federal Income Taxes (Net)	2,172	(591)
Deferred Federal Income Taxes (Net of Amortization) Resulting from the Following Timing Differences:		
Depreciation (Liberalized and Asset Depreciation Range)	17,439	13,931
Unbilled Revenue	(1,221)	3,315
Accelerated Amortization of Emergency Facilities (Amortization of Prior-Year Provisions)	(1,848)	(1,882)
Provision for Revenue Refunds	—	2,213
Other	2,188	1,154
Investment Tax Credit Applicable to Deferred Federal Income Taxes on Certain Timing Differences	2,221	(5,196)
Deferred Federal Income Taxes (Net)	18,779	13,535
Deferred Investment Tax Credits (Net)	3,423(c)	5,038
Total Federal Income Taxes	$ 24,374	$ 17,982

(a) The AEP System allocates Federal income taxes currently payable in accordance with SEC regulations, which require that the benefit of tax losses be allocated to the AEP System companies with taxable income. The benefits of these tax losses, without affecting taxes payable, are reallocated to the AEP System companies giving rise to such losses, as it is expected that these losses would be usable in subsequent years to reduce taxes payable of the loss companies.

(b) In accordance with an order of the SEC under the Public Utility Holding Company Act of 1935, a tax loss of the Generating Subsidiary is to be first applied to reduce the taxable income of the Company and any unused amount is to be allocated among the other System companies included in the consolidated Federal income tax return, but with the provision that any losses so allocated to other System companies shall be reallocated to the Company if usable by it in subsequent years. The effect of tax losses allocated to other companies would be included in the reallocation referred to in (a) above.

(c) The System consolidated Federal income tax return for 1977, filed in 1978, showed a taxable income which was less than that estimated for the year-end accrual. The decrease was principally attributable to additional percentage repair allowance deductions of the Company and affiliated companies and mine development expense deductions of the Company claimed over the estimated amounts utilized in preparing the 1977 year-end accrual. These differences had no significant effect on the amount of income taxes payable for 1977 because of the effect of investment tax credits; however, total System Federal income taxes for 1977 would have been reduced due to the related reversal of deferred investment tax credits. The increase in income ($3,194,000) resulting from these differences in estimates was recorded by the Company in the third quarter of 1978.

The Company joins in the filing of a consolidated Federal income tax return with its affiliated companies in the AEP System. Unused System investment tax credits at December 31, 1978 aggregated approximately $201,000,000, of which approximately $21,300,000 may be carried forward through 1981, $52,800,000 through 1982, $20,500,000 through 1983, $27,400,000 through 1984, and $79,000,000 through 1985. Of these amounts, approximately $26,000,000 had been applied as a reduction of deferred income taxes prior to December 31, 1978 and will not be reflected in net income when realized in future years except as affected by changes in deferred income taxes.

The System consolidated Federal income tax returns for the years prior to 1965 have been settled. The returns for the years 1965 through 1969 together with certain unrecorded refund claims relating to the years 1965, 1966 and 1967 are currently being settled on the basis of a net refund for the period, the amount of which the System companies deem immaterial. The returns for the years 1970 through 1973 have been reviewed by the Internal Revenue Service and additional taxes for those years have been proposed, some of which the System companies have protested. In the opinion of the System companies, adequate provision has been made for such additional taxes.

4. Other Property and Investments:

The following is an analysis of other property and investments:

	Year Ended December 31,	
	1978	1977
	(In Thousands)	
Nonutility Property and Other Property Investments:		
Western Coal Lands Acquired as Source of Low-Sulfur Fuel	$149,713	$120,799
Other Coal Properties and Fuel-Handling Facilities	4,946	3,692
Miscellaneous (Net)	15,495	12,674
Subtotal	170,154	137,165
Ohio Valley Electric Corporation Subordinated Notes	—	56
Other Investments	145	200
Total Other Property and Investments	$170,299	$137,421

5. Common Stock, Premium on Capital Stock, and Other Paid-in Capital:

There were no common stock transactions and no transactions affecting premium on capital stock during the years 1978 and 1977. The Company received from its parent cash capital contributions of $60,000,000 in 1978 and $58,000,000 in 1977; such contributions were credited to other paid-in capital.

6. Retained Earnings:

Various restrictions on the use of retained earnings for cash dividends on common stock and other purposes are contained in or result from covenants in mortgage indentures, debenture and bank loan agreements, charter provisions, and orders of regulatory authorities. Approximately $48,500,000 at December 31, 1978 was so restricted.

7. Cumulative Preferred Stock

The following is an analysis of cumulative preferred stock:

Series	Current Call Price(a)	Redemption Restricted Prior to	Par Value	Shares Outstanding	Amount December 31, 1978	Amount December 31, 1977
					(In Thousands)	
4⅛%	$106.125		$100	120,000	$ 12,000	$ 12,000
4.56%	102.000		100	60,000	6,000	6,000
4.12%	102.728		100	40,000	4,000	4,000
7.08%	106.450		100	300,000	30,000	30,000
7.76%	107.320		100	350,000	35,000	35,000
8.68%	107.440		100	300,000	30,000	30,000
12 %	112.000(b)	9/1/80	100	300,000	30,000	30,000
$2.15	27.150	5/1/82	25	1,600,000	40,000	40,000
$2.25	27.250	3/1/83	25	1,600,000	40,000	—
Total Cumulative Preferred Stock					$227,000	$187,000

(a) Callable at the option of the Company, at the price indicated plus accrued dividends. The involuntary liquidation preference is par value.

(b) A sinking fund for the 12% series requires the Company to provide, on or before October 1 of each year, beginning in 1980, for the purchase, or redemption at $100 a share, of 15,000 shares of such series. The Company has the right, on each sinking fund date, to redeem an additional 15,000 shares. Unless all sinking fund provisions have been met, no distribution may be made on the common stock.

In 1976 shareowners authorized the issuance of up to 4,000,000 shares of $25 par value cumulative preferred stock (which ranks equally with the $100 par value cumulative preferred stock) and in 1978 increased the authorization to 7,200,000 shares. In 1977 the Company issued and sold 1,600,000 shares of the $2.15 series and in 1978 the Company issued and sold 1,600,000 shares of the $2.25 series.

At December 31, 1978, authorized shares of cumulative preferred stock were as follows:

Par Value	Shares Authorized
$100	2,250,000
25	7,200,000

8. Long-term Debt, Short-term Debt, Lines of Credit, and Compensating Balances:

Long-term debt by major category was outstanding as follows (less portion due within one year):

	December 31, 1978	December 31, 1977
	(In Thousands)	
First Mortgage Bonds	$ 832,286	$482,826
Sinking Fund Debentures	24,083	25,260
Notes Payable to Banks, due 1980	82,000	360,000
Installment Purchase Contracts	99,841	99,750
Other Long-term Debt	4,880	9,226
Total (less portion due within one year)	$1,043,090	$977,062

First mortgage bonds outstanding were as follows:

Series	Due	December 31, 1978	December 31, 1977
		(In Thousands)	
6½%	1978(a)	$ —	$ 30,000
3 %	1978(b)	—	24,173
2¾%	1980	18,015	18,015
3¼%	1982	16,046	16,046
10¼%	1982	70,000	70,000
3⅝%	1983	13,762	13,762
11 %	1983	60,000	60,000
3⅛%	1984	15,082	15,082
10⅞%	1984(c)(d)(e)	66,000	70,500
10 %	1985(e)	13,500	14,250
3⅞%	1988	22,974	22,974
4¾%	1988	17,557	17,557
4⅜%	1993	42,902	42,902
7 %	1998	$ 35,000	$ 35,000
8⅞%	2000	50,000	50,000
8⅜%	2003	40,000	40,000
9½%	2003(e)	255,000	—
9½%	2008	100,000	—
Unamortized Debt Discount—Net		(552)	(262)
		835,286	539,999
Less Portion due Within One Year		3,000	57,173
Total		$832,286	$482,826

(a) Retired February 1, 1978.
(b) Retired September 1, 1978.
(c) Guaranteed by American Electric Power Company, Inc.
(d) These bonds are obligations of the Generating Subsidiary. The unamortized discount amounted to $189,000 and $221,000 at December 31, 1978 and 1977, respectively.
(e) Sinking fund payments are required as follows:
10% series due 1985—$750,000 annually on March 1.
10⅞% series due 1984—$2,250,000 annually on December 1, through 1983, with the noncumulative election to redeem an additional $2,250,000 in each year.
9½% series due 2003—$11,500,000 annually on June 1, 1980 through 1991 and $13,500,000 annually on June 1, 1992 through 2002 with the noncumulative option to redeem an additional amount in each of the specified years from a minimum of $100,000 to a maximum equal to the scheduled requirement for each year, but with a maximum optional redemption, as to all years in the aggregate, of $75,000,000.

In January 1979, the Company issued $80,000,000 of 10¼% first mortgage bonds due in 1987. The

Generating Subsidiary has a delayed-delivery contract to sell an additional $45,000,000 of its first mortgage bonds, 9½% Series due 2003, on March 1, 1979.

The indentures relating to the first mortgage bonds contain improvement, maintenance and replacement provisions requiring the deposit of cash or bonds with the trustee, or in lieu thereof, certification of unfunded property additions. The Company has elected to use unfunded property additions to meet these provisions in the past.

Sinking fund debentures of the Company outstanding were as follows:

	December 31, 1978	December 31, 1977
	(In Thousands)	
5⅛% Due 1986	$12,076	$12,491
7¼% Due 1998	11,941	12,694
Unamortized Debt Premium	66	75
Total	$24,083	$25,260

Installment purchase contracts of the Company were as follows:

	December 31, 1978	December 31, 1977
	(In Thousands)	
City of Lawrenceburg, Indiana:		
8½% Series due 2006	$25,000	$25,000
7% Series due 2006	40,000	40,000
6⅞% Series due 2006	12,000	12,000
City of Sullivan, Indiana:		
6⅞% Series due 2006	25,000	25,000
Unamortized Debt Discount	(2,159)	(2,250)
Total	$99,841	$99,750

Under the terms of certain installment purchase contracts, the Company is required to pay purchase price installments in amounts sufficient to enable the cities to pay interest on and the principal (at stated maturities and upon mandatory redemption) of related pollution control revenue bonds issued to finance the construction of pollution control facilities at the Company's Tanners Creek and Breed Plants.

Other long-term debt of the Company outstanding consisted of:

	December 31, 1978	December 31, 1977
	(In Thousands)	
Coal reserve obligations—payable in equal annual installments through 1980 with interest at 8%	$ 8,252	$12,377
Notes payable—due 1978 through 1985, 6%-7%	902	934
Other	262	162
	9,416	13,473
Less portion due within one year	4,536	4,247
Total	$ 4,880	$ 9,226

Consolidated long-term debt outstanding at December 31, 1978 is due as follows:

	Principal Amount (In Thousands)
1979	$ 7,536
1980	118,859
1981	15,032
1982	101,304
1983	89,035
Later Years	721,505
Total	$1,053,271

At December 31, 1978 and 1977, the principal amounts of debentures reacquired in anticipation of sinking fund requirements were $2,183,000 and $1,815,000, respectively. The companies may make additional debenture or first mortgage bond sinking fund payments of up to $3,050,000 annually ($2,250,000 relating to Generating Subsidiary).

The interest rate on the long-term notes payable to banks (an average of 12.2% at December 31, 1978 and 8.4% at December 31, 1977) depends on the prime commercial rate plus a fractional percentage. The Generating Subsidiary has informal arrangements with the banks to maintain average compensating bank balances equal to approximately 15% of certain of the notes outstanding on an average basis or such smaller amount as the banks consider appropriate in view of other banking relationships or, in lieu thereof, to pay a fee on any draw-down of the compensating balances based on the approximate effective interest cost of the related notes, assuming the full compensating balances had been maintained. At December 31, 1978 and 1977, the compensating balances under the arrangements were approximately $9,800,000 and $34,100,000, respectively. The effective interest rate, representing the actual interest rates on the notes outstanding adjusted for the effect of the compensating balance requirements, averaged 13.9% at December 31, 1978 and was approximately 9.6% at December 31, 1977.

Short-term debt and interest rates thereon were as follows:

	1978	1977
	(Dollars in Thousands)	
Weighted average interest rates for debt outstanding at end of year:		
Notes Payable to Banks	10.9%	7.8%
Commercial Paper	11.2%	7.4%
Maximum amount of debt outstanding at any month-end during the year:		
Notes Payable to Banks	$69,490	$87,400
Commercial Paper	$55,450	$76,042

	1978	1977
	(Dollars in Thousands)	
Weighted average interest rate of debt outstanding during the year (a):		
Notes Payable to Banks	9.4%	6.6%
Commercial Paper	9.1%	6.6%
Average amount of debt outstanding during the year:		
Notes Payable to Banks	$31,862	$39,457
Commercial Paper	$36,211	$58,716

(a) Average interest rates are determined by dividing interest expensed for the year by average month-end debt.

The Company had unused short-term bank lines of credit of approximately $144,000,000 and $208,000,000 at December 31, 1978 and 1977, respectively, under which notes could be issued with no maturity more than 270 days after date of issue. The available lines of credit are subject to withdrawal at the banks' option, and $135,000,000 and $200,000,000, respectively, of such lines are shared with other AEP System companies. In accordance with informal agreements with the banks, compensating balances of up to 10% or, in certain instances, equivalent fees are required to maintain the lines of credit, and, on any amounts actually borrowed, generally either additional compensating balances of up to 10% are maintained or adjustments in interest rates are made. Substantially all bank balances are maintained by the Company to compensate the banks for services and for both used and available lines of credit.

9. Supplemental Income Statement Information and Related-Party Transactions:

Electric operating revenues shown in the Consolidated Statement of Income include sales of energy to AEP System companies of approximately $17,500,000 and $14,500,000 for the years ended December 31, 1978 and 1977, respectively.

Operating expenses shown in the Consolidated Statement of Income include certain items not shown separately, as follows:

	Year Ended December 31, 1978	Year Ended December 31, 1977
	(In Thousands)	
Purchased Power (a)	$ 6,241	$ 2,965
Interchange Power (Net):		
AEP System Electric Utilities	80,043	140,957
Other Companies (b)	30,024	911
	$116,308	$144,833

	Year Ended December 31, 1978	Year Ended December 31, 1977
	(In Thousands)	
Taxes, Other Than Income Taxes:		
Real and Personal Property Taxes	$ 14,617	$ 13,609
State Gross Sales, Excise and Franchise Taxes, and Miscellaneous State and Local Taxes	9,842	8,078
Social Security Taxes—Federal and State	1,973	1,721
	$ 26,432	$ 23,408

(a) Includes power purchased from OVEC of approximately $1,558,000 in 1978 and $476,000 in 1977.

(b) Includes interchange power sold to OVEC of approximately $908,000 in 1978 and $956,000 in 1977.

Charges to income for royalties and advertising are less than 1% of gross revenues in each case.

Sales and purchases of energy and interchange power transactions are regulated by the various commissions having jurisdiction.

American Electric Power Service Corporation provides certain services to the Company and the affiliated companies in the AEP System. The costs of the services are determined by the service company on a direct-charge basis to the extent practicable and on reasonable bases of proration for indirect costs. The charges for services are made on a cost basis but include no compensation for the use of equity capital, all of which is furnished to the service company by AEP. The service company is subject to the regulation of the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935.

10. Commitments and Contingencies:

The construction budget of the Company and the Generating Subsidiary for the year 1979 is estimated at $241,000,000 and, in connection therewith, commitments have been made.

The Company participates with its parent, two associated utility companies, several unaffiliated utility companies, and Ohio Valley Electric Corporation (OVEC) in supplying the U.S. Department of Energy (DOE) with the power requirements of its plant near Portsmouth, Ohio. The proceeds from the sales of power by OVEC are designed to be sufficient for OVEC to meet its operating expenses and fixed costs, including amortization of long-term debt capital (balance approximately $43,300,000 as of December 31, 1978), over a period ending in 1982, and to provide for an annual return on its equity capital. The Company, as a participant, is entitled to receive from OVEC, and is obligated to pay for, 7.6% of the power not required by DOE. The power agreement terminates

in 1979 but DOE has notified OVEC of its desire to negotiate an extension to 1992.

In 1978, three court proceedings brought in recent years by certain municipalities in Indiana and Michigan, all wholesale customers of the Company, were combined into a single consolidated case in a U.S. District Court and a fourth action was commenced in the same court. A trial of the consolidated case was held and in January 1979 the court ruled for the plaintiffs that the Company, its parent, and American Electric Power Service Corporation have violated the antitrust laws, awarded the municipalities damages of approximately $12,100,000 when trebled, placed limitations on the Company's putting into effect or charging wholesale rates to the plaintiffs and enjoined the Company from certain practices. The financial statements at December 31, 1978 do not include any provision for such damages. The companies are appealing the decision and provisions of the judgment awarding monetary damages have been stayed.

In another proceeding, the Company is awaiting decision on its appeal to FERC, filed in 1977, with respect to a ruling by an administrative law judge on a complaint made to the commission by the same group of municipalities. That complaint, alleging that the municipal electric systems had been threatened with termination of wholesale electric service, had earlier been upheld by the FERC judge.

In March 1979, two other municipal customers brought a separate action against the Company, its parent and the Service Corporation alleging violations of the antitrust laws and seeking damages of at least $7,000,000 before trebling and other remedies. Certain issues in the complaint are similar to those tried in the consolidated case discussed in the second preceding paragraph.

As previously reported, the Securities and Exchange Commission (SEC) had commenced an investigation, through its staff, into certain aspects of the AEP System's operations, including its promotion of all-electric housing during the 1960's and the acquisition and operation of certain coal and transportation properties. The SEC staff had maintained that commission authorization should have been obtained for some of the transactions. The AEP System companies disagreed but did agree to a negotiated settlement in order to avoid long litigation with the SEC. As a result, the AEP System companies agreed to a consent order in a U. S. District Court in which they neither admitted nor denied the allegations. As part of the agreement, a special auditor was appointed to review intercompany charges and costs associated with the programs and transactions involved in the investigation; the auditor's report was filed in December 1978. The AEP System companies are engaged in a continuing program for the orderly and economic divestment of a limited amount of real estate, acquired in connection with the housing and industrial development programs, that was subject to question.

In 1975, an investigation was commenced under the Federal Power Act concerning the reasonableness and prudence of the coal-purchasing policies and practices of members of the AEP System, the manner in which wholesale fuel-adjustment clauses are implemented by System members, and related matters. In 1978 the FERC staff issued a preliminary report which alleged overcharges of approximately $10,000,000 on the part of the entire AEP System, of which only a relatively small portion relates to the Company's operations. The report also questioned certain aspects of the AEP System's fuel positions and policies. The AEP System companies are preparing a response to these allegations.

In 1976 a cable-television organization filed an antitrust suit in a U.S. District Court alleging that the Company, with five telephone companies named as co-conspirators, had attempted to monopolize communications by terminating contracts and increasing charges for the rental of utility poles, and sought damages which when trebled would aggregate more than $150,000,000. In early 1979, the court entered a judgment denying damages and injunctive relief.

The companies are subject to certain developing laws and regulations with respect to air and water quality, land use, and other environmental matters. While the companies are unable to predict the ultimate effect of such laws and regulations, it is possible that they may be required to pay penalties for failure to comply during certain periods or that compliance therewith may require the companies to incur substantial additional costs to modify or replace existing and proposed equipment and facilities.

Other highly complex litigation relates to the Donald C. Cook Nuclear Plant's fuel-supply contracts. Two contractors, United Nuclear Corporation and General Atomic Company (GAC), are variously obligated to supply uranium concentrates and six fabricated nuclear-fuel reloads to the Company. Each contractor claims, among other things, that it is not or may not be obligated to make deliveries of uranium concentrates or fabricated nuclear-fuel reloads and that it is entitled to a price higher than contracted. The Company received the first two reloads and assured delivery of the remaining four reloads through rights-reserved agreements with GAC, which were incorporated into injunctive

orders of the court. Under the agreements, pending the court's judgment and without prejudice to the ultimate rights of the parties, the reloads were to be supplied at a higher provisional cost to the Company. In 1978, a U.S. District Court entered judgment ordering GAC to pay the Company damages of approximately $16,000,000 and to deliver the remaining reloads at the price specified in the contract. GAC has appealed the judgment. A stay of the monetary portion of the judgment has been granted, but motions to stay the specific-performance portion of the judgment have been denied.

The companies intend to apply to regulatory commissions to provide, through future increased rates, for the costs that will be incurred to store spent nuclear fuel and to decommission the Nuclear Plant at the end of its service life. The companies plan to effect modifications to increase the present spent-fuel storage capacity of the Nuclear Plant to permit normal operations through the early 1990's, at a cost which is not expected to cause a material increase in the construction budget. The companies are also studying alternative methods of decommissioning the Nuclear Plant but cannot reasonably estimate, at this time, the future costs that will be incurred.

The Price-Anderson Act limited the public liability of a licensee of a nuclear plant to $560,000,000 for a single nuclear incident, to be covered in part by private insurance with the balance to be covered by agreements of indemnity with the Nuclear Regulatory Commission. The Generating Subsidiary has purchased private insurance in the maximum available amount of $140,000,000. In the event of a nuclear incident involving any commercial nuclear facility in the country, the Generating Subsidiary, together with other licensees, could be individually assessed $5,000,000 per incident for each reactor owned (subject to a maximum of $10,000,000 in any year for each reactor owned in the event of more than one incident). The Price-Anderson indemnities have been decreased by the aggregate amount which is assessable against existing licensees and will continue to decrease as new operating units are licensed.

The Generating Subsidiary has procured property insurance in the maximum available amount of $220,000,000 for damage to the nuclear plant facilities and is a self-insurer for any property loss in excess of that amount.

11. Leases:

The companies, as part of their operations, lease property, plant, and equipment under leases ranging in length from 2 to 35 years. Most of the leases require the companies to pay related property taxes, maintenance costs, and other costs of operation. The companies expect that in the normal course of business, leases will generally be renewed or replaced by other leases. The greatest part of the rentals is under leases having purchase options or having renewal options for substantially all of the economic lives of the properties.

Rentals are analyzed as follows:

	Year Ended December 31,	
	1978	1977
	(In Thousands)	
Gross Rentals	$60,000	$32,000
Less Rental Recoveries (including Sublease Rentals) (a)	1,000	1,000
Net Rentals (b)	$59,000	$31,000

(a) Includes amounts paid for or reimbursed by associated companies.

(b) Classified as:

Operating Expenses	$51,000	$26,000
Clearing and Miscellaneous Accounts (portions of which are charged to income)	8,000	5,000
	$59,000	$31,000

Future minimum lease payments, by year and in the aggregate, under the companies' capital leases and noncancelable operating leases consisted of the following at December 31, 1978:

	Capital Leases(a)	Operating Leases
	(In Thousands)	
1979	$ 6,000	$ 7,000
1980	6,000	7,000
1981	6,000	7,000
1982	6,000	7,000
1983	5,000	7,000
Later Years	74,000	74,000
Total Future Minimum Lease Payments	103,000	$109,000
Less Estimated Interest Element Included Therein (b)	61,000	
Estimated Present Value of Future Minimum Lease Payments	$ 42,000	

(a) Excludes leases of nuclear fuel, all of which are capital leases. Nuclear fuel rentals comprise the unamortized balance of the lessor's cost (approximately $99,000,000 at December 31, 1978 and $93,000,000 at December 31, 1977), less salvage value, if any, to be paid over the period of usage in proportion to heat produced, and carrying charges on the lessor's unrecovered cost. It is contemplated that portions of the presently leased material will be replenished by additional leased material.

(b) Interest rates used range from 4.9% to 12.1%.

The following is a pro forma analysis of leased properties under capital leases and related obligations, assuming that such leases were capitalized:

	December 31, 1978	December 31, 1977
	(In Thousands)	
Nuclear Fuel	$143,000	$132,000
Coal-Mining and Coal-Transportation Equipment	15,000	17,000
Real Estate	13,000	13,000
Electric Distribution System Property	12,000	12,000
Other	11,000	10,000
Gross Properties under Capital Leases	194,000	184,000
Less Accumulated Provision for Amortization	58,000	53,000
Net Properties under Capital Leases	$136,000	$131,000
Obligations under Capital Leases (a)	$141,000	$136,000

(a) Including an estimated $37,000,000 and $31,000,000, respectively, due within one year.

Had capital leases been capitalized, any additional net expense would have been insignificant. The pro forma data do not give recognition to offsetting adjustments in allowable revenues that the companies believe would normally be expected to occur through the regulatory rate-making process, if the related leases had been capitalized.

Included in the above analyses of future minimum lease payments and of properties under capital leases and related obligations are certain leases as to which portions of the related rentals are paid for or reimbursed by associated companies in the AEP System based on their usage of the leased property. The Company cannot predict the extent to which or proportion in which the associated companies will utilize the properties under such leases in the future.

12. Unaudited Quarterly Financial Information:

The following consolidated quarterly financial information is unaudited but, in the opinion of the Company, includes all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation of the amounts shown:

Quarterly Periods Ended	Operating Revenues	Operating Income	Net Income
	(In Thousands)		
1978—			
Mar. 31	$145,106	$41,553	$32,196
June 30	157,958	40,183	34,491(a)
Sept. 30	152,218	40,749	22,739(b)
Dec. 31	148,198	37,349	25,401(a)
1977—			
Mar. 31	128,258	31,821	23,191
June 30	118,070	30,698	22,871
Sept. 30	133,016	33,812	25,817
Dec. 31	133,480	34,069	25,241

(a) Includes increases in AFUDC of approximately $1,567,000 recorded in the second quarter and $3,372,000 recorded in the fourth quarter relating to changes in AFUDC rates, applied in each case effective as of January 1, 1978.

(b) Includes the effect of a revenue refund (see Note 2), and a change in tax estimate (see Note 3).

13. Unaudited Replacement-Cost Information:

Estimated replacement-cost and related amounts pertaining to depreciation, as of and for the years ended December 31, 1978 and 1977, of productive capacity (as represented by property in service, excluding nondepreciable items such as land and excluding other amounts for which replacement-cost data are not required to be computed) are considerably greater than the related original-cost amounts reported in the consolidated financial statements. A quantitative analysis of such unaudited replacement-cost information is included in the Company's 1978 Annual Report (Form 10-K) to the Securities and Exchange Commission. Reference is made elsewhere herein for information with regard to obtaining a copy of the Company's Form 10-K for the year 1978.

Operating Statistics and Balance Sheet Data

	1978	1977	1976	1975	1974
OPERATING STATISTICS					
ELECTRIC OPERATING REVENUES (Thousands):					
From Kilowatt-hour Sales:					
Residential:					
Without Electric Heating	$ 96,624	$ 90,833	$ 71,888	$ 69,438	$ 53,265
With Electric Heating	54,067	46,948	37,447	33,493	27,080
Total Residential	150,691	137,781	109,335	102,931	80,345
Commercial	96,370	92,312	72,527	69,176	50,554
Industrial	121,346	109,357	80,233	75,167	63,314
Sales for Resale:					
Municipalities	39,121	44,091	26,841	22,551	23,493
Cooperatives	17,732	15,619	10,491	9,178	7,548
Other Electric Utilities	166,441	103,517	110,382	75,887	55,994
Total Sales for Resale	223,294	163,227	147,714	107,616	87,035
Miscellaneous	7,729	6,062	2,573	4,650	3,389
Total from Kilowatt-hour Sales	599,430	508,739	412,382	359,540	284,637
Other Operating Revenues	4,050	4,085	3,811	3,815	2,969
Total Electric Operating Revenues	$603,480	$512,824	$416,193	$363,355	$287,606

	1978	1977	1976	1975	1974
SOURCES AND SALES OF ENERGY (Millions of Kilowatt-hours):					
Sources:					
Net Generated—Steam:					
Fossil Fuel	7,231	7,317	7,701	7,255	8,815
Nuclear Fuel	10,101(a)	4,786	6,809	4,458(a)	—
Net Generated—Hydroelectric	75	68	72	89	73
Net Generated—Other	—	—	—	—	14
Subtotal	17,407	12,171	14,582	11,802	8,902
Purchased	301	182	232	368	694
Net Interchange	4,475	7,922	6,523	6,778	8,451
Total Sources	22,183	20,275	21,337	18,948	18,047
Less: Losses, Company Use, Etc.	1,340	1,270	1,290	1,305	1,335
Net Sources	20,843	19,005	20,047	17,643	16,712
Sales:					
Residential:					
Without Electric Heating	2,352	2,456	2,384	2,374	2,181
With Electric Heating	1,622	1,605	1,577	1,451	1,413
Total Residential	3,974	4,061	3,961	3,825	3,594
Commercial	2,498	2,671	2,579	2,464	2,192
Industrial	4,319	4,473	4,209	3,835	4,134
Sales for Resale:					
Municipalities	1,585	1,642	1,527	1,522	1,847
Cooperatives	814	786	754	690	651
Other Electric Utilities	7,468	5,195	6,849	5,152	4,166
Total Sales for Resale	9,867	7,623	9,130	7,364	6,664
Miscellaneous	185	177	168	155	128
Total Sales	20,843	19,005	20,047	17,643	16,712

(a) Includes 691 million kilowatt-hours in 1978 and 2,309 million kilowatt-hours in 1975 as test generation. The fuel cost associated with such generation is charged to other operation expense.

AVERAGE COST OF FUEL CONSUMED (a):	1978	1977	1976	1975	1974
Cents per Million Btu:					
Coal	109.68	74.96	65.89	56.09	51.68
Fuel Oil	229.68	168.80	76.72(b)	190.44	187.38
Nuclear	34.65	29.72	26.34	27.83	—
Overall	71.16	59.12	46.47(b)	65.56	69.51
Cents per Kilowatt-hour Generated:					
Coal	1.11	.73	.63	.54	.49
Fuel Oil	2.40	1.88	.84(b)	2.11	1.85
Nuclear	.38	.33	.28	.30	—
Overall	.75	.61	.47(b)	.53	.67
RESIDENTIAL SERVICE—AVERAGES:					
Annual Kwh Use per Customer—					
Total	10,260	10,641	10,439	10,305	10,525
With Electric Heating	22,067	22,830	23,200	22,153	23,239
Annual Electric Bill—					
Total	$ 389	$ 361	$ 288	$ 277	$ 234
With Electric Heating	$ 736	$ 668	$ 551	$ 511	$ 439
Price per Kwh (Cents)—					
Total	3.79	3.39	2.76	2.69	2.22
With Electric Heating	3.34	2.93	2.37	2.31	1.89
NUMBER OF ELECTRIC CUSTOMERS—Year-End:					
Residential:					
Without Electric Heating	315,472	313,085	312,211	310,953	281,904
With Electric Heating	74,900	72,059	69,237	66,812	64,233
Total Residential	390,372	385,144	381,448	377,765	346,137
Commercial	42,106	41,907	41,703	41,456	37,593
Industrial	2,689	2,500	2,452	2,418	2,416
Sales for Resale:					
Municipalities	23	23	23	22	23
Cooperatives	64	61	59	58	58
Other Electric Utilities	20	16	15	18	6
Total Sales for Resale	107	100	97	98	87
Miscellaneous	1,331	1,304	1,280	1,259	1,167
Total Electric Customers	436,605	430,955	426,980	422,996	387,400
BALANCE SHEET DATA—Year-End (Millions)					
Utility Plant	$ 2,397	$ 2,107	$ 1,933	$ 1,771	$ 1,630
Accumulated Provision for Depreciation	410	359	317	275	249
Net Utility Plant	1,987	1,748	1,616	1,496	1,381
Total Assets and Other Debits	2,350	2,123	1,914	1,764	1,545
Common Stock, Premium on Capital Stock, and Other Paid-in Capital	527	467	409	367	318
Retained Earnings	137	105	76	80	71
Cumulative Preferred Stock	227	187	147	147	117
Long-term Debt (c)	1,051	1,038	914	895	739

(a) Excludes effect of deferred collection of fuel costs.

(b) Includes effect of refund received from supplier of fuel oil resulting from settlement of litigation concerning pricing. Without such refund, the average cost of fuel oil for 1976 would have been 173.27 cents per million Btu and 1.91 cents per kilowatt-hour generated, and the overall cost of fuel would have been 49.33 cents per million Btu and 0.50 cents per kilowatt-hour generated.

(c) Including Portion Due Within One Year.

Directors

FRANK N. BIEN
W. A. BLACK (f)
LAWRENCE R. BRUNKE
RICHARD E. DISBROW
J. LEE FLANAGAN
E. W. HERMANSEN
G. E. LEMASTERS
GERALD P. MALONEY (a)
RICHARD C. MENGE
J. F. STARK
JOHN TILLINGHAST (m)
W. S. WHITE, JR.
RORERT O. WHITMAN (b)

Officers

W. S. WHITE, JR.
President

J. F. STARK (g)
Executive Vice President

W. A. BLACK (f)
Executive Vice President

J. F. STARK (h)
Senior Vice President

FRANK N. BIEN
Vice President

RICHARD E. DISBROW
Vice President

JOHN E. DOLAN (l)
Vice President

A. JOSEPH DOWD
Vice President

GERALD P. MALONEY
Vice President

RICHARD C. MENGE
Vice President

JOHN TILLINGHAST (m)
Vice President

JOHN R. BURTON
Secretary

ROBERT O. WHITMAN (c)
Treasurer

PETER J. DEMARIA (d)
Treasurer

H. D. ANDERSON, JR.
Assistant Secretary and Assistant Treasurer

ALLEN H. STUHLMANN
Assistant Secretary and Assistant Treasurer

JOHN F. DILORENZO, JR.
Assistant Secretary

CEDRIC L. MAST (j)
Assistant Secretary

WARREN O. KELTNER (k)
Assistant Secretary

WILLIAM E. OLSON
Assistant Secretary

PETER J. DEMARIA (c)
Assistant Treasurer

WILLIAM N. D'ONOFRIO (i)
Assistant Treasurer

GERALD R. KNORR (i)
Assistant Treasurer

The principal occupation of each of the above directors and officers of Indiana & Michigan Electric Company, with ten exceptions, is as an officer of American Electric Power Service Corporation of New York, N. Y. The exceptions are the Messrs. W. A. Black, Lawrence R. Brunke, J. Lee Flanagan, E. W. Hermansen, Warren O. Keltner, G. E. LeMasters, J. F. Stark, Richard C. Menge, Allen H. Stuhlmann, and Cedric L. Mast whose principal occupations are as officers of Indiana & Michigan Electric Company, as indicated.

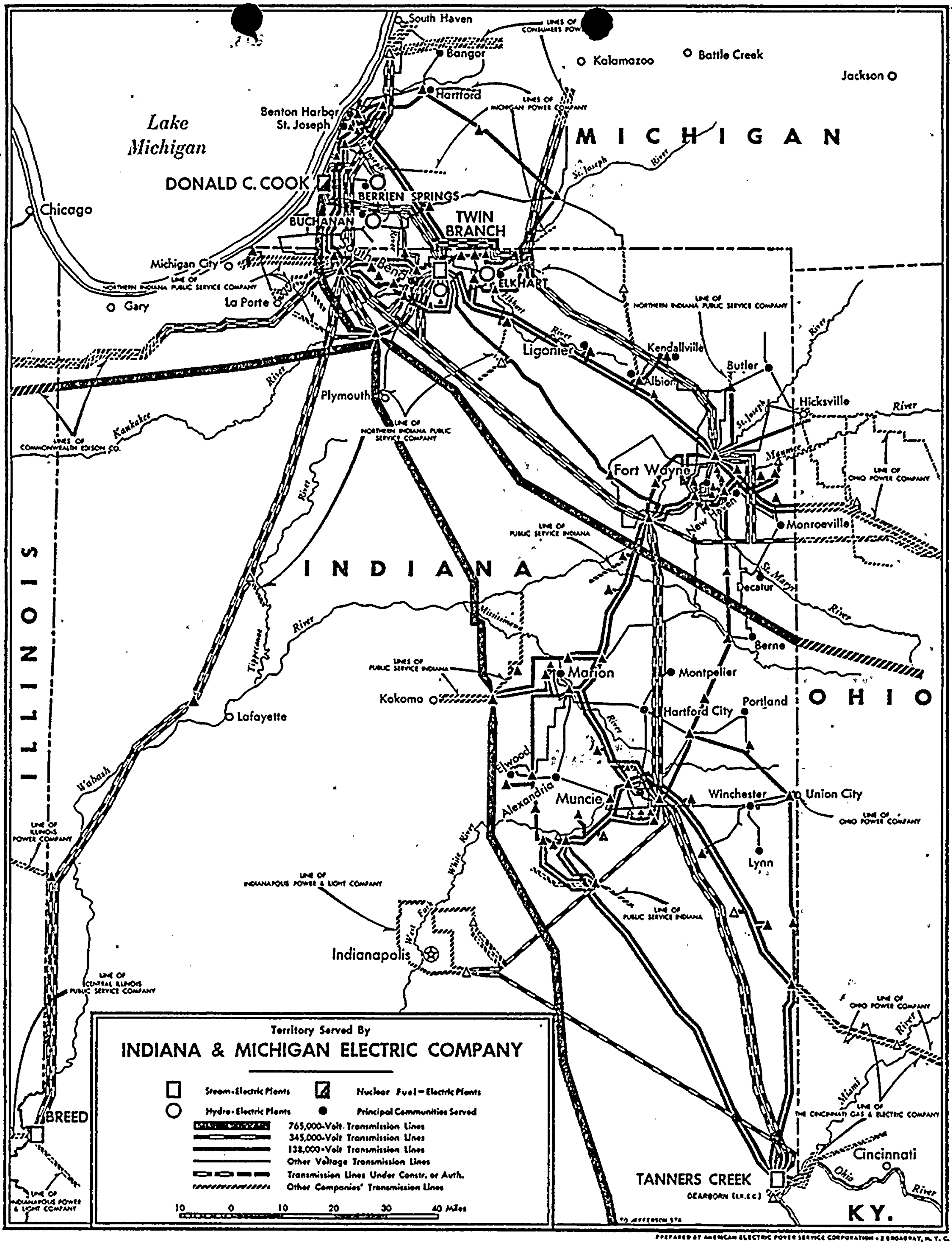
(a) Elected April 25, 1978
(b) Resigned April 25, 1978
(c) Resigned April 27, 1978
(d) Elected April 27, 1978
(e) Resigned April 27, 1978
(f) Elected July 1, 1978
(g) Resigned July 1, 1978
(h) Elected July 1, 1978
(i) Elected July 1, 1978
(j) Resigned January 1, 1979
(k) Elected January 1, 1979
(l) Elected March 1, 1979
(m) Resigned March 29, 1979

Price Range of Cumulative Preferred Stock

By Quarters (1978 and 1977)

Cumulative Preferred Stock	1978—Quarters				1977—Quarters			
	1st	2nd	3rd	4th	1st	2nd	3rd	4th
($100 Par Value)								
4⅛% Series								
Dividends Paid Per Share	$1.03125	$1.03125	$1.03125	$1.03125	$1.03125	$1.03125	$1.03125	$1.03125
Market Price—$ Per Share (OTC)								
Ask (high/low)	—	—	—	—	—	—	—	—
Bid (high/low)	—	—	—	—	40/40	43½/43½	—	—
4.56% Series								
Dividends Paid Per Share	$1.14	$1.14	$1.14	$1.14	$1.14	$1.14	$1.14	$1.14
Market Price—$ Per Share (OTC)								
Ask (high/low)	—	—	—	—	—	—		—
Bid (high/low)	—	—	—	—	—	—	46/45	—
4.12% Series								
Dividends Paid Per Share	$1.03	$1.03	$1.03	$1.03	$1.03	$1.03	$1.03	$1.03
Market Price—$ Per Share (OTC)								
Ask (high/low)	46/46	—	—	—	—	—	—	—
Bid (high/low)	45/45	—	—	—	43/43	45/45	45/44	46/44
7.08% Series								
Dividends Paid Per Share	$1.77	$1.77	$1.77	$1.77	$1.77	$1.77	$1.77	$1.77
Market Price —$ Per Share (NYSE)—High	79½	76	77½	77½	81	81⅜	83½	80½
—Low	74	69⅞	69½	64¼	76½	77⅛	77	75
7.76% Series								
Dividends Paid Per Share	$1.94	$1.94	$1.94	$1.94	$1.94	$1.94	$1.94	$1.94
Market Price—$ Per Share (NYSE)—High	85	84¼	86⅞	82	89	89½	91	89
—Low	80⅞	75	76	74	82½	84½	86¾	84
8.68% Series								
Dividends Paid Per Share	$2.17	$2.17	$2.17	$2.17	$2.17	$2.17	$2.17	$2.17
Market Price—$ Per Share (NYSE)—High	98	93	98⅞	94½	99	99¾	101½	99⅞
—Low	91½	82	83½	82	94½	91	96	94
12% Series								
Dividends Paid Per Share	$3.00	$3.00	$3.00	$3.00	$3.00	$3.00	$3.00	$3.00
Market Price—$ Per Share (NYSE)—High	116	113	113¾	112¾	123	120⅝	123¼	121
—Low	111½	109	108¼	103	117	117	118½	113¼
($25 Par Value)								
$2.15 Series*								
Dividends Paid Per Share	$ .5375	$ .5375	$ .5375	$ .5375		$ .215	$ .5375	$ .5375
Market Price—$ Per Share (NYSE)—High	23¾	22⅞	23½	22⅞		—	25¾	25
—Low	22¾	20¼	21¼	19⅝		—	24⅛	23¼
$2.25 Series**								
Dividends Paid Per Share		$ .7125***	$ .5625	$ .5625				
Market Price—$ Per Share (NYSE)—High		24	24⅞	24⅛				
—Low		21⅝	21¾	20⅛				

OTC—Over-the-Counter
NYSE—New York Stock Exchange
* Issued in May 1977
** Issued in March 1978
*** Includes partial dividend for first quarter.
Note—The above quotations bid and asked represent prices between dealers and do not represent actual transactions.
Market quotations provided by National Quotation Bureau, Inc. — Dash indicates quotation not available.



INDIANA & MICHIGAN ELECTRIC COMPANY AND GENERATING SUBSIDIARY