Indiana & Michigan Electric Company

ANNUAL REPORT 1977

AMERICAN ELECTRIC POWER SYSTEM

INDIANA & MICHIGAN ELECTRIC COMPANY
AND GENERATING COMPANY
2101 Spy Run Avenue, Fort Wayne, Indiana 46801

Contents

Background of the Company

INDIANA & MICHIGAN ELECTRIC COMPANY (I&M) is one of seven operating company subsidiaries of American Electric Power Company, Inc. 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. Its principal executive offices are in Fort Wayne, Indiana.

Indiana & Michigan Power Company, a generating company subsidiary of Indiana & Michigan Electric 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 August 23, 1975. The subsidiary sells all of the plant's generation to the parent for distribution to the latter's customers.

I&M serves 231 communities and approximately 431,000 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 1,508,000. 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.

Indiana & Michigan Electric'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 American Electric Power 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. Indiana & Michigan Electric 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

(In Thousands)

Year Ended December 31,	1977	1976(a)	1975(a)	1974(a)	1973(a)
OPERATING REVENUES—Electric	$512,824	$416,193	$363,355	$287,606	$235,335
OPERATING EXPENSES:					
Operation:					
Fuel for Electric Generation	74,052	70,127	55,775	55,216	35,944
Purchased and Interchange Power—Net	144,833	126,712	121,194	111,161	61,399
Other	44,706	40,251	37,800	27,959	25,327
Maintenance	28,452	20,140	17,078	17,747	15,550
Depreciation	48,824	47,852	32,734	24,853	23,787
Taxes, Other Than Income Taxes	23,408	18,920	14,015	10,956	10,467
Federal and State Income Taxes	18,149	(8,625)	6,026	(3,086)	(1,352)
Total Operating Expenses	382,424	315,377	284,622	244,806	171,122
OPERATING INCOME	130,400	100,816	78,733	42,800	64,213
OTHER INCOME AND DEDUCTIONS:					
Allowance for Funds Used During Construction	—	28,874	45,482	59,454	40,791
Allowance for Other Funds Used During Construction	26,889	—	—	—	—
Miscellaneous Nonoperating Income Less Deductions	952	718	135	1,537	1,561
Total Other Income and Deductions	27,841	29,592	45,617	60,991	42,352
INCOME BEFORE INTEREST CHARGES	158,241	130,408	124,350	103,791	106,565
INTEREST CHARGES:					
Interest on Long-term Debt	73,188	68,294	59,770	61,205	45,865
Interest on Short-term Debt	6,697	7,342	10,446	8,665	5,294
Miscellaneous Interest Charges	887	898	606	518	560
Total Interest Charges	80,772	76,534	70,822	70,388	51,719
Allowance for Borrowed Funds Used During Construction (Credit)	(19,651)	—	—	—	—
Net Interest Charges	61,121	76,534	70,822	70,388	51,719
CONSOLIDATED INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGES	97,120	53,874	53,528	33,403	54,846
NON-RECURRING CUMULATIVE EFFECT OF ACCOUNTING CHANGES (Net of $603 Applicable Taxes)	—	—	—	8,151	—
CONSOLIDATED NET INCOME	$ 97,120	$ 53,874	$ 53,528	$ 41,554	$ 54,846

(a) Restated to reflect certain revenue refunds and adjustments.

Management's Comments on Consolidated Summary of Operations

Reference is made to the consolidated financial statements, Notes to Consolidated Financial Statements and Operating Statistics and Balance Sheet Data for additional information affecting results of operations.

The amounts and percentage relationships discussed herein reflect the restatements described in Note 2 of Notes to Consolidated Financial Statements.

Operating Revenues—Electric

Electric operating revenues increased by $52,838,000 (15%) in 1976 over 1975, and by $96,631,000 (23%) in 1977 over 1976. The substantial increase in operating revenues for each of these periods was attributable to an interaction of factors. The growth in revenues was affected by rate increases which were put into effect at various times in 1976 and 1977. The growth in revenues during 1976 was also attributable to increased kilowatt-hour sales (in large part to other electric utilities).

Provision for revenue refunds moderated the growth in operating revenues in 1976, in which year the Company provided for revenue refunds due customers aggregating $5,806,000 resulting from settlement of litigation with a fuel supplier concerning pricing. Growth in operating revenues in 1977 was limited by reduced sales to other electric utilities.

Conservation measures by some customers have tended to limit the growth of operating revenues.

Operating Expenses

Fuel expense in 1976 increased over 1975 by $14,352,000 (26%) primarily due to greater generation, offset in part by lower average fuel costs resulting from a growth in use of nuclear energy. In 1977, fuel for electric generation increased over 1976 by $3,925,000 (6%) primarily due to a 21% increase in the cost of fossil fuel consumed, which was partially offset by a 17% decrease in generation and a decrease in nuclear fuel consumed associated with reduced generation occasioned by the outages of Cook Nuclear Plant Unit No. 1 for refueling.

Purchased and interchange power increased by $18,121,000 in 1977 primarily due to the outage for refueling of Unit No. 1 of the Nuclear Plant in that year.

The increase in maintenance expense in 1976 over 1975 of $3,062,000 (18%) was associated with certain maintenance work being performed in 1976 which had previously been deferred and with the placing into service of Unit No. 1 of the Nuclear Plant. The increase in maintenance expense in 1977 over 1976 of $8,312,000 (41%) was also associated with certain increased maintenance activity in 1977 which had previously been deferred, and to higher labor cost and increased costs of material, supplies and services in the area of power production maintenance.

The increase in depreciation expense in 1976 over 1975 of $15,118,000 (46%) was primarily caused by Unit No. 1 of the Nuclear Plant being placed in service. The increase in 1977 over 1976 was 2%, as no new major plant additions were placed in service until the latter months of 1977.

Taxes, other than income taxes, increased in 1976 and 1977 principally due to increases in utility plant in service. In addition, the increase in 1977 was affected by the completion in 1976 of the amortization (approximately $3,000,000) of certain deferred credits to income associated with property taxes which had been deferred pursuant to regulatory authorization.

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) decreased in 1976 from 1975 by $16,608,000 (37%) primarily due to the termination of AFUDC on Unit No. 1 of the Nuclear Plant in the latter part of 1975. The foregoing decrease was partially offset by increased AFUDC associated with construction costs of precipitator installation projects at two of the Company's plants.

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

AFUDC, including both the portion classified as other income ($26,889,000) and the portion classified as a credit to interest charges ($19,651,000), for the year 1977 increased by $17,666,000 (61%) over the year 1976. This increase was related to an increased amount invested in construction of Unit No. 2 of the Nuclear Plant, precipitator installation projects at two of the Company's plants and the effect of the Generating Subsidiary's compounding AFUDC beginning in 1977. (See Note 1 of Notes to Consolidated Financial Statements.)

Interest Charges

Interest on long-term debt in 1976 increased by $8,524,000 (14%) over 1975 due to additional long-term debt financing effected in 1976 in connection with the construction programs of the Company and the Generating Subsidiary, and the refinancing by the Company of maturing debt securities. Interest on short-term debt in 1976 decreased by $3,104,000 (30%) from 1975 due to a reduction in the average level of short-term borrowings accompanied by a decline in the general level of the prime interest rate.

Interest on long-term debt increased by $4,894,000 (7%) in 1977 over 1976 due to additional long-term financing effected in 1977. Interest on short-term debt decreased by $645,000 (9%) from 1976 largely due to a decrease in the average level of short-term borrowings.

Auditors' Opinion

Haskins & Sells
Certified Public Accountants
Two Broadway
New York, New York 10004

Indiana & Michigan Electric Company
Fort Wayne, Indiana

We have examined the balance sheets of Indiana & Michigan Electric Company and its generating subsidiary, Indiana & Michigan Power Company, consolidated, as of December 31, 1977 and 1976 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.

In our report dated February 22, 1977, our opinion on the 1976 financial statements was qualified as being subject to such adjustments, if any, as might have been required if the outcome of certain court proceedings described in paragraphs six and seven of Note 10 of Notes to Consolidated Financial Statements had been known. As a result of certain subsequent events, we no longer qualify our opinion on the 1976 financial statements, as presented herein, as to these matters.

As discussed in paragraphs three and four of Note 2 of Notes to Consolidated Financial Statements, the Company is collecting certain wholesale revenues subject to possible refund and has been incurring, since 1975, 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 the antitrust matter, filed in 1977, described in paragraph one of Note 10 of Notes to Consolidated Financial Statements.

In our opinion, subject to the effect, if any, of the outcome of the antitrust matter and the rate matters referred to in the preceding paragraph, the financial statements identified above present fairly the financial position of the above companies, consolidated, as of December 31, 1977 and 1976 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.

Haskins & Sells

February 21, 1978 (February 23, 1978
as to paragraph four of Note 2 of
Notes to Consolidated Financial
Statements)

Consolidated Statement of Income

(In Thousands)

Year Ended December 31,	1977	1976 (Note 2)
OPERATING REVENUES—ELECTRIC (Note 2)	$512,824	$416,193
OPERATING EXPENSES:		
Operation:		
Fuel for Electric Generation	74,052	70,127
Purchased and Interchange Power (Net) (Notes 2 and 9)	144,833	126,712
Other	44,706	40,251
Maintenance (Note 1)	28,452	20,140
Depreciation (Note 1)	48,824	47,852
Taxes, Other Than Income Taxes	23,408	18,920
State Income Taxes	704	(114)
Federal Income Taxes (Notes 1 and 3)	17,445	(8,511)
Total Operating Expenses	382,424	315,377
OPERATING INCOME	130,400	100,816
OTHER INCOME AND DEDUCTIONS (Notes 1 and 3):		
Allowance for Funds Used During Construction	—	28,874
Allowance for Other Funds Used During Construction	26,889	—
Miscellaneous Nonoperating Income Less Deductions	952	718
Total Other Income and Deductions	27,841	29,592
INCOME BEFORE INTEREST CHARGES	158,241	130,408
INTEREST CHARGES:		
Interest on Long-term Debt	73,188	68,294
Interest on Short-term Debt	6,697	7,342
Miscellaneous Interest Charges	887	898
Total Interest Charges	80,772	76,534
Allowance for Borrowed Funds Used During Construction (Credit) (Note 1)	(19,651)	—
Net Interest Charges	61,121	76,534
CONSOLIDATED NET INCOME	$ 97,120	$ 53,874

See Notes to Consolidated Financial Statements.

Consolidated Balance Sheet

(Dollars in Thousands)

December 31,	1977	1976
Assets and Other Debits		
ELECTRIC UTILITY PLANT (Note 1)		
Production	$ 864,902	$ 798,713
Transmission	401,562	389,982
Distribution	244,103	233,757
General (includes Nuclear Fuel)	40,965	64,792
Construction Work in Progress	555,500	446,061
Total Electric Utility Plant	2,107,032	1,933,305
Less Accumulated Provision for Depreciation	358,826	316,916
Electric Utility Plant, less Provision	1,748,206	1,616,389
OTHER PROPERTY AND INVESTMENTS (Notes 1 and 4)	137,421	107,308
CURRENT ASSETS:		
Cash (Note 5)	54,735	56,799
Special Deposits and Working Funds	24,065	475
Temporary Cash Investments (at cost, which approximates market)	8,494	—
Accounts Receivable:		
Customers	38,052	40,717
Associated Companies	9,382	4,909
Miscellaneous	4,968	3,233
Accumulated Provision for Uncollectible Accounts	(221)	(212)
Materials and Supplies (at average cost or less):		
Construction and Operation Materials and Supplies	11,468	11,520
Fuel	17,320	11,417
Accrued Utility Revenues	18,149	13,562
Prepayments and Other Current Assets	4,322	3,894
Total Current Assets	190,734	146,314
DEFERRED DEBITS:		
Unamortized Debt Expense (Note 1)	2,172	1,604
Other Work in Progress	4,780	4,407
Deferred Collection of Fuel Costs (Note 2)	1,655	1,655
Property Taxes	1,450	1,500
Other Deferred Debits (Note 3)	36,521	35,074
Total Deferred Debits	46,578	44,240
Total	$2,122,939	$1,914,251

See Notes to Consolidated Financial Statements.

Liabilities and Other Credits — *December 31,*	1977	1976
LONG-TERM DEBT (less portion due within one year) (Note 5):		
First Mortgage Bonds	$ 482,826	$ 542,164
Sinking Fund Debentures	25,260	26,644
Notes Payable to Banks, due 1980	360,000	300,000
Installment Purchase Contracts	99,750	24,301
Other Long-term Debt	9,226	13,475
Total Long-term Debt (less portion due within one year)	977,062	906,584
CUMULATIVE PREFERRED STOCK:		
Par Value $100 (Note 6):		
Authorized ... 2,250,000 shares		
Outstanding, 4⅛ % Series ... 120,000 shares	12,000	12,000
Outstanding, 4.56% Series ... 60,000 shares	6,000	6,000
Outstanding, 4.12% Series ... 40,000 shares	4,000	4,000
Outstanding, 7.08% Series ... 300,000 shares	30,000	30,000
Outstanding, 7.76% Series ... 350,000 shares	35,000	35,000
Outstanding, 8.68% Series ... 300,000 shares	30,000	30,000
Outstanding, 12 % Series with Sinking Fund ... 300,000 shares	30,000	30,000
Par Value $25 (Note 6):		
Authorized ... 4,000,000 shares		
Outstanding, $2.15 Series ... 1,600,000 shares	40,000	—
Premiums	381	381
Total Cumulative Preferred Stock (including premiums)	187,381	147,381
COMMON STOCK, NO PAR VALUE:		
Authorized ... 2,500,000 shares		
Outstanding ... 1,400,000 shares	56,584	56,584
OTHER PAID-IN CAPITAL (Note 7)	410,228	352,228
RETAINED EARNINGS (Note 8)	104,566	76,286
CURRENT LIABILITIES:		
Long-term Debt Due Within One Year	61,421	7,248
Short-term Debt (Note 5):		
Notes Payable to Banks	49,650	86,439
Commercial Paper	52,200	61,574
Accounts Payable—General	19,650	25,099
Accounts Payable—Associated Companies	16,306	21,953
Dividends Declared:		
Common Stock	11,360	16,590
Cumulative Preferred Stock	3,854	2,994
Customer Deposits	1,739	1,506
Taxes Accrued	18,804	19,891
Interest Accrued	19,041	16,388
Other Current Liabilities	16,653	19,627
Total Current Liabilities	270,678	279,309
COMMITMENTS AND CONTINGENT LIABILITIES (Note 10)		
DEFERRED CREDITS AND OPERATING RESERVES:		
Deferred Income Taxes (Note 1):		
Accelerated Amortization	15,461	17,344
Liberalized Depreciation	85,417	71,485
Other	1,265	—
Deferred Investment Tax Credits (Notes 1 and 3)	10,785	5,650
Other Deferred Credits and Operating Reserves	3,512	1,400
Total Deferred Credits and Operating Reserves	116,440	95,879
Total	$2,122,939	$1,914,251

Consolidated Statement of Sources of Funds for Plant and Property Additions

(In Thousands)

Year Ended December 31,	1977	1976
FUNDS FROM OPERATIONS:		
Consolidated Net Income	$ 97,120	$ 53,874
Principal Non-fund Charges (Credits) to Income:		
Depreciation	48,824	47,852
Provision for Deferred Income Taxes (Net)	13,535	17,431
Deferred Investment Tax Credit Adjustments (Net)	5,038	(25,431)
Allowance for Funds Used During Construction	(26,889)*	(28,874)
Other (Net)	85	(3,211)
Total Funds from Operations	137,713	61,641
FUNDS FROM FINANCINGS:		
Issuances and Contributions:		
Long-term Debt (Net Proceeds)	135,391	24,288
Cumulative Preferred Stock	38,120	—
Capital Contributions from Parent Company	58,000	42,000
Short-term Debt (Net)	—	52,821
Total	231,511	119,109
Less—Retirements:		
Long-term Debt	10,873	5,617
Short-term Debt (Net)	46,163	—
Net Funds from Financings	174,475	113,492
DIVIDENDS ON COMMON STOCK	(52,920)	(45,990)
DIVIDENDS ON CUMULATIVE PREFERRED STOCK	(14,041)	(11,977)
SALES OF PROPERTY	97,311	3,908
DEFERRED COLLECTION OF FUEL COSTS	—	1,345
OTHER CHANGES (NET)	(4,523)	(969)
DECREASE (INCREASE) IN WORKING CAPITAL (Excluding Short-term Debt and Long-term Debt Due Within One Year) (a)	(61,061)	58,600
Total	$276,954	$180,050
PLANT AND PROPERTY ADDITIONS:		
Gross Additions to Utility Plant	$272,433	$172,276
Gross Other Additions	31,410	36,648
Total Gross Additions	303,843	208,924
Allowance for Funds Used During Construction	(26,889)*	(28,874)
Total	$276,954	$180,050
(a) DECREASE (INCREASE) IN WORKING CAPITAL (Excluding Short-term Debt and Long-term Debt Due Within One Year):		
Cash and Cash Items	$(30,020)	$ 43,623
Accounts Receivable	(3,534)	(10,004)
Materials and Supplies	(5,851)	2,767
Accounts Payable	(11,096)	13,978
Taxes Accrued	(1,087)	3,280
Other (Net)	(9,473)	4,956
	$(61,061)	$ 58,600

* Excludes Allowance for Borrowed Funds Used During Construction. See Note 1.

See Notes to Consolidated Financial Statements.

Consolidated Statement of Retained Earnings

(In Thousands)

Year Ended December 31,	1977	1976
Balance at Beginning of Year:		
Before Restatement	$ 78,931	$ 82,117
Restatement (Note 2)	(2,645)	(1,726)
After Restatement	76,286	80,391
Consolidated Net Income	97,120	53,874
Total	173,406	134,265
Deductions:		
Dividends:		
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 with Sinking Fund	3,600	3,600
$2.15 Series	2,064	—
Common Stock	52,920	45,990
Total Dividends	66,961	57,967
Capital Stock Expense	1,879	12
Total Deductions	68,840	57,979
Balance at End of Year (Note 8)	$104,566	$ 76,286

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 is completing the construction of and will 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 is scheduled for commercial operation in 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), formerly the Federal Power Commission. The financial statements have been prepared, with full reservation of legal rights, on the basis of the accounts which are maintained for FERC purposes. Such statements have been restated to reflect the effect of certain regulatory commission orders described in Note 2.

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. A FERC order revised, effective January 1, 1977, the prescribed procedure under the Uniform System of Accounts for the determination of the maximum rate of and accounting for the allowance for funds used during construction. The composite rate used to determine the cost of funds used during construction during 1977 and 1976 approximated 8.5%. However, the Generating Subsidiary, commencing as of January 1, 1977, compounded the allowance semiannually as permitted under the revised FERC procedure.

Effective for periods subsequent to December 31, 1976, in accordance with the FERC order, the allowance is shown in the consolidated statement of income in terms of its equity and debt components, the equity portion being reflected under other income and deductions and the debt portion being reflected as a credit under interest charges. The breakdown of the allowance into its equity and debt components is determined in accordance with a formula prescribed under the FERC order. The allowance for 1976 has not been reclassified into equity and debt components because the companies believe that such allocation based on their then existing capital structures would not necessarily be comparable to components determined subsequent to December 31, 1976 by using the FERC formula.

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 Rates per Annum
Production:	
Nuclear	4.0%
Steam	3.1%
Transmission	2.9%
Distribution	3.3%
General	3.5%

Income is charged with the costs of labor, materials, supervision and other expenses incurred in maintaining the properties in efficient operating condition. 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.

The Company and the Generating Subsidiary normalize, over the life of the property, the effect of tax reductions resulting from the application of investment tax credits to provisions for current and certain deferred Federal income taxes.

Pension Plan

The Company and the Generating Subsidiary participate with other companies in the American Electric Power System in a trusteed plan to provide pensions for all their 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 have been phased out as to substantially all employees. The pension plan conforms to the Employee Retirement Income Security Act of 1974.

The cost of the plan for the years ended December 31, 1977 and 1976 was approximately $2,170,000 and $2,390,000, respectively. These amounts cover the cost of currently accruing benefits, together with interest on unfunded prior-service costs. A change in the interest rate used in the most recent actuarial computations, from 5¼% to 5½%, effective for periods subsequent to December 31, 1976, eliminated unfunded prior-service costs as of that date. The plan may be modified or terminated at any time, subject to limitations of labor agreements.

Other

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

Miscellaneous nonoperating income for the years ended December 31, 1977 and 1976 includes gains amounting to $306,000 and $142,000, 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.

See Note 2 for the method of accounting for fuel costs.

Certain prior-year amounts have been reclassified to conform with classifications used in the current year.

2. Operating Revenues and Operating Expenses:

In June 1977, FERC ordered that negotiated settlement agreements between the Company and certain municipal and wholesale-for-resale customers become effective. Accordingly, the Company refunded $3,596,000 to the municipal customers and $3,171,000 to the wholesale-for-resale customers, plus interest through the refund dates. Also, in April 1977, pursuant to a FERC order, the Company billed additional amounts to certain wholesale customers for service rendered from July 1, 1976 to March 25, 1977.

The effect of restating 1976 results of operations that were reported in the 1976 annual report to shareowners, to reflect the above orders, is as follows (in thousands):

Increase (Decrease) in:	
Operating Revenues—Electric	$(1,355)
Taxes, Other Than Income Taxes	(13)
Federal Income Taxes	(735)
Miscellaneous Interest Charges	312
Consolidated Net Income	(919)

The restatement reduced retained earnings at January 1, 1976 by $1,726,000.

Revenues collected by the Company from other wholesale customers which are still subject to possible refund are estimated at $19,425,000 and $5,880,000 for the years 1977 and 1976, respectively. Such revenues aggregated approximately $27,255,000 at December 31, 1977.

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 American Electric Power System. The effect of such changes was to increase charges to the Company, subject to possible refund by its interchange power suppliers, by approximately $27,968,000 and $29,674,000 for the years 1977 and 1976, respectively, and aggregates approximately $78,336,000 at December 31, 1977. On February 23, 1978, an administrative law judge of FERC issued an initial decision ordering one of the affiliated interchange power suppliers to make refunds, the amounts of which the Company has not been able to compute, as of the date of the annual report to shareowners, but which if finally ordered by FERC, could result in the Company becoming entitled to refunds in a substantial amount. The Company expects that System subsidiaries, including the Company, will urge that the action of the administrative law judge be revised so as to sustain the 1975 change in rates, but cannot predict the final outcome of the proceeding or the effect thereof on the Company.

During 1976, the regulatory commissions having jurisdiction over rate levels ordered revisions in the Company's deferred fuel-adjustment clauses resulting in an elimination of the lag in fuel cost recovery. As a result, it was no longer necessary to continue the deferral of incremental fuel costs. The Company intends to file applications with the commissions seeking approval to collect, over an appropriate period of time, the fuel costs deferred when the fuel-adjustment clauses were changed. At December 31, 1977 and 1976, the amount so deferred was $1,655,000 ($861,000 after income tax effects).

Operating revenues derived from domestic governmental entities represent approximately 10% of total operating revenues for 1977.

3. Federal Income Taxes:

The details of Federal income taxes, current and deferred, are as follows:

	Year Ended December 31, 1977	Year Ended December 31, 1976
	(In Thousands)	
Charged (Credited) to Operating Expenses:		
Current Federal Income Taxes—Net	$(1,128)	$ (511)
Deferred Federal Income Taxes—Net	13,535	17,431
Investment Tax Credit Adjustments—Net	5,038	(25,431)
Total	17,445	(8,511)
Charged to Other Income and Deductions	537	512
Total Federal Income Taxes	$17,982	$(7,999)

The consolidated effective income tax rates were less than the Federal income tax statutory rates for the years 1977 and 1976. 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 income before Federal income taxes by the statutory tax rate.

	Year Ended December 31, 1977	Year Ended December 31, 1976
	(In Thousands)	
Consolidated Net Income	$ 97,120	$ 53,874
Federal Income Taxes	17,982	(7,999)
Pre-Tax Book Income	$115,102	$ 45,875
Income Tax on Pre-Tax Book Income at Statutory Rate of 48%	$ 55,249	$ 22,020
Increase (Decrease) in Federal Income Taxes Resulting from:		
Excess of Tax over Book Depreciation	(16,080)	(20,266)
Allowance for Funds Used During Construction and Items Capitalized on the Books but Deducted for Tax Purposes	(24,005)	(15,350)
Mine Development and Exploration Expense	(1,962)	(5,488)
Provision for Revenue Refunds	(2,912)	794
Unbilled Revenue	(2,176)	(1,289)
Property Tax Adjustment	(1,848)	(1,670)
ADR Repair Allowance	(1,824)	(1,200)
Miscellaneous Items	(1,394)	101
	$ 3,048	$(22,348)
Income Tax on Current-Year Taxable Income—Separate-Return Basis	$ 3,048	$ — (a)
Reduction Due to System Consolidation	(3,048)	—
Minimum Tax on Preference Items	18	2
Current-Year Investment Tax Credit	—	30(b)
Currently Payable	18	32
Adjustments of Prior-Year Accruals—Net	(774)	(31)
Adjustments for Losses of Affiliated Companies, Other Than the System Parent Company, Used by the Company or the Generating Subsidiary (or Losses of the Company or the Generating Subsidiary Used by Affiliated Companies)—Net(c):		
Federal Income Taxes	68	(27,322)
Investment Tax Credit	97	27,322
Current Federal Income Taxes—Net	(591)	1
Deferred Income Tax Expense—Net of Amortization—Resulting from the Following Timing Differences:		
Depreciation (Liberalized and Asset Depreciation Range)	13,931	19,507
Unbilled Revenue	3,315	3,858
Accelerated Amortization of Emergency Facilities (Amortization of Prior-Year Provisions)	(1,882)	(1,942)
Provision for Revenue Refunds	2,213	(735)
Other	1,154	(1,305)
Investment Tax Credit Applicable to Deferred Income Taxes on Certain Timing Differences	(5,196)	(1,952)
Deferred Federal Income Taxes—Net	13,535	17,431
Investment Tax Credit Adjustments—Net	5,038	(25,431)
Total Federal Income Taxes	$ 17,982	$ (7,999)

(a) Because of a net operating tax loss no provision was required.

(b) Represents an estimated provision for recapture of prior-year investment tax credits.

(c) Tax losses of the Company and/or its Generating Subsidiary for 1974, 1976 and 1977 were used to reduce taxes of affiliated companies in the System. With approval of FERC, credits to tax expense of the Company and its Generating Subsidiary were made equal to the reductions obtained by the affiliated companies, as it is expected that those losses will be usable by the Company and its Generating Subsidiary in subsequent periods. See (d) below. In 1977 charges were made to tax expense of the Company, similarly, for losses of other companies used by it. Investment tax credit adjustments related to such credits or debits are included in other deferred debits or credits until the related tax adjustments reverse in subsequent years.

(d) In accordance with an order of the Securities and Exchange Commission (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 affiliated companies included in the consolidated return, but with the provision that any losses so allocated to other affiliated companies shall be reallocated to the Company if usable by it in subsequent years. The effect of tax losses allocated to other companies has been included in the credits referred to in (c) above.

Unused System investment tax credits at December 31, 1977 aggregated approximately $117,800,000, of which $19,100,000 may be carried forward through 1981, $53,100,000 through 1982, $20,600,000 through 1983, and approximately $25,000,000 through 1984. Of these amounts, approximately $15,700,000 had been applied as a reduction of deferred income taxes prior to December 31, 1977 and will not be reflected in net income by the System companies when realized in future years except as affected by changes in deferred income taxes.

To the extent that normalizable timing differences have eliminated taxable income or have been included in carryforwards from 1974 which subsequently have been utilized, provisions have been made for 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 at the respective dates shown below:

	December 31, 1977	December 31, 1976
	(In Thousands)	
Nonutility Property and Other Property Investments:		
Western Coal Lands Acquired as Source of Low-Sulfur Fuel ...	$120,799	$ 90,743
Other Coal Properties	2,778	2,700
Fuel-Handling Facilities	914	912
Miscellaneous, less Provisions for Depreciation	12,674	12,559
Subtotal	137,165	106,914
Ohio Valley Electric Corporation Subordinated Notes (Note 10)	56	117
Other Investments	200	277
Total Other Property and Investments	$137,421	$107,308

5. Long-term Debt, Short-term Debt and Lines of Credit:

First mortgage bonds outstanding were as follows (in thousands):

	December 31, 1977	December 31, 1976
6½% Series due 1978(a)	$ 30,000	$ 30,000
3 % Series due 1978	24,173	24,173
2¾% Series due 1980	18,015	18,015
3¼% Series due 1982	16,046	16,046
10¼% Series due 1982	70,000	70,000
3⅝% Series due 1983	13,762	13,762
11 % Series due 1983	60,000	60,000
3⅛% Series due 1984	15,082	15,082
10⅞% Series due 1984(b)	70,500	75,000
10 % Series due 1985	14,250	15,000
3⅞% Series due 1988	22,974	22,974
4¾% Series due 1988	17,557	17,557
4⅝% Series due 1993	42,902	42,902
7 % Series due 1998	35,000	35,000
8⅞% Series due 2000	50,000	50,000
8⅜% Series due 2003	40,000	40,000
Unamortized Debt Premium and (Discount)—Net	(262)	(347)
(Less) Portion Due Within One Year	(57,173)	(3,000)
Total	$482,826	$542,164

(a) Retired February 1, 1978.

(b) These bonds are obligations of the Generating Subsidiary, and are guaranteed by American Electric Power Company, Inc. The unamortized discount amounted to $221,000 and $253,000 at December 31, 1977 and 1976, respectively. Such bonds require sinking fund payments of $2,250,000 annually.

The indentures 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. As to the 10% series due 1985, issued by the Company, and the 10⅞% series due 1984, issued by the Generating Subsidiary, annual sinking fund payments aggregating $750,000 and $2,250,000, respectively, are required.

Sinking fund debentures outstanding were as follows (in thousands):

	December 31, 1977	December 31, 1976
5⅛% due 1986	$12,491	$13,392
7¼% due 1998	12,694	13,168
Unamortized Debt Premium	75	84
Total	$25,260	$26,644

Installment purchase contracts of the Company were as follows (in thousands):

	December 31, 1977	1976
City of Lawrenceburg, Indiana:		
8½% Series due (July 1) 2006	$25,000	$25,000
7% Series due (May 1) 2006	40,000	—
6⅞% Series due (May 1) 2006	12,000	—
City of Sullivan, Indiana:		
6⅞% Series due (May 1) 2006	25,000	—
Unamortized Debt Discount	(2,250)	(699)
Total	$99,750	$24,301

Under the terms of the contracts, the Company is required to pay the cities' purchase price installments in amounts sufficient to enable the cities to pay interest on the principal (at stated maturities, with sinking fund provisions commencing in 1997) of the cities' pollution control revenue bonds issued to finance construction of pollution control facilities at the Company's Tanners Creek and Breed Plants.

Other long-term debt outstanding consisted of (in thousands):

	December 31, 1977	1976
Coal reserve obligations—payable in equal annual installments through 1980 with interest at 8%	$12,377	$16,503
Notes payable—due 1978 through 1985, 6%-7%	934	967
Other	162	253
	13,473	17,723
Less portion due within one year	4,247	4,248
Total	$ 9,226	$13,475

Maturities of first mortgage bonds, long-term notes payable to banks, and other long-term debt and debenture and first mortgage bond sinking fund payments aggregate $61,421,000, $7,456,000, $385,758,000, $3,832,000 and $90,104,000 in 1978, 1979, 1980, 1981 and 1982, respectively. At December 31, 1976 and 1977, the principal amounts of debentures reacquired in anticipation of sinking fund requirements were $1,240,000 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).

In 1978, prior to the date of this annual report, the Generating Subsidiary issued $15,000,000 additional long-term notes payable to banks. As of the date of the annual report, the Company's filing with the Securities and Exchange Commission to register $100,000,000 of new first mortgage bonds had become effective.

The interest rate on the long-term notes payable to banks (an average of 8.38% at December 31, 1977 and 7% at December 31, 1976) depends on the prime commercial rate plus a fractional percentage. In connection with $300,000,000 principal amount of the long-term notes payable to banks, the Generating Subsidiary has informal arrangements with the banks to maintain average compensating bank balances equal to approximately 15% of the notes outstanding or, in lieu thereof, to pay a fee on any draw-down of the compensating balance based on the approximate effective interest cost of the related notes, assuming the full compensating balances had been maintained. At December 31, 1977 and 1976 the compensating balances under the arrangements were approximately $34,100,000 and $45,000,000, respectively. The effective interest rate, representing the actual interest rates on the notes outstanding adjusted for the effect of the compensating balance requirements, averaged 9.59% at December 31, 1977 and was approximately 8¼% at December 31, 1976.

Short-term debt and interest rates thereon were as follows (dollars in thousands):

	1977	1976
Weighted average interest rates for borrowings outstanding at end of year:		
Notes Payable to Banks	7.76%	6.24%
Commercial Paper	7.35%	6.09%
Maximum amount of borrowings outstanding at any month-end during the year:		
Notes Payable to Banks	$87,400	$87,584
Commercial Paper	$76,042	$70,770
Weighted average interest rate of borrowings during the year (a):		
Notes Payable to Banks	6.59%	6.90%
Commercial Paper	6.60%	7.23%
Average amount of borrowings outstanding during the year:		
Notes Payable to Banks	$39,457	$55,956
Commercial Paper	$58,716	$52,980

(a) The average interest rates are determined by dividing the interest accrued during the year by the average of the month-end borrowings.

The Company had unused short-term bank lines of credit of approximately $208,000,000 and $105,000,000 at December 31, 1977 and 1976, 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 $200,000,000 and $81,000,000, respectively, of such lines are shared with other 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, 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.

6. Cumulative Preferred Stock:

The cumulative preferred stock is redeemable, in whole or in part, at the option of the Company on thirty days' notice, plus accrued dividends:

4⅛% Series .... at $106.125 a share.
4.56% Series .... at $102 a share.
4.12% Series .... at $102.728 a share.
7.08% Series .... at $106.45 a share if redeemed prior to February 1, 1981, and at diminishing prices thereafter.

7.76% Series .... at $107.32 a share if redeemed prior to November 1, 1981, and at diminishing prices thereafter.

8.68% Series .... at $109.61 a share if redeemed prior to December 1, 1978, and at diminishing prices thereafter. These shares may not be redeemed prior to such date in connection with certain refunding operations.

12% Series .... at $112 a share if redeemed prior to September 1, 1985, and at diminishing prices thereafter. These shares may not be redeemed prior to September 1, 1980 in connection with certain refunding operations.

$2.15 Series .... at $27.15 a share if redeemed prior to May 1, 1982, and at diminishing prices thereafter. These shares may not be redeemed prior to such date in connection with certain refunding operations.

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 sinking fund shall be cumulative so that if on any October 1 the requirement shall not have been met, the portion not having been met shall become an additional requirement for the following October 1. Unless all sinking fund provisions have been made, no distribution may be made on the common stock.

In October 1976, shareowners authorized the issuance of up to 4,000,000 new shares of cumulative preferred stock, par value $25, which ranks equally with the cumulative preferred stock, par value $100. In May 1977, the Company issued and sold 1,600,000 shares of the $2.15 series.

As of the date of the annual report to shareowners the Company's filing with the Securities and Exchange Commission to register 1,600,000 shares of new cumulative preferred stock; $25 par value, had become effective.

7. Common Stock and Other Paid-in Capital:

There were no common stock transactions during the years 1977 and 1976. The Company received from its parent cash capital contributions of $58,000,000 in 1977 and $42,000,000 in 1976 which were credited to other paid-in capital.

8. 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, 1977 was so restricted.

9. Related-Party Transactions:

Operating revenues—electric include sales of energy to associated companies during 1977 and 1976 of approximately $14,464,000 and $8,942,000, respectively.

Power purchased from affiliated companies amounted to $476,000 in 1977 and $1,278,000 in 1976. Interchange power—net with associated companies totalled $140,957,000 and $127,904,000 in the respective years. See Note 2 for additional information.

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

American Electric Power Service Corporation provides engineering and certain administrative services to the Company and the affiliated companies in the American Electric Power System. The costs of these 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 capital, all of which is furnished to the service company by American Electric Power Company, Inc. 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 Contingent Liabilities:

Certain municipalities in Indiana and Michigan, served at wholesale by the Company, in recent years

have filed four separate actions against the Company, including one in 1977 that alleged damages of $150,000,000 when trebled. Three of the actions are in the form of antitrust suits in a U.S. District Court; the fourth, a complaint before FERC. All of them basically involve a comparison of the Company's retail rates to industrial customers and wholesale rates to the municipalities, and the question of the Company's ability to continue to serve all of its customers, wholesale and retail, with adequate electric power. With respect to the former, the Company has taken the position that the rates involved are set by the regulatory agencies having jurisdiction; with respect to the latter, that it will continue to serve all of its customers to the best of its ability. All four matters remain pending.

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, are variously obligated to supply uranium concentrates and six fabricated nuclear fuel reloads to the Company. Each contractor claims, among other things, that for reasons of "commercial impracticability" it need no longer make deliveries under the contracts or, alternatively, that it is entitled to a price higher than contracted. The Company has assured delivery of the six reloads through rights-reserved agreements with General Atomic Company, which have been incorporated into injunctive orders of the court. Under the agreements, pending resolution of the disputes and without prejudice to the ultimate rights of the parties, the Company and General Atomic Company shall each, in substance, pay one-half of the excess of the actual cost of the reloads over the contract price. The effect of the order will be to increase substantially the Company's cost of nuclear fuel until the disputes under the contracts are resolved.

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 1960s and the acquisition and operation of certain coal and transportation properties. The staff has expressed the view, with which the Company and other members of the System disagree, that SEC authorization should have been obtained prior to certain of the transactions.

The staff did not act upon an application filed with the SEC seeking after-the-fact approval, if required, of the transactions in question. Instead, the staff advised the System companies that the SEC had authorized a civil injunctive action against the companies in which violations of the Public Utility Holding Company Act of 1935 (with respect to non-utility business) would be alleged. Efforts are under way to negotiate a judicially supervised settlement of the matter.

In 1977, a shareowner of AEP commenced an action in the Supreme Court of the State of New York, allegedly as a derivative action on behalf of AEP and the Generating Subsidiary, naming as defendants AEP, the Generating Subsidiary and directors of AEP. The complaint refers to the SEC investigation described above and seeks recovery from the individual defendants of alleged losses to the System of at least $11,000,000.

In 1976 a cable-television organization filed an antitrust suit 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. Basically, this suit stems from the unwillingness of the cable-television companies to pay what the Company believes to be a fair charge for their use of its poles.

In 1974 three customers of the Company challenged the validity of Indiana's fuel-adjustment clause and sought recovery of $75,000,000 which the plaintiffs claimed had been collected illegally via the fuel-adjustment clause. A state court dismissed the action on the grounds that the matter was within the primary jurisdiction of the Public Service Commission, not the courts. The plaintiffs' appeal of the dismissal is pending before the Indiana Court of Appeals.

Although unable to predict the outcome of the above actions, the Company believes, based upon opinions of its counsel and management's present knowledge, that the ultimate disposition of these matters will not result in any material adverse effect on the Company's financial position and operations.

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.

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 modi-

fications to increase the present spent fuel storage capacity of the nuclear plant to permit normal operations through the late 1980s, 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. Effective August 1, 1977, 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 for each reactor owned (subject to a maximum of $10,000,000 in any year 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. In a U.S. District Court decision, in a case to which the companies are not a party, the $560,000,000 limitation of liability provision was declared unconstitutional. That decision has been appealed to the U.S. Supreme Court.

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.

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), formerly the Energy Research and Development Administration, with the power requirements of its plant near Portsmouth, Ohio. In 1977, the DOE power agreement was extended through March 31, 1979. The agreement provides for future increases in the DOE contract demand and for decreases upon notification. The proceeds from the sale of power to DOE and from sales of available power to the group of utility participants are designed to be sufficient for OVEC to meet its operating expenses and fixed costs, including amortization of long-term debt capital (balance approximately $62,000,000 as of December 31, 1977), over a period ending on January 1, 1982, and to provide 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 construction budget of the Company and the Generating Subsidiary for the year 1978 is estimated at $249,000,000 and, in connection therewith, commitments have been made.

11. Leases:

The Company, as part of its operations, leases property, plant and equipment under leases ranging in length from 2 to 35 years. Most of the leases require the Company to pay related property taxes, maintenance costs, and other costs of operation. The Company expects that in the normal course of business, leases will generally be renewed or replaced by other leases.

Total rental expense charged directly to income was approximately $26,000,000 for 1977 and $25,200,000 for 1976. In addition, approximately $1,600,000 and $1,700,000 were charged to clearing and other accounts in the respective years; parts of such amounts were charged to income.

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

Description	December 31, 1977	December 31, 1976
	(In Thousands)	
Nuclear Fuel	$132,400	$42,800
Coal-Mining and Coal-Transportation Equipment	13,400	13,700
Real Estate	12,700	12,700
Electric Distribution System Property	12,500	12,500
Other	—	900
	171,000	82,600
Less Accumulated Provision for Amortization	48,000	33,500
Net Properties under Capital Leases	$123,000	$49,100
Obligations under Capital Leases (a)	$126,900	$52,000

(a) Including an estimated $38,900,000 and $13,800,000, respectively, due within one year.

Had capital leases been capitalized, an additional net expense estimated at $1,000,000 for 1977 and 1976 (without regard to possible effects of income taxes) would have been recorded.

The above 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.

Future minimum lease payments, by year and in the aggregate, under the Company's capital leases and noncancelable operating leases consisted of the following at December 31, 1977:

	Capital Leases	Operating Leases
	(In Thousands)	
1978	$ 6,600	$ 7,000
1979	6,400	6,700
1980	6,400	6,300
1981	6,300	5,900
1982	6,200	5,700
1983-87	30,900	26,600
1988-92	22,400	22,700
1993-97	13,800	16,100
After 1997	26,300	900
Total Future Minimum Lease Payments	125,300	$97,900
Less Estimated Interest Element Included Therein (a)	91,100	
Estimated Present Value of Future Minimum Lease Payments	$ 34,200	

(a) Interest rates used range from 4.9% to 11.9%.

The amounts above concerning future lease payments exclude leases of nuclear fuel. Such rentals comprise the unamortized balance of the lessor's cost (approximately $92,700,000 at December 31, 1977 and $15,900,000 at December 31, 1976), less salvage value, if any, to be paid to approximately August 1981 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.

The greatest part of the rentals is under leases having purchase options or renewal options for substantially all of the economic lives of the properties.

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)		
1977(a)			
Mar. 31	$128,258	$31,821	$23,191
June 30	118,070	30,698	22,871
Sep. 30	133,016	33,812	25,817
Dec. 31	133,480	34,069	25,241
1976(b)			
Mar. 31	107,613	25,227	12,510
June 30	98,619	19,666	8,066
Sep. 30	99,049	24,947	13,350
Dec. 31	110,912	30,976	19,948

(a) Amounts for 1977 differ from information available in quarterly reports due to the restatement referred to in Note 2.

(b) As restated (see Note 2). Amounts for 1976 were originally reported in the 1976 annual report to shareowners as follows:

Mar. 31	$107,899	$25,349	$12,698
June 30	98,892	19,778	8,251
Sep. 30	99,522	25,173	13,656
Dec. 31	111,235	31,123	20,188

13. Unaudited Replacement-Cost Information:

Estimated replacement cost and related amounts pertaining to depreciation, as of and for the years ended December 31, 1977 and 1976, 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 1977 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 1977.

Directors

Frank N. Bien
Lawrence R. Brunke (a)
Ralph J. Byler (b)
E. E. Clapper (c)
Herbert B. Cohn (e)
Richard E. Disbrow (d)
J. Lee Flanagan
E. W. Hermansen (d)
G. E. LeMasters
Richard C. Menge
George V. Patterson (c)
J. F. Stark
John Tillinghast (f)
W. S. White, Jr.
Robert O. Whitman

Officers

W. S. White, Jr.
President

J. F. Stark
Executive Vice President

Frank N. Bien
Vice President

Herbert B. Cohn (e)
Vice President

Richard E. Disbrow (d)
Vice President

A. Joseph Dowd (f)
Vice President

Gerald P. Maloney
Vice President

Richard C. Menge
Vice President

George V. Patterson (c)
Vice President

John Tillinghast
Vice President

Robert O. Whitman
Treasurer

John R. Burton
Secretary

Peter R. Steenland (g)
Asst. Vice President

H. D. Anderson, Jr.
Asst. Secretary and
Asst. Treasurer

Allen H. Stuhlmann
Asst. Secretary and
Asst. Treasurer

John F. Di Lorenzo, Jr. (h)
Assistant Secretary

A. Joseph Dowd (e)
Assistant Secretary

Cedric L. Mast
Assistant Secretary

William E. Olson
Assistant Secretary

Peter J. DeMaria
Assistant Treasurer

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

(a) Elected: March 1, 1977
(b) Resigned: March 1, 1977
(c) Resigned: August 1, 1977
(d) Elected: August 1, 1977
(e) Resigned: October 1, 1977
(f) Elected: October 1, 1977
(g) Resigned: April 27, 1977
(h) Elected: May 26, 1977

Operating Statistics and Balance Sheet Data

	Year Ended December 31,				
	1977	1976	1975	1974	1973
OPERATING STATISTICS					
ELECTRIC OPERATING REVENUES (Thousands) (a):					
From Kilowatt-hour Sales (b):					
Residential—without Electric Heating	$ 90,833	$ 71,888	$ 69,438	$ 53,265	$ 46,986
Residential—with Electric Heating	46,948	37,447	33,493	27,080	20,238
Residential—Total	137,781	109,335	102,931	80,345	67,224
Commercial	92,312	72,527	69,176	50,554	44,780
Industrial	109,357	80,233	75,167	63,314	54,649
Municipalities	44,091	26,841	22,551	23,493	18,429
Cooperatives	15,619	10,491	9,178	7,548	5,680
Other Electric Utilities	103,517	110,382	75,887	55,994	39,766
Miscellaneous	6,062	2,573	4,650	3,389	3,042
Total from Kilowatt-hour Sales	508,739	412,382	359,540	284,637	233,570
Other Operating Revenues	4,085	3,811	3,815	2,969	1,765
Total Electric Operating Revenues	$512,824	$416,193	$363,355	$287,606	$235,335
SOURCE AND DISPOSAL OF ENERGY: (Millions of Kilowatt-hours)					
Net Generated—Steam (c):					
Fossil Fuel	7,317	7,701	7,255	8,815	9,893
Nuclear Fuel	4,786	6,809	4,458	—	—
Net Generated—Hydro	68	72	89	73	90
Net Generated—Other	—	—	—	14	17
Purchased	182	232	368	694	872
Net Interchange	7,922	6,523	6,778	8,451	7,578
Total Available	20,275	21,337	18,948	18,047	18,450
Less: Losses, Company Use, etc.	1,270	1,290	1,305	1,335	1,301
Net Sources	19,005	20,047	17,643	16,712	17,149
Kilowatt-hour Sales (Millions):					
Residential—without Electric Heating	2,456	2,384	2,374	2,181	2,208
Residential—with Electric Heating	1,605	1,577	1,451	1,413	1,261
Residential—Total	4,061	3,961	3,825	3,594	3,469
Commercial	2,671	2,579	2,464	2,192	2,203
Industrial	4,473	4,209	3,835	4,134	4,324
Municipalities	1,642	1,527	1,522	1,847	1,867
Cooperatives	786	754	690	651	605
Other Electric Utilities	5,195	6,849	5,152	4,166	4,560
Miscellaneous	177	168	155	128	121
Total Kilowatt-hour Sales	19,005	20,047	17,643	16,712	17,149

(a) Restated for the years 1976, 1975, 1974 and 1973.
(b) Beginning in 1974 includes unbilled revenue adjustment.
(c) Includes data with respect to the Generating Subsidiary.

	Year Ended December 31,				
	1977	1976	1975	1974	1973
ANNUAL FUEL COST (¢ per Million Btu)	59.12	46.47	56.66	69.51	37.97
RESIDENTIAL SERVICE—AVERAGES:					
Annual Kwh Use per Customer—					
Total	10,641	10,439	10,305	10,525	10,268
With Electric Heating	22,830	23,200	22,153	23,239	22,737
Annual Electric Bill—					
Total	$ 361.04	$ 288.11	$ 277.31	$ 233.81	$ 199.00
With Electric Heating	$ 667.93	$ 550.63	$ 511.34	$ 439.35	$ 364.98
Price per Kwh (Cents)—					
Total	3.39	2.76	2.69	2.22	1.94
With Electric Heating	2.93	2.37	2.31	1.89	1.61

NUMBER OF ELECTRIC CUSTOMERS AT END OF YEAR:					
Residential—without Electric Heating	313,085	312,211	310,953	281,904	282,078
Residential—with Electric Heating	72,059	69,237	66,812	64,233	58,844
Residential Total	385,144	381,448	377,765	346,137	340,922
Commercial	41,907	41,703	41,456	37,593	36,949
Industrial	2,500	2,452	2,418	2,416	2,367
Municipalities	23	23	22	23	22
Cooperatives (Delivery Points)	61	59	58	58	56
Other Electric Utilities	16	15	18	6	8
Miscellaneous	1,304	1,280	1,259	1,167	1,156
Total Electric Customers	430,955	426,980	422,996	387,400	381,480

BALANCE SHEET DATA (Millions)					
Utility Plant	$ 2,107	$ 1,933	$ 1,771	$ 1,630	$ 1,457
Accum. Prov. for Depreciation	359	317	275	249	244
Net Utility Plant	1,748	1,616	1,496	1,381	1,213
Total Assets	2,123	1,914	1,764	1,545	1,362
Long-term Debt*	1,038	914	895	739	711
Cumulative Preferred Stock and Premium	187	147	147	117	117
Common Stock and Other Paid-in Capital	467	409	367	318	288
Retained Earnings	105	76	80	71	78

* Including Portion Due Within One Year.

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

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

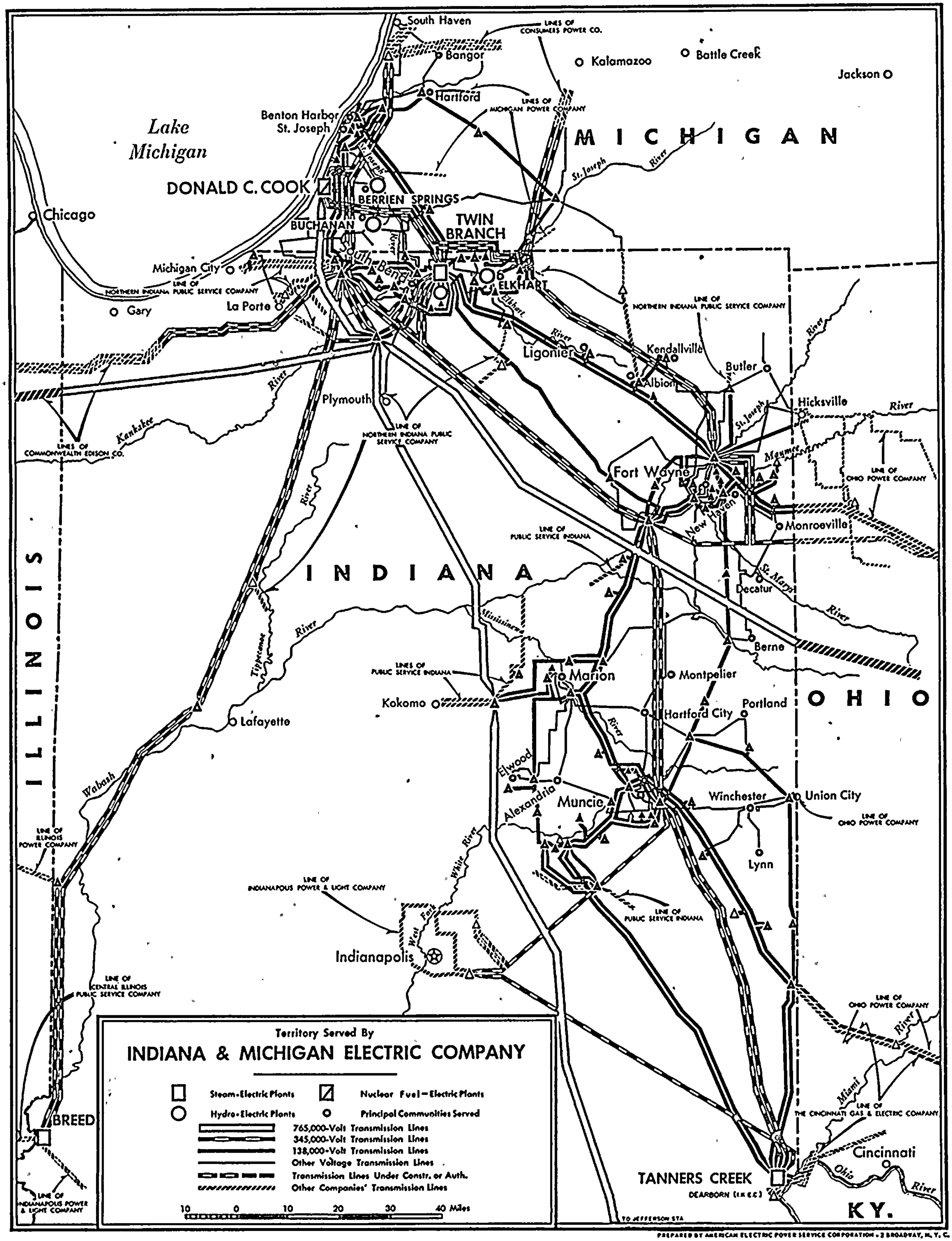
Transfer Agent of Cumulative Preferred Stock

Morgan Guaranty Trust Company of New York
30 West Broadway, New York, N. Y. 10007

Registrar of Cumulative Preferred Stock

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

This Annual Report has been prepared for the purpose of providing financial and statistical information concerning the Company, and not in connection with any sale, offer for sale or solicitation of an offer to buy any securities.



INDIANA & MICHIGAN ELECTRIC COMPANY AND GENERATING SUBSIDIARY