# AEP Texas Central Company

2007 Second Quarter Report

Consolidated Financial Statements

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

| Term | Meaning |
|---|---|
| ADITC | Accumulated Deferred Investment Tax Credits. |
| AEP or Parent | American Electric Power Company, Inc. |
| AEP System or the System | American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries. |
| AEP East companies | APCo, CSPCo, I&M, KPCo and OPCo. |
| AEP West companies | PSO, SWEPCo, TCC and TNC. |
| AEPSC | American Electric Power Service Corporation, a service subsidiary providing management and professional services to AEP and its subsidiaries. |
| ALJ | Administrative Law Judge. |
| APCo | Appalachian Power Company, an AEP electric utility subsidiary. |
| CAA | Clean Air Act. |
| CSPCo | Columbus Southern Power Company, an AEP electric utility subsidiary. |
| CSW | Central and South West Corporation, a subsidiary of AEP (Effective January 21, 2003, the legal name of Central and South West Corporation was changed to AEP Utilities, Inc.). |
| CTC | Competition Transition Charge. |
| EDFIT | Excess Deferred Federal Income Taxes. |
| EITF | Financial Accounting Standards Board's Emerging Issues Task Force. |
| ERCOT | Electric Reliability Council of Texas. |
| FASB | Financial Accounting Standards Board. |
| Federal EPA | United States Environmental Protection Agency. |
| FERC | Federal Energy Regulatory Commission. |
| FIN | FASB Interpretation No. |
| FIN 48 | FIN 48, "Accounting for Uncertainty in Income Taxes" and FASB Staff Position FIN 48-1 "Definition of *Settlement* in FASB Interpretation No. 48." |
| GAAP | Accounting Principles Generally Accepted in the United States of America. |
| IRS | Internal Revenue Service. |
| I&M | Indiana Michigan Power Company, an AEP electric utility subsidiary. |
| KPCo | Kentucky Power Company, an AEP electric utility subsidiary. |
| MTM | Mark-to-Market. |
| OPCo | Ohio Power Company, an AEP electric utility subsidiary. |
| PSO | Public Service Company of Oklahoma, an AEP electric utility subsidiary. |
| PUCT | Public Utility Commission of Texas. |
| REP | Texas Retail Electric Provider. |
| Risk Management Contracts | Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges. |
| RTO | Regional Transmission Organization. |
| SEC | United States Securities and Exchange Commission. |
| SFAS | Statement of Financial Accounting Standards issued by the Financial Accounting Standards Board. |
| SFAS 71 | Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation." |
| SFAS 133 | Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." |
| SFAS 157 | Statement of Financial Accounting Standards No. 157, "Fair Value Measurements." |
| SFAS 158 | Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." |
| SFAS 159 | Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." |
| SIA | System Integration Agreement. |
| SWEPCo | Southwestern Electric Power Company, an AEP electric utility subsidiary. |

| Term | Meaning |
| --- | --- |
| TCC | AEP Texas Central Company, an AEP electric utility subsidiary. |
| Texas Restructuring Legislation | Legislation enacted in 1999 to restructure the electric utility industry in Texas. |
| TNC | AEP Texas North Company, an AEP electric utility subsidiary. |
| True-up Proceeding | A filing made under the Texas Restructuring Legislation to finalize the amount of stranded costs and other true-up items and the recovery of such amounts. |
| Utility Money Pool | AEP System's Utility Money Pool. |

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**
**For the Three and Six Months Ended June 30, 2007 and 2006**
**(in thousands)**
**(Unaudited)**

| | Three Months Ended 2007 | Three Months Ended 2006 | Six Months Ended 2007 | Six Months Ended 2006 |
|---|---|---|---|---|
| **REVENUES** | | | | |
| Electric Generation, Transmission and Distribution | $ 194,327 | $ 149,688 | $ 366,314 | $ 272,899 |
| Sales to AEP Affiliates | 1,353 | 1,546 | 2,483 | 3,144 |
| Other | 7,063 | 10,255 | 10,877 | 20,734 |
| **TOTAL** | 202,743 | 161,489 | 379,674 | 296,777 |
| **EXPENSES** | | | | |
| Fuel and Other Consumables Used for Electric Generation | - | 996 | 825 | 2,722 |
| Purchased Electricity for Resale | 702 | 1,152 | 2,211 | 2,832 |
| Other Operation | 57,470 | 63,236 | 114,866 | 122,138 |
| Maintenance | 8,746 | 8,787 | 16,531 | 16,576 |
| Depreciation and Amortization | 56,652 | 37,236 | 102,672 | 70,596 |
| Taxes Other Than Income Taxes | 19,125 | 16,671 | 37,649 | 37,034 |
| **TOTAL** | 142,695 | 128,078 | 274,754 | 251,898 |
| **OPERATING INCOME** | 60,048 | 33,411 | 104,920 | 44,879 |
| **Other Income (Expense):** | | | | |
| Interest Income | 3,987 | 527 | 8,946 | 1,032 |
| Carrying Costs Income | - | 20,413 | - | 39,836 |
| Allowance for Equity Funds Used During Construction | 814 | 631 | 1,973 | 1,004 |
| Interest Expense | (46,337) | (29,882) | (92,358) | (56,655) |
| **INCOME BEFORE INCOME TAXES** | 18,512 | 25,100 | 23,481 | 30,096 |
| Income Tax Expense | 6,388 | 8,125 | 7,819 | 9,348 |
| **NET INCOME** | 12,124 | 16,975 | 15,662 | 20,748 |
| Preferred Stock Dividend Requirements | 60 | 61 | 120 | 121 |
| **EARNINGS APPLICABLE TO COMMON STOCK** | 12,064 | 16,914 | 15,542 | 20,627 |

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

*See Condensed Notes to Condensed Consolidated Financial Statements.*

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY AND COMPREHENSIVE INCOME (LOSS)**
**For the Six Months Ended June 30, 2007 and 2006**
**(in thousands)**
**(Unaudited)**

| | Common Stock | Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|---|---|---|---|---|---|
| **DECEMBER 31, 2005** | $ 55,292 | $ 132,606 | $ 760,884 | $ (1,152) | $ 947,630 |
| Preferred Stock Dividends | | | (121) | | (121) |
| **TOTAL** | | | | | 947,509 |
| **COMPREHENSIVE INCOME** | | | | | |
| **Other Comprehensive Income, Net of Taxes:** | | | | | |
| Cash Flow Hedges, Net of Tax of $121 | | | | 224 | 224 |
| **NET INCOME** | | | 20,748 | | 20,748 |
| **TOTAL COMPREHENSIVE INCOME** | | | | | 20,972 |
| **JUNE 30, 2006** | $ 55,292 | $ 132,606 | $ 781,511 | $ (928) | $ 968,481 |
| **DECEMBER 31, 2006** | $ 55,292 | $ 132,606 | $ 217,218 | $ - | $ 405,116 |
| FIN 48 Adoption, Net of Tax | | | (2,187) | | (2,187) |
| Preferred Stock Dividends | | | (120) | | (120) |
| **TOTAL** | | | | | 402,809 |
| **COMPREHENSIVE INCOME** | | | | | |
| **NET INCOME** | | | 15,662 | | 15,662 |
| **TOTAL COMPREHENSIVE INCOME** | | | | | 15,662 |
| **JUNE 30, 2007** | $ 55,292 | $ 132,606 | $ 230,573 | $ - | $ 418,471 |

*See Condensed Notes to Condensed Consolidated Financial Statements.*

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**ASSETS**
**June 30, 2007 and December 31, 2006**
**(in thousands)**
**(Unaudited)**

| | 2007 | 2006 |
|---|---|---|
| **CURRENT ASSETS** | | |
| Cash and Cash Equivalents | $ 52 | $ 779 |
| Other Cash Deposits | 195,652 | 104,203 |
| Advances to Affiliates | 141,670 | 394,004 |
| Accounts Receivable: | | |
| Customers | 55,587 | 31,215 |
| Affiliated Companies | 6,355 | 8,613 |
| Accrued Unbilled Revenues | 33,913 | 10,093 |
| Allowance for Uncollectible Accounts | (36) | (49) |
| Total Accounts Receivable | 95,819 | 49,872 |
| Materials and Supplies | 30,358 | 28,347 |
| Prepayments and Other | 24,399 | 5,672 |
| **TOTAL** | 487,950 | 582,877 |
| **PROPERTY, PLANT AND EQUIPMENT** | | |
| Electric: | | |
| Transmission | 982,092 | 904,527 |
| Distribution | 1,625,010 | 1,579,498 |
| Other | 227,251 | 220,028 |
| Construction Work in Progress | 119,539 | 165,979 |
| **Total** | 2,953,892 | 2,870,032 |
| Accumulated Depreciation and Amortization | 638,489 | 630,239 |
| **TOTAL - NET** | 2,315,403 | 2,239,793 |
| **OTHER NONCURRENT ASSETS** | | |
| Regulatory Assets | 187,487 | 193,111 |
| Securitized Transition Assets | 2,115,511 | 2,158,408 |
| Employee Benefits and Pension Assets | 35,495 | 35,574 |
| Deferred Charges and Other | 61,859 | 69,493 |
| **TOTAL** | 2,400,352 | 2,456,586 |
| **Assets Held for Sale – Texas Generation Plant** | - | 44,475 |
| **TOTAL ASSETS** | $ 5,203,705 | $ 5,323,731 |

*See Condensed Notes to Condensed Consolidated Financial Statements.*

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**LIABILITIES AND SHAREHOLDERS' EQUITY**
**June 30, 2007 and December 31, 2006**
**(Unaudited)**

| | 2007 | 2006 |
|---|---|---|
| | **(in thousands)** | |
| **CURRENT LIABILITIES** | | |
| Accounts Payable: | | |
| General | $ 18,743 | $ 26,934 |
| Affiliated Companies | 17,353 | 21,234 |
| Long-term Debt Due Within One Year – Nonaffiliated | 144,837 | 78,227 |
| Customer Deposits | 24,231 | 18,742 |
| Accrued Taxes | 33,454 | 74,499 |
| Accrued Interest | 91,808 | 44,712 |
| Other | 26,255 | 34,762 |
| **TOTAL** | 356,681 | 299,110 |
| | | |
| **NONCURRENT LIABILITIES** | | |
| Long-term Debt – Nonaffiliated | 2,845,059 | 2,937,387 |
| Deferred Income Taxes | 1,044,234 | 1,034,123 |
| Regulatory Liabilities and Deferred Investment Tax Credits | 476,067 | 598,027 |
| Deferred Credits and Other | 57,272 | 44,047 |
| **TOTAL** | 4,422,632 | 4,613,584 |
| | | |
| **TOTAL LIABILITIES** | 4,779,313 | 4,912,694 |
| | | |
| Cumulative Preferred Stock Not Subject to Mandatory Redemption | 5,921 | 5,921 |
| | | |
| Commitments and Contingencies (Note 4) | | |
| | | |
| **COMMON SHAREHOLDER'S EQUITY** | | |
| Common Stock – Par Value – $25 Per Share: | | |
| Authorized – 12,000,000 Shares | | |
| Outstanding – 2,211,678 Shares | 55,292 | 55,292 |
| Paid-in Capital | 132,606 | 132,606 |
| Retained Earnings | 230,573 | 217,218 |
| **TOTAL** | 418,471 | 405,116 |
| | | |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | $ 5,203,705 | $ 5,323,731 |

*See Condensed Notes to Condensed Consolidated Financial Statements.*

## AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
## For the Six Months Ended June 30, 2007 and 2006
## (in thousands)
## (Unaudited)

| | 2007 | 2006 |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| **Net Income** | $ 15,662 | $ 20,748 |
| **Adjustments for Noncash Items:** | | |
| Depreciation and Amortization | 102,672 | 70,596 |
| Deferred Income Taxes | 17,578 | 6,095 |
| Carrying Costs on Stranded Cost Recovery | - | (39,836) |
| Mark-to-Market of Risk Management Contracts | - | 5,426 |
| Fuel Over/Under Recovery, Net | (147,147) | 3,908 |
| Deferred Property Taxes | (13,376) | (16,592) |
| Change in Other Noncurrent Assets | (12,564) | (15,640) |
| Change in Other Noncurrent Liabilities | 6,959 | 11,014 |
| **Changes in Certain Components of Working Capital:** | | |
| Accounts Receivable, Net | (45,947) | 164,453 |
| Fuel, Materials and Supplies | (2,376) | (7,652) |
| Accounts Payable | (3,386) | (102,422) |
| Customer Deposits | 5,489 | (6,876) |
| Accrued Taxes, Net | (51,810) | (9,596) |
| Accrued Interest | 45,202 | (730) |
| Other Current Assets | (1,464) | 9,924 |
| Other Current Liabilities | (8,538) | (12,444) |
| **Net Cash Flows From (Used For) Operating Activities** | (93,046) | 80,376 |
| **INVESTING ACTIVITIES** | | |
| Construction Expenditures | (109,250) | (136,475) |
| Change in Other Cash Deposits, Net | (69,898) | 9,340 |
| Change in Advances to Affiliates, Net | 252,334 | - |
| Proceeds from Sale of Assets | 45,837 | 7,048 |
| **Net Cash Flows From (Used For) Investing Activities** | 119,023 | (120,087) |
| **FINANCING ACTIVITIES** | | |
| Issuance of Long-term Debt – Affiliated | - | 125,000 |
| Issuance of Long-term Debt – Nonaffiliated | 6,247 | - |
| Change in Advances from Affiliates, Net | - | (54,154) |
| Retirement of Long-term Debt – Nonaffiliated | (32,125) | (30,641) |
| Retirement of Preferred Stock | - | (1) |
| Principal Payments for Capital Lease Obligations | (706) | (372) |
| Dividends Paid on Cumulative Preferred Stock | (120) | (121) |
| **Net Cash From (Used For) Financing Activities** | (26,704) | 39,711 |
| **Net Decrease in Cash and Cash Equivalents** | (727) | - |
| **Cash and Cash Equivalents at Beginning of Period** | 779 | - |
| **Cash and Cash Equivalents at End of Period** | $ 52 | $ - |
| **SUPPLEMENTARY INFORMATION** | | |
| Cash Paid for Interest, Net of Capitalized Amounts | $ 33,769 | $ 51,577 |
| Net Cash Paid for Income Taxes | 40,816 | 13,440 |
| Noncash Acquisitions Under Capital Leases | 554 | 2,145 |
| Construction Expenditures Included in Accounts Payable at June 30, | 7,816 | 14,840 |

*See Condensed Notes to Condensed Consolidated Financial Statements.*

## CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Significant Accounting Matters
2. New Accounting Pronouncements
3. Rate Matters
4. Commitments, Guarantees and Contingencies
5. Disposition and Assets Held for Sale
6. Benefit Plans
7. Income Taxes
8. Financing Activities

## 1. SIGNIFICANT ACCOUNTING MATTERS

***General***

The accompanying unaudited condensed financial statements and footnotes were prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, they do not include all the information and footnotes required by GAAP for complete financial statements.

In the opinion of management, the unaudited interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the results of operations, financial position and cash flows for the interim periods. The results of operations for the six months ended June 30, 2007 are not necessarily indicative of results that may be expected for the year ending December 31, 2007. The accompanying condensed financial statements are unaudited and should be read in conjunction with the audited 2006 financial statements and notes thereto, which are included in TCC's 2006 Annual Report as filed with the SEC on February 28, 2007.

***Revenue Recognition***

*Traditional Electricity Supply and Delivery Activities*

TCC recognizes revenues from wholesale electricity supply sales and electricity transmission and distribution delivery services. TCC recognizes the revenues in the financial statements upon delivery of the energy to the customer and include unbilled as well as billed amounts. In general, TCC records expenses upon receipt of purchased electricity and when expenses are incurred. TCC records third party purchases as non-trading and these purchases are accounted for on a gross basis as Purchased Electricity for Resale.

***Reclassifications***

Certain prior period financial statement items have been reclassified to conform to current period presentation. These revisions had no impact on TCC's previously reported results of operations or changes in shareholders' equity.

## 2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of exposure drafts or final pronouncements, management thoroughly reviews the new accounting literature to determine the relevance, if any, to TCC's business. The following represents a summary of new pronouncements issued or implemented in 2007 and standards issued but not implemented that management has determined relate to TCC's operations.

***SFAS 157 "Fair Value Measurements" (SFAS 157)***

In September 2006, the FASB issued SFAS 157, enhancing existing guidance for fair value measurement of assets and liabilities and instruments measured at fair value that are classified in shareholders' equity. The statement defines fair value, establishes a fair value measurement framework and expands fair value disclosures. It emphasizes that fair value is market-based with the highest measurement hierarchy being market prices in active markets. The standard requires fair value measurements be disclosed by hierarchy level and an entity include its own credit standing in the measurement of its liabilities and modifies the transaction price presumption.

SFAS 157 is effective for interim and annual periods in fiscal years beginning after November 15, 2007. Management expects that the adoption of this standard will impact MTM valuations of certain contracts, but is unable to quantify the effect. Although the statement is applied prospectively upon adoption, the effect of certain transactions is applied retrospectively as of the beginning of the fiscal year of application, with a cumulative effect adjustment to the appropriate balance sheet items. TCC will adopt SFAS 157 effective January 1, 2008.

***SFAS 159 "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159)***

In February 2007, the FASB issued SFAS 159, permitting entities to choose to measure many financial instruments and certain other items at fair value. The standard also establishes presentation and disclosure requirements designed to facilitate comparison between entities that choose different measurement attributes for similar types of assets and liabilities.

SFAS 159 is effective for annual periods in fiscal years beginning after November 15, 2007. If the fair value option is elected, the effect of the first remeasurement to fair value is reported as a cumulative effect adjustment to the opening balance of retained earnings. In the event TCC elects the fair value option promulgated by this standard, the valuations of certain assets and liabilities may be impacted. The statement is applied prospectively upon adoption. TCC will adopt SFAS 159 effective January 1, 2008. Management expects the adoption of this standard to have an immaterial impact on the financial statements.

***EITF Issue No. 06-11 "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards" (EITF 06-11)***

In June 2007, the FASB ratified the EITF consensus on the treatment of income tax benefits of dividends on employee share-based compensation. The issue is how a company should recognize the income tax benefit received on dividends that are paid to employees holding equity-classified nonvested shares, equity-classified nonvested share units, or equity-classified outstanding share options and charged to retained earnings under SFAS 123R, "Share-Based Payments." Under EITF 06-11, a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity-classified nonvested equity shares, nonvested equity share units, and outstanding equity share options should be recognized as an increase to additional paid-in capital.

EITF 06-11 will be applied prospectively to the income tax benefits of dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after September 15, 2007. Management expects that the adoption of this standard will have an immaterial effect on the financial statements. TCC will adopt EITF 06-11 effective January 1, 2008.

***FIN 48 "Accounting for Uncertainty in Income Taxes" and FASB Staff Position FIN 48-1 "Definition of Settlement in FASB Interpretation No. 48" (FIN 48)***

In July 2006, the FASB issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" and in May 2007, the FASB issued FASB Staff Position FIN 48-1 "Definition of *Settlement* in FASB Interpretation No. 48." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements by prescribing a recognition threshold (whether a tax position is more likely than not to be sustained) without which, the benefit of that position is not recognized in the financial statements. It requires a measurement determination for recognized tax positions based on the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

FIN 48 requires that the cumulative effect of applying this interpretation be reported and disclosed as an adjustment to the opening balance of retained earnings for that fiscal year and presented separately. TCC adopted FIN 48 effective January 1, 2007. The impact of this interpretation was an unfavorable adjustment to retained earnings of $2,187,000.

***FIN 39-1 "Amendment of FASB Interpretation No. 39" (FIN 39-1)***

In April 2007, the FASB issued FIN 39-1. It amends FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts" by replacing the interpretation's definition of contracts with the definition of derivative instruments per SFAS 133. It also requires entities that offset fair values of derivatives with the same party under a netting agreement to also net the fair values (or approximate fair values) of related cash collateral. The entities must disclose whether or not they offset fair values of derivatives and related cash collateral and amounts recognized for cash collateral payables and receivables at the end of each reporting period.

FIN 39-1 is effective for fiscal years beginning after November 15, 2007. Management expects this standard to change the method of netting certain balance sheet amounts but is unable to quantify the effect. It requires retrospective application as a change in accounting principle for all periods presented. TCC will adopt FIN 39-1 effective January 1, 2008.

***Future Accounting Changes***

The FASB's standard-setting process is ongoing and until new standards have been finalized and issued by FASB, management cannot determine the impact on the reporting of operations and financial position that may result from any such future changes. The FASB is currently working on several projects including business combinations, revenue recognition, liabilities and equity, derivatives disclosures, emission allowances, leases, insurance, subsequent events and related tax impacts. Management also expects to see more FASB projects as a result of its desire to converge International Accounting Standards with GAAP. The ultimate pronouncements resulting from these and future projects could have an impact on future results of operations and financial position.

## 3. RATE MATTERS

As discussed in TCC's 2006 Annual Report, TCC is involved in rate and regulatory proceedings at the FERC and the PUCT. The Rate Matters note within the 2006 Annual Report should be read in conjunction with this report to gain a complete understanding of material rate matters still pending that could impact results of operations, cash flows and possibly financial condition. The following discusses ratemaking developments in 2007 and updates the 2006 Annual Report.

### TCC TEXAS RESTRUCTURING

***Texas District Court Appeal Proceedings***

TCC recovered its net recoverable stranded generation costs through a securitization financing and is refunding its net other true-up items through a CTC rate rider credit under 2006 PUCT orders. TCC appealed the PUCT stranded costs true-up orders seeking relief in both state and federal court on the grounds that certain aspects of the orders are contrary to the Texas Restructuring Legislation, PUCT rulemakings and federal law and fail to fully compensate TCC for its net stranded cost and other true-up items. The significant items appealed by TCC are:

- The PUCT ruling that TCC did not comply with the Texas Restructuring Legislation and PUCT rules regarding the required auction of 15% of its Texas jurisdictional installed capacity, which led to a significant disallowance of capacity auction true-up revenues,
- The PUCT ruling that TCC acted in a manner that was commercially unreasonable, because TCC failed to determine a minimum price at which it would reject bids for the sale of its nuclear generating plant and it bundled out-of-the-money gas units with the sale of its coal unit, which led to the disallowance of a significant portion of TCC's net stranded generation plant cost, and
- The two federal matters regarding the allocation of off-system sales related to fuel recoveries and the potential tax normalization violation. See "Deferred Investment Tax Credits and Excess Deferred Federal Income Taxes" and "Deferred Fuel " sections below.

Municipal customers and other intervenors also appealed the PUCT true-up orders seeking to further reduce TCC's true-up recoveries. In March 2007, the Texas District Court judge hearing the various appeals affirmed the PUCT's April 4, 2006 final true-up order for TCC with two significant exceptions. The judge determined that the PUCT erred by applying an invalidated rule to determine the carrying cost rate for the true-up of stranded costs. However, the District Court did not rule that the carrying cost rate was inappropriate. If the District Court's ruling on the carrying cost rate is ultimately upheld on appeal and remanded to the PUCT for reconsideration, the PUCT could either confirm the existing weighted average carrying cost (WACC) rate or determine a new rate. If the PUCT reduces the rate, it could result in a material adverse change to TCC's recoverable carrying costs, results of operations, cash flows and financial condition.

The District Court judge also determined the PUCT improperly reduced TCC's net stranded plant costs for commercial unreasonableness. If upheld on appeal, this ruling could have a materially favorable effect on TCC's results of operations and cash flows.

TCC, the PUCT and intervenors appealed the District Court rulings to the Court of Appeals. Management cannot predict the outcome of these proceedings. If TCC ultimately succeeds in its appeals, it could have a favorable effect on future results of operations, cash flows and financial condition. If municipal customers and other intervenors succeed in their appeals, or if TCC has a tax normalization violation, it could have a substantial adverse effect on future results of operations, cash flows and financial condition.

## OTHER TEXAS RESTRUCTURING MATTERS

### *Deferred Investment Tax Credits and Excess Deferred Federal Income Taxes*

In TCC's 2006 true-up and securitization orders, the PUCT reduced net regulatory assets and the amount to be securitized by $51 million related to the present value of ADITC and by $10 million related to EDFIT associated with TCC's generation assets for a total reduction of $61 million.

TCC filed a request for a private letter ruling with the IRS in June 2005 regarding the permissibility under the IRS rules and regulations of the ADITC and EDFIT reduction proposed by the PUCT. The IRS issued its private letter ruling in May 2006, which stated that the PUCT's flow-through to customers of the present value of the ADITC and EDFIT benefits would result in a normalization violation. To address the matter and avoid a possible normalization violation, the PUCT agreed to allow TCC to defer an amount of the CTC refund totaling $103 million ($61 million in present value of ADITC and EDFIT associated with TCC's generation assets plus $42 million of related carrying costs) pending resolution of the normalization issue. If it is ultimately determined that a refund to customers through the true-up process of the ADITC and EDFIT is not a normalization violation, then TCC will be required to refund the $103 million, plus additional carrying costs adversely affecting future results of operations and cash flows. However, if such refund of ADITC and EDFIT is ultimately determined to cause a normalization violation, TCC anticipates it will be permitted to retain the $61 million present value of ADITC and EDFIT plus carrying costs, favorably impacting future results of operations and cash flows.

If a normalization violation occurs, it could result in TCC's repayment to the IRS of ADITC on all property, including transmission and distribution property, which approximates $104 million as of June 30, 2007, and a loss of TCC's right to claim accelerated tax depreciation in future tax returns. Tax counsel advised management that a normalization violation should not occur until all remedies under law have been exhausted and the tax benefits are returned to ratepayers under a nonappealable order. Management intends to continue its efforts to work with the PUCT to avoid a normalization violation that would adversely affect future results of operations and cash flows.

### *Deferred Fuel*

TCC's deferred fuel over-recovery regulatory liability is a component of the other true-up items net regulatory liability refunded through the CTC rate rider credit. In 2002, TCC filed with the PUCT seeking to reconcile fuel costs and establish its final deferred fuel balance. In its final fuel reconciliation order, the PUCT ordered a substantial reduction in TCC's recoverable fuel costs for, among other things, the reallocation of additional AEP System off-system sales margins to TCC under a FERC-approved tariff. TCC appealed the PUCT's rulings regarding a number of issues in the fuel order in state court and challenged the jurisdiction of the PUCT over the allocation of off-system sales margins in the federal court. Intervenors also appealed the PUCT's final fuel rulings in state court seeking to increase the various allowances.

In 2006, the Federal District Court issued an order precluding the PUCT from enforcing the off-system sales reallocation portion of its ruling in the final TCC fuel reconciliation proceeding. The Federal court ruled that the FERC, not the PUCT, has jurisdiction over the allocation. The PUCT appealed both Federal District Court decisions to the United States Court of Appeals. In April 2007, the PUCT petitioned the United States Supreme Court for a review of the Court of Appeals' order. If the PUCT's appeals are ultimately unsuccessful, TCC could record income of $16 million related to the reversal of the previously-recorded fuel over-recovery regulatory liabilities related to the reallocation of off-system sales margins to TCC.

If the PUCT is unsuccessful in the federal court system, it or another interested party may file a complaint at the FERC to address the allocation issue. If a complaint at the FERC results in the PUCT's decisions being adopted by the FERC, there could be an adverse effect on results of operations and cash flows. An unfavorable FERC ruling may result in a retroactive reallocation of off-system sales margins from AEP East companies to AEP West companies under the then-existing SIA allocation method. Although management cannot predict the ultimate outcome of this federal litigation, management believes that the allocations were in accordance with the then-existing FERC-approved SIA and that it should not be expected to reallocate additional off-system sales margins to the West companies including TCC.

In January 2007, TCC began refunding as part of the CTC rate rider credit, $149 million of its $165 million over-recovered deferred fuel regulatory liability. The remaining $16 million refund related to the favorable Federal District Court order has been deferred pending the outcome of the federal court appeal and would be subject to refund only upon a successful appeal by the PUCT.

***Excess Earnings***

In 2005, the Texas Court of Appeals issued a decision finding that the PUCT's prior order from the unbundled cost of service case requiring TCC to refund excess earnings prior to and outside of the true-up process was unlawful under the Texas Restructuring Legislation. TCC refunded $55 million of excess earnings, including interest, of which $30 million went to the affiliated REP. In November 2005, the PUCT filed a petition for review with the Supreme Court of Texas seeking reversal of the Texas Court of Appeals' decision. In June 2007, the Supreme Court of Texas declined the petition for review. Certain intervenors have contended in the stranded cost proceeding that a reduction to stranded cost is required, but a surcharge of unlawfully-refunded amounts is unnecessary. TCC believes it has properly reflected the effects of the Court of Appeals' ruling and the PUCT's rules on stranded costs. However, a ruling in favor of the intervenor's position could have a material adverse effect on future results of operations and cash flow.

***Oklaunion Refund***

In 2005, TCC filed a special request with the PUCT allowing TCC to file its true-up proceeding before it had completed the sale of its share of the Oklaunion power plant. TCC agreed to provide customers the net economic benefit related to its continued ownership of the Oklaunion power plant until the sale closed. TCC also agreed to reduce stranded costs in the event the Oklaunion power plant sales price increased. In June 2007, TCC filed with the PUCT reporting no change in the sales price and to include the net economic benefit from the operation of the Oklaunion power plant in the CTC credit rider. As of June 30, 2007, TCC has recorded a $3 million regulatory liability for the net economic benefit related to the operation of the Oklaunion power plant. Management is unable to predict the ultimate outcome of this filing. If the PUCT orders a refund greater than the $3 million recorded liability, it would have an adverse effect on future results of operations and cash flow.

***Energy Delivery Base Rate Filings***

TCC filed a base rate case seeking to increase transmission and distribution energy delivery services (wires) base rates in Texas. TCC requested an increase in annual base rates of $81 million. TCC's request includes a return on common equity of 11.25% and a favorable impact of an expiration of the CSW merger savings rate credits (merger credits). In March 2007, various intervenors and the PUCT staff filed their recommendations. Though the recommendations varied, the range of recommended increase was $8 million to $30 million. The recommended return on common equity ranged from 9.00% to 9.75%. In April 2007, TCC filed rebuttal testimony reducing its requested increase to $70 million including a reduced requested return on common equity of 10.75%.

Beginning in June 2007, TCC implemented an interim base rate increase of $50 million, subject to refund, in accordance with Texas law. In addition, TCC's merger credits were terminated in June 2007, which effectively increased base rates by $20 million on an annual basis. In June 2007, an ALJ issued an interim order affirming the termination of the merger credits. The PUCT affirmed the ALJ ruling. Management has evaluated its exposure to a future refund of revenues being collected, subject to refund, and believes it is recognizing a reasonable amount of such revenues. A decision from the PUCT is expected in the third quarter of 2007. Management is unable to predict the ultimate effect of this filing and any true-up of recognized revenues collected, subject to refund, on future results of operations, cash flows and financial condition.

## 4. COMMITMENTS, GUARANTEES AND CONTINGENCIES

TCC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation cannot be predicted. For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material adverse effect on the financial statements. The Commitments, Guarantees and Contingencies note within the 2006 Annual Report should be read in conjunction with this report.

### GUARANTEES

There are certain immaterial liabilities recorded for guarantees in accordance with FASB Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." There is no collateral held in relation to any guarantees. In the event any guarantee is drawn, there is no recourse to third parties.

#### *Indemnifications and Other Guarantees*

*Contracts*

TCC enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. Prior to June 30, 2007, TCC entered into sale agreements including indemnifications with a maximum exposure of $143 million related to the sale price of generation assets. See "Texas Plants – TCC Generation Assets" and "Texas Plants – Oklaunion Power Station" sections of Note 8 of the 2006 Annual Report. There are no material liabilities recorded for any indemnifications.

*Master Operating Lease*

TCC leases certain equipment under a master operating lease. Under the lease agreement, the lessor is guaranteed to receive up to 87% of the unamortized balance of the equipment at the end of the lease term. If the fair market value of the leased equipment is below the unamortized balance at the end of the lease term, TCC has committed to pay the difference between the fair market value and the unamortized balance, with the total guarantee not to exceed 87% of the unamortized balance. At June 30, 2007, the maximum potential loss for these lease agreements assuming the fair market value of the equipment is zero at the end of the lease term is $6 million.

### CONTINGENCIES

#### *Carbon Dioxide ($CO_2$) Public Nuisance Claims*

In 2004, eight states and the City of New York filed an action in federal district court for the Southern District of New York against AEP, AEPSC, Cinergy Corp, Xcel Energy, Southern Company and Tennessee Valley Authority. The Natural Resources Defense Council, on behalf of three special interest groups, filed a similar complaint against the same defendants. The actions allege that $CO_2$ emissions from the defendants' power plants constitute a public nuisance under federal common law due to impacts of global warming, and sought injunctive relief in the form of specific emission reduction commitments from the defendants. The defendants' motion to dismiss the lawsuits was granted in September 2005. The dismissal was appealed to the Second Circuit Court of Appeals. Briefing and oral argument have concluded. On April 2, 2007, the U.S. Supreme Court issued a decision holding that the Federal EPA has authority to regulate emissions of $CO_2$ and other greenhouse gases under the CAA, which may impact the Second Circuit's analysis of these issues. The Second Circuit requested supplemental briefs addressing the impact of the Supreme Court's decision on this case. Management believes the actions are without merit and intends to defend against the claims.

***Coal Transportation Dispute***

PSO, TCC, TNC, the Oklahoma Municipal Power Authority and the Public Utilities Board of the City of Brownsville, Texas, as joint owners of a generating station, disputed transportation costs for coal received between July 2000 and the present time. The joint plant remitted less than the amount billed and the dispute is pending before the Surface Transportation Board. Based upon a weighted average probability analysis of possible outcomes, PSO, as operator of the plant, recorded provisions for possible loss in 2004, 2005, 2006 and the first six months of 2007. The provision immaterially affected income for TCC's ownership share. Management continues to work toward mitigating the disputed amounts to the extent possible.

***Claims by the City of Brownsville, Texas Against TCC***

In April 2007, the City of Brownsville, Texas served its Fifth Amended Answer and Cross-Claims in litigation pending in the District Court of Dallas County, Texas. The cross-claims seek recovery against TCC based on allegations of breach of contract, breach of fiduciary duty, unjust enrichment, constructive trust, conversion, breach of the Texas theft liability act and fraud allegedly occurring in connection with a transaction in which Brownsville purchased TCC's interest in the Oklaunion electric generating station. Management believes that the claims are without merit and intends to defend against them vigorously.

***FERC Long-term Contracts***

In 2002, the FERC held a hearing related to a complaint filed by Nevada Power Company and Sierra Pacific Power Company (the Nevada utilities). The complaint sought to break long-term contracts entered during the 2000 and 2001 California energy price spike which the customers alleged were "high-priced." The complaint alleged that TCC and certain other AEP subsidiaries sold power at unjust and unreasonable prices because the market for power was allegedly dysfunctional at the time such contracts were executed. An ALJ recommended rejection of the complaint, holding that the markets for future delivery were not dysfunctional, and that the Nevada utilities failed to demonstrate that the public interest required that changes be made to the contracts. In June 2003, the FERC issued an order affirming the ALJ's decision. In December 2006, the U.S. Court of Appeals for the Ninth Circuit reversed the FERC order and remanded the case to the FERC for further proceedings. In May 2007, TCC, along with other sellers involved in the case including other AEP subsidiaries, sought review of the Ninth Circuit's decision by the U.S. Supreme Court. The Solicitor General of the United States has asked the Supreme Court for an extension of time, until August 6, 2007, to respond to the petitions for review. Management is unable to predict the outcome of these proceedings or their impact on future results of operations and cash flows. Management asserted claims against certain companies that sold power to TCC and certain other AEP subsidiaries, which was resold to the Nevada utilities, seeking to recover a portion of any amounts owed to the Nevada utilities.

## 5. DISPOSITION AND ASSETS HELD FOR SALE

***Texas Plants – Oklaunion Power Station***

In February 2007, TCC sold its 7.81% share of Oklaunion Power Station to the Public Utilities Board of the City of Brownsville for $42.8 million plus adjustments. The sale did not have a significant effect on TCC's results of operations. Management does not expect that the remaining litigation will have a significant impact on future results of operations. See "Claims by the City of Brownsville, Texas Against TCC" section of Note 4.

TCC's assets related to the Oklaunion Power Station were classified in Assets Held for Sale – Texas Generation Plant on TCC's Condensed Consolidated Balance Sheet at December 31, 2006. The plant did not meet the "component-of-an-entity" criteria because the plant did not have cash flows that could be clearly distinguished operationally. The plant also did not meet the "component-of-an-entity" criteria for financial reporting purposes because the plant did not operate individually, but rather as a part of the AEP System.

**Assets Held for Sale were as follows:**

| Texas Plants (TCC) | June 30, 2007 | December 31, 2006 |
|---|---|---|
| | (in millions) | |
| **Assets:** | | |
| Other Current Assets | $ - | $ 1 |
| Property, Plant and Equipment, Net | - | 43 |
| **Total Assets Held for Sale – Texas Generation Plant** | $ - | $ 44 |

## 6. BENEFIT PLANS

TCC participates in AEP sponsored qualified pension plans and nonqualified pension plans. A substantial majority of employees are covered by either one qualified plan or both a qualified and a nonqualified pension plan. In addition, TCC participates in other postretirement benefit plans sponsored by AEP to provide medical and death benefits for retired employees.

TCC adopted SFAS 158 as of December 31, 2006 and recorded a SFAS 71 regulatory asset for qualifying SFAS 158 costs of regulated operations that for ratemaking purposes are deferred for future recovery.

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

The following table provides the components of AEP's net periodic benefit cost for the plans for the three and six months ended June 30, 2007 and 2006:

| | Pension Plans | | Other Postretirement Benefit Plans | |
|---|---|---|---|---|
| **Three Months Ended June 30, 2007 and 2006** | 2007 | 2006 | 2007 | 2006 |
| | (in millions) | | | |
| Service Cost | $ 23 | $ 24 | $ 11 | $ 10 |
| Interest Cost | 57 | 57 | 26 | 25 |
| Expected Return on Plan Assets | (82) | (83) | (26) | (23) |
| Amortization of Transition Obligation | - | - | 7 | 7 |
| Amortization of Net Actuarial Loss | 14 | 19 | 3 | 5 |
| **Net Periodic Benefit Cost** | $ 12 | $ 17 | $ 21 | $ 24 |

| | Pension Plans | | Other Postretirement Benefit Plans | |
|---|---|---|---|---|
| **Six Months Ended June 30, 2007 and 2006** | 2007 | 2006 | 2007 | 2006 |
| | (in millions) | | | |
| Service Cost | $ 47 | $ 48 | $ 21 | $ 20 |
| Interest Cost | 116 | 114 | 52 | 50 |
| Expected Return on Plan Assets | (167) | (166) | (52) | (46) |
| Amortization of Transition Obligation | - | - | 14 | 14 |
| Amortization of Net Actuarial Loss | 29 | 39 | 6 | 10 |
| **Net Periodic Benefit Cost** | $ 25 | $ 35 | $ 41 | $ 48 |

The following table provides the net periodic benefit cost for the plans for the three and six months ended June 30, 2007 and 2006:

| | Pension Plans | | Other Postretirement Benefit Plans | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (in thousands) | | | |
| Three Months Ended | $ 101 | $ 772 | $ 1,574 | $ 1,696 |
| Six Months Ended | 202 | 1,545 | 3,149 | 3,392 |

## 7. INCOME TAXES

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

***Audit Status***

TCC also files income tax returns in various state and local jurisdictions. With few exceptions, TCC and other AEP subsidiaries are no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years before 2000. The IRS and other taxing authorities routinely examine the tax returns. Management believes that TCC and other AEP subsidiaries have filed tax returns with positions that may be challenged by the tax authorities. TCC and other AEP subsidiaries are currently under examination in several state and local jurisdictions. However, management does not believe that the ultimate resolution of these audits will materially impact results of operations.

The AEP System settled with the IRS on all issues from the audits of consolidated federal income tax returns for years prior to 1997. The AEP System effectively settled all outstanding proposed IRS adjustments for years 1997 through 1999 and through June 2000 for the CSW pre-merger tax period and anticipates payment for the agreed adjustments to occur during 2007. Returns for the years 2000 through 2005 are presently being audited by the IRS and management anticipates that the audit of the 2000 through 2003 years will be completed by the end of 2007.

***FIN 48 Adoption***

TCC adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, TCC recognized a $2,187,000 increase in the liabilities for unrecognized tax benefits, as well as related interest expense and penalties, which was accounted for as a reduction to the January 1, 2007 balance of retained earnings.

At January 1, 2007, the total amount of unrecognized tax benefits under FIN 48 was $20.7 million. Management believes it is reasonably possible that there will be a $3.4 million net decrease in unrecognized tax benefits due to the settlement of audits and the expiration of statute of limitations within 12 months of the reporting date. TCC's total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was $9.3 million. There are $6.4 million of tax positions, for which the ultimate deductibility is highly certain but the timing of such deductibility is uncertain. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period.

Prior to the adoption of FIN 48, TCC and other AEP subsidiaries recorded interest and penalty accruals related to income tax positions in tax accrual accounts. With the adoption of FIN 48, TCC and other AEP subsidiaries began recognizing interest accruals related to income tax positions in interest expense and penalties in Other Operations. As of January 1, 2007, TCC accrued $2.5 million for the payment of uncertain interest and penalties.

## 8. FINANCING ACTIVITIES

### *Long-term Debt*

Long-term debt and other securities issued, retired and principal payments made during the first six months of 2007 were:

| | Type of Debt | Principal Amount (in thousands) | Interest Rate (%) | Due Date |
|---|---|---|---|---|
| **Issuances:** | Pollution Control Bonds | $ 6,330 | 4.45 | 2020 |

| | Type of Debt | Principal Amount (in thousands) | Interest Rate (%) | Due Date |
|---|---|---|---|---|
| **Retirements and Principal Payments:** | Securitization Bonds | $ 32,125 | 5.01 | 2008 |

In July 2007, TCC redeemed $6 million of 6.00% Pollution Control Bonds due in 2020.

### *Lines of Credit*

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of its subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds the utility subsidiaries. The AEP System corporate borrowing program operates in accordance with the terms and conditions approved in a regulatory order. The amount of outstanding loans (borrowings) to/from the Utility Money Pool as of June 30, 2007 and December 31, 2006 are included in Advances to/from Affiliates on TCC's balance sheets. TCC's Utility Money Pool activity and corresponding authorized borrowing limits for the six months ended June 30, 2007 are described in the following table:

| Maximum Borrowings from Utility Money Pool | Maximum Loans to Utility Money Pool | Average Borrowings from Utility Money Pool | Average Loans to Utility Money Pool | Loans to Utility Money Pool as of June 30, 2007 | Authorized Short-Term Borrowing Limit |
|---|---|---|---|---|---|
| (in thousands) | | | | | |
| $ - | $ 394,180 | $ - | $ 237,161 | $ 141,670 | $ 600,000 |

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the six months ended June 30, 2007 and 2006 are summarized in the following table:

| | Maximum Interest Rates for Funds Borrowed from the Utility Money Pool | Minimum Interest Rates for Funds Borrowed from the Utility Money Pool | Maximum Interest Rates for Funds Loaned to the Utility Money Pool | Minimum Interest Rates For Funds Loaned to the Utility Money Pool | Average Interest Rate for Funds Borrowed from the Utility Money Pool | Average Interest Rate for Funds Loaned to the Utility Money Pool |
|---|---|---|---|---|---|---|
| | (in percentage) | | | | | |
| 2007 | - | - | 5.46 | 5.30 | - | 5.35 |
| 2006 | 5.39 | 4.37 | 5.11 | 4.19 | 4.64 | 4.74 |

### *Dividend Restrictions*

Under the Federal Power Act, TCC is restricted from paying dividends out of stated capital.