AEP Texas North Company

2007 Third 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
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 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.
CAA	Clean Air Act.
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.).
EITF	Financial Accounting Standards Board's Emerging Issues Task Force.
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.
MTM	Mark-to-Market.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
PUCT	Public Utility Commission of Texas.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
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.
SPP	Southwest Power Pool.
SWEPCo	Southwestern Electric Power Company, an AEP electric utility subsidiary.
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
TNC	AEP Texas North Company, an AEP electric utility subsidiary.
Utility Money Pool	AEP System's Utility Money Pool.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three and Nine Months Ended September 30, 2007 and 2006
(in thousands)
(Unaudited)

	Three Months Ended 2007	Three Months Ended 2006	Nine Months Ended 2007	Nine Months Ended 2006
REVENUES				
Electric Generation, Transmission and Distribution	$ 54,030	$ 79,805	$ 137,606	$ 219,681
Sales to AEP Affiliates	25,292	7,711	78,044	25,596
Other	125	246	640	149
TOTAL	79,447	87,762	216,290	245,426
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	2,523	14,016	24,377	33,175
Purchased Electricity for Resale	2,089	17,042	6,538	64,321
Other Operation	18,968	19,267	55,845	59,162
Maintenance	4,610	5,088	16,339	15,505
Depreciation and Amortization	10,173	10,503	30,946	31,202
Taxes Other Than Income Taxes	4,796	5,478	14,918	16,874
TOTAL	43,159	71,394	148,963	220,239
OPERATING INCOME	36,288	16,368	67,327	25,187
Other Income (Expense):				
Interest Income	78	203	406	542
Allowance for Equity Funds Used During Construction	29	146	73	636
Interest Expense	(3,503)	(4,472)	(12,179)	(13,351)
INCOME BEFORE INCOME TAXES	32,892	12,245	55,627	13,014
Income Tax Expense	11,343	3,799	18,677	1,326
NET INCOME	21,549	8,446	36,950	11,688
Preferred Stock Dividend Requirements	26	26	78	78
Gain on Reacquired Preferred Stock	-	-	-	2
EARNINGS APPLICABLE TO COMMON STOCK	$ 21,523	$ 8,420	$ 36,872	$ 11,612

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

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY AND COMPREHENSIVE INCOME (LOSS)
For the Nine Months Ended September 30, 2007 and 2006
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
DECEMBER 31, 2005	$ 137,214	$ 2,351	$ 174,858	$ (504)	$ 313,919
Common Stock Dividends			(12,750)		(12,750)
Preferred Stock Dividends			(78)		(78)
Gain on Reacquired Preferred Stock			2		2
TOTAL					301,093
COMPREHENSIVE INCOME					
Other Comprehensive Loss, Net of Taxes:					
Cash Flow Hedges, Net of Tax of $660				(1,226)	(1,226)
NET INCOME			11,688		11,688
TOTAL COMPREHENSIVE INCOME					10,462
SEPTEMBER 30, 2006	$ 137,214	$ 2,351	$ 173,720	$ (1,730)	$ 311,555
DECEMBER 31, 2006	$ 137,214	$ 2,351	$ 176,950	$ (10,159)	$ 306,356
FIN 48 Adoption, Net of Tax			(557)		(557)
Common Stock Dividends			(4,000)		(4,000)
Preferred Stock Dividends			(78)		(78)
TOTAL					301,721
COMPREHENSIVE INCOME					
Other Comprehensive Income, Net of Taxes:					
Cash Flow Hedges, Net of Tax of $378				703	703
NET INCOME			36,950		36,950
TOTAL COMPREHENSIVE INCOME					37,653
SEPTEMBER 30, 2007	$ 137,214	$ 2,351	$ 209,265	$ (9,456)	$ 339,374

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
ASSETS
September 30, 2007 and December 31, 2006
(in thousands)
(Unaudited)

	2007	2006
CURRENT ASSETS		
Cash and Cash Equivalents	$ 72	$ 84
Other Cash Deposits	5	8,863
Advances to Affiliates	-	13,543
Accounts Receivable:		
Customers	11,382	21,677
Affiliated Companies	29,935	5,634
Accrued Unbilled Revenues	4,247	2,292
Miscellaneous	56	65
Allowance for Uncollectible Accounts	(18)	(9)
Total Accounts Receivable	45,602	29,659
Fuel	11,781	8,559
Materials and Supplies	9,535	9,319
Prepayments and Other	2,231	1,681
TOTAL	69,226	71,708
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Production	292,376	290,485
Transmission	340,908	327,845
Distribution	518,311	512,265
Other	161,734	159,451
Construction Work in Progress	48,294	38,847
Total	1,361,623	1,328,893
Accumulated Depreciation and Amortization	492,276	486,961
TOTAL - NET	869,347	841,932
OTHER NONCURRENT ASSETS		
Regulatory Assets	40,396	38,402
Deferred Charges and Other	18,155	15,472
TOTAL	58,551	53,874
TOTAL ASSETS	$ 997,124	$ 967,514

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
LIABILITIES AND SHAREHOLDERS' EQUITY
September 30, 2007 and December 31, 2006
(Unaudited)

	2007	2006
CURRENT LIABILITIES	(in thousands)	
Advances from Affiliates	$ 14,517	$ -
Accounts Payable:		
General	8,092	4,448
Affiliated Companies	42,380	43,993
Long-term Debt Due Within One Year – Nonaffiliated	-	8,151
Accrued Taxes	23,422	21,782
Other	8,989	14,934
TOTAL	97,400	93,308
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	268,852	268,785
Long-term Risk Management Liabilities	-	1,081
Deferred Income Taxes	123,882	124,048
Regulatory Liabilities and Deferred Investment Tax Credits	125,819	139,429
Deferred Credits and Other	39,448	32,158
TOTAL	558,001	565,501
TOTAL LIABILITIES	655,401	658,809
Cumulative Preferred Stock Not Subject to Mandatory Redemption	2,349	2,349
Commitments and Contingencies (Note 4)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – $25 Per Share:		
Authorized – 7,800,000 Shares		
Outstanding – 5,488,560 Shares	137,214	137,214
Paid-in Capital	2,351	2,351
Retained Earnings	209,265	176,950
Accumulated Other Comprehensive Income (Loss)	(9,456)	(10,159)
TOTAL	339,374	306,356
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 997,124	$ 967,514

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2007 and 2006
(in thousands)
(Unaudited)

	2007	2006
OPERATING ACTIVITIES		
Net Income	$ 36,950	$ 11,688
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	30,946	31,202
Deferred Income Taxes	2,083	(4,667)
Mark-to-Market of Risk Management Contracts	-	4,836
Deferred Property Taxes	(3,435)	(4,359)
Fuel Over/Under Recovery, Net	(7,752)	1,112
Change in Other Noncurrent Assets	(6,417)	(5,203)
Change in Other Noncurrent Liabilities	(3,755)	(1,742)
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	(15,943)	71,005
Fuel, Materials and Supplies	(3,438)	(4,493)
Accounts Payable	(671)	(66,653)
Customer Deposits	278	(3,571)
Accrued Taxes, Net	3,332	7,984
Other Current Assets	(298)	2,496
Other Current Liabilities	(5,552)	(5,304)
Net Cash Flows From Operating Activities	26,328	34,331
INVESTING ACTIVITIES		
Construction Expenditures	(62,088)	(52,366)
Change in Other Cash Deposits, Net	8,858	979
Change in Advances to Affiliates, Net	13,543	29,903
Proceeds from Sales of Assets	12,050	250
Net Cash Flows Used For Investing Activities	(27,637)	(21,234)
FINANCING ACTIVITIES		
Issuance of Long-term Debt – Nonaffiliated	43,709	-
Change in Advances from Affiliates, Net	14,517	-
Retirement of Long-term Debt – Nonaffiliated	(52,461)	-
Retirement of Cumulative Preferred Stock	-	(6)
Principal Payments for Capital Lease Obligations	(390)	(263)
Dividends Paid on Common Stock	(4,000)	(12,750)
Dividends Paid on Cumulative Preferred Stock	(78)	(78)
Net Cash Flows From (Used For) Financing Activities	1,297	(13,097)
Net Decrease in Cash and Cash Equivalents	(12)	-
Cash and Cash Equivalents at Beginning of Period	84	-
Cash and Cash Equivalents at End of Period	$ 72	$ -
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 14,098	$ 13,988
Net Cash Paid (Received) for Income Taxes	11,400	(252)
Noncash Acquisitions Under Capital Leases	159	1,178
Construction Expenditures Included in Accounts Payable at September 30,	4,019	2,155

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. Benefit Plans
6. Business Segments
7. Income Taxes
8. Financing Activities

1. **<u>SIGNIFICANT ACCOUNTING MATTERS</u>**

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 annual financial statements.

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

Property, Plant and Equipment and Equity Investments

Electric utility property, plant and equipment are stated at original purchase cost. Property, plant and equipment of nonregulated operations and other investments are stated at fair market value at acquisition (or as adjusted for any applicable impairments) plus the original cost of property acquired or constructed since the acquisition, less disposals. Additions, major replacements and betterments are added to the plant accounts. Normal and routine retirements from the plant accounts, net of salvage, are charged to accumulated depreciation for both cost-based rate-regulated and nonregulated operations under the group composite method of depreciation. The group composite method of depreciation assumes that on average, asset components are retired at the end of their useful lives and thus there is no gain or loss. The equipment in each primary electric plant account is identified as a separate group. Under the group composite method of depreciation, continuous interim routine replacements of items such as boiler tubes, pumps, motors, etc. result in the original cost, less salvage, being charged to accumulated depreciation. For the nonregulated generation assets, a gain or loss would be recorded if the retirement is not considered an interim routine replacement. The depreciation rates that are established for the generating plants take into account the past history of interim capital replacements and the amount of salvage received. These rates and the related lives are subject to periodic review. Removal costs are charged to regulatory liabilities for cost-based rate-regulated operations and charged to expense for nonregulated operations. The costs of labor, materials and overhead incurred to operate and maintain the plants are included in operating expenses.

Long-lived assets are required to be tested for impairment when it is determined that the carrying value of the assets may no longer be recoverable or when the assets meet the held for sale criteria under SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Equity investments are required to be tested for impairment when it is determined there may be an other than temporary loss in value.

The fair value of an asset or investment is the amount at which that asset or investment could be bought or sold in a current transaction between willing parties, as opposed to a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and are used as the basis for the measurement, if available. In the absence of quoted prices for identical or similar assets or investments in active markets, fair value is estimated using various internal and external valuation methods including cash flow analysis and appraisals.

Revenue Recognition

Traditional Electricity Supply and Delivery Activities

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

Components of Accumulated Other Comprehensive Income (Loss) (AOCI)

AOCI is included on the balance sheets in the common shareholder's equity section. AOCI for TNC as of September 30, 2007 and December 31, 2006 is shown in the following table.

Components	September 30, 2007	December 31, 2006
	(in thousands)	
Cash Flow Hedges	$ 1	$ (702)
SFAS 158 Costs	(9,457)	(9,457)

Related Party Transactions

Oklaunion PPA between TNC and AEP Energy Partners

On January 1, 2007, TNC began a 20-year Power Purchase & Sale Agreement (PPA) with an affiliate, AEP Energy Partners (AEPEP), whereby TNC agrees to sell AEPEP 100% of TNC's capacity and associated energy from its undivided interest (54.69%) in the Oklaunion plant. AEPEP is to pay TNC for the capacity and associated energy delivered to the delivery point, the sum of fuel, operation and maintenance, depreciation, capacity and all taxes other than federal income taxes applicable. A portion of the payment is fixed and is payable regardless of the level of output. There are no penalties if TNC fails to maintain a minimum availability level or exceeds a maximum heat rate level. The PPA was approved by the FERC on July 12, 2006.

TNC recorded revenue of $24.4 million and $75.1 million from AEPEP for the three months and nine months ended September 30, 2007, respectively. These amounts are included in Sales to AEP Affiliates on its 2007 Condensed Consolidated Statement of Income.

Texas Restructuring – SPP

In August 2006, the PUCT adopted a rule extending the delay in implementation of customer choice in the SPP area of Texas until no sooner than January 1, 2011. Approximately 3% of TNC's business was in SPP. A petition was filed in May 2006 requesting approval to transfer Mutual Energy SWEPCO L.P.'s (a subsidiary of AEP C&I Company, LLC) customers and TNC's facilities and certificated service territory located in the SPP area to SWEPCo. In January 2007, the final regulatory approval was received for the transfers. The transfers were effective February 2007 and were recorded at the net book value of $11.6 million.

Reclassifications

Certain prior period financial statement items have been reclassified to conform to current period presentation. These revisions had no impact on TNC'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 TNC'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 TNC'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, 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. Management is evaluating the effect of the adoption of SFAS 157 on results of operations and financial condition. 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. Although management has not completed its analysis, management expects this cumulative effect adjustment will have an immaterial impact on the financial statements. TNC 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. If TNC 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. TNC will adopt SFAS 159 effective January 1, 2008. Although management has not completed its analysis, 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 impact on the financial statements. TNC 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. TNC adopted FIN 48 effective January 1, 2007. The impact of this interpretation was an unfavorable adjustment to retained earnings of $557,000.

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. TNC 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 the 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 TNC's 2006 Annual Report, TNC 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.

Deferred Fuel

In 2002, TNC 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 substantial reductions in TNC's recoverable fuel costs for, among other things, the reallocation of additional AEP System off-system sales margins to TNC under a FERC-approved tariff. TNC appealed the PUCT's ruling 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 ruling 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 TNC fuel reconciliation proceeding. The Federal court ruled that the FERC, not the PUCT, has jurisdiction over the allocation. The PUCT appealed the Federal District Court decision to the United States Court of Appeals. The Court of Appeals affirmed the District Court's decision in the TNC case. In April 2007, the PUCT petitioned the United States Supreme Court for a review of the Court of Appeals' order. In October 2007, the United States Supreme Court denied review of TNC's case. As a result, TNC recorded income of $9 million in the third quarter of 2007 by reversing the previously recorded provision resulting from the PUCT's ordered reallocation of off-system sales margins.

The PUCT or another interested party may file a complaint at the FERC to address the allocation issue. Although management cannot predict if a complaint may be filed at the FERC, management believes the allocations used were in accordance with the then-existing FERC-approved SIA and additional off-system sales margins should not be retroactively reallocated to the AEP West companies including TNC.

Energy Delivery Base Rate Filings

TNC filed a base rate case seeking to increase transmission and distribution energy delivery services (wires) base rates in Texas. TNC requested an increase in annual base rates of $25 million. The request included a return on common equity of 11.25% and a favorable impact from an expiration of the CSW merger savings rate credits (merger credits). In March 2007, various intervenors and the PUCT staff filed their recommendations In May 2007, TNC reached a settlement agreement for a revenue increase of $14 million including an $8 million increase in base rates and a $6 million increase related to the impact of the expiration of the merger credits. TNC received a final order in May 2007 and began billing the increase in June 2007.

4. COMMITMENTS, GUARANTEES AND CONTINGENCIES

TNC 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 FIN 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

TNC enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. Prior to September 30, 2007, TNC entered into sale agreements including indemnifications with a maximum exposure that was not significant. There are no material liabilities recorded for any indemnifications.

Master Operating Lease

TNC 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, TNC 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. Assuming the fair market value of the equipment is zero at the end of the lease term, the maximum potential loss for these lease agreements was approximately $3 million as of September 30, 2007.

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. In September 2007, the Surface Transportation Board ruled that the disputed rates were not unreasonable under the standalone cost rate test. The joint owners filed a Petition for Reconsideration. Based upon this ruling, PSO, as operator of the plant, adjusted the provision recorded in prior periods. TNC made an adjustment to its provision based on its ownership share. After mitigation by certain contractual rights, TNC's fuel expense decreased by $9.4 million.

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 TNC 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. On September 25, 2007, the U.S. Supreme Court decided to review the Ninth Circuit's decision. 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 TNC and certain other AEP subsidiaries, which was resold to the Nevada utilities, seeking to recover a portion of any amounts that may be owed to the Nevada utilities.

5. BENEFIT PLANS

TNC 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, TNC participates in other postretirement benefit plans sponsored by AEP to provide medical and death benefits for retired employees.

TNC 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 nine months ended September 30, 2007 and 2006:

	Pension Plans		Other Postretirement Benefit Plans	
Three Months Ended September 30, 2007 and 2006	**2007**	**2006**	**2007**	**2006**
		(in millions)		
Service Cost	$ 24	$ 23	$ 11	$ 10
Interest Cost	59	57	26	26
Expected Return on Plan Assets	(85)	(82)	(26)	(24)
Amortization of Transition Obligation	-	-	6	7
Amortization of Net Actuarial Loss	15	20	3	5
Net Periodic Benefit Cost	$ 13	$ 18	$ 20	$ 24

	Pension Plans		Other Postretirement Benefit Plans	
Nine Months Ended September 30, 2007 and 2006	**2007**	**2006**	**2007**	**2006**
		(in millions)		
Service Cost	$ 72	$ 71	$ 32	$ 30
Interest Cost	176	171	78	76
Expected Return on Plan Assets	(254)	(248)	(78)	(70)
Amortization of Transition Obligation	-	-	20	21
Amortization of Net Actuarial Loss	44	59	9	15
Net Periodic Benefit Cost	$ 38	$ 53	$ 61	$ 72

The following table provides TNC's net periodic benefit cost for the plans for the three and nine months ended September 30, 2007 and 2006:

	Pension Plans		Other Postretirement Benefit Plans	
	2007	**2006**	**2007**	**2006**
		(in thousands)		
Three Months Ended	$ 70	$ 326	$ 631	$ 715
Nine Months Ended	210	978	1,892	2,145

6. BUSINESS SEGMENTS

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

7. INCOME TAXES

TNC joins in the filing of a consolidated federal income tax return with its affiliates in the AEP System. The allocation of the AEP System's current consolidated federal income tax to the AEP System companies allocates the benefit of current tax losses to the AEP System companies giving rise to such losses in determining their current 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

TNC also files income tax returns in various state and local jurisdictions. With few exceptions, TNC 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 TNC and other AEP subsidiaries have filed tax returns with positions that may be challenged by the tax authorities. TNC 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

TNC adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, TNC recognized a $557,000 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, TNC's total amount of unrecognized tax benefits under FIN 48 was $6.9 million. Management believes it is reasonably possible that there will be a $1.6 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. TNC's total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was $2.6 million. There are $2.9 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, TNC and other AEP subsidiaries recorded interest and penalty accruals related to income tax positions in tax accrual accounts. With the adoption of FIN 48, TNC 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, TNC accrued $1.0 million for the payment of uncertain interest and penalties.

8. <u>FINANCING ACTIVITIES</u>

Long-term Debt

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

	Type of Debt	Principal Amount (in thousands)	Interest Rate (%)	Due Date
Issuances:	Pollution Control Bonds	$ 44,310	4.45	2020

	Type of Debt	Principal Amount (in thousands)	Interest Rate (%)	Due Date
Retirements and Principal Payments:	Defeased First Mortgage Bonds	$ 8,151	7.75	2007
	Pollution Control Bonds	44,310	6.00	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, and a Nonutility Money Pool, which funds the majority of the nonutility 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 and the Nonutility Money Pool as of September 30, 2007 and December 31, 2006 are included in Advances to/from Affiliates on TNC's balance sheets. TNC's Utility Money Pool activity and corresponding authorized borrowing limits for the nine months ended September 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	Borrowings from Utility Money Pool as of September 30, 2007	Authorized Short-Term Borrowing Limit
		(in thousands)			
$ 43,641	$ 3,200	$ 29,244	$ 2,365	$ 32,800	$ 250,000

The activity in the above table does not include short-term lending activity of TNC's wholly-owned subsidiary, AEP Texas North Generation Company LLC (TNGC), who is a participant in the Nonutility Money Pool. For the nine months ended September 30, 2007, TNGC had the following activity in the Nonutility Money Pool:

Maximum Borrowings from Nonutility Money Pool	Maximum Loans to Nonutility Money Pool	Average Borrowings from Nonutility Money Pool	Average Loans to Nonutility Money Pool	Loans to Nonutility Money Pool as of September 30, 2007
		(in thousands)		
$ -	$ 20,152	$ -	$ 15,435	$ 18,283

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the nine months ended September 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	5.94	5.30	5.35	5.34	5.47	5.35
2006	5.41	3.63	5.22	3.83	4.81	4.56

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

	Maximum Interest Rates for Funds Borrowed from the Nonutility Money Pool	Minimum Interest Rates for Funds Borrowed from the Nonutility Money Pool	Maximum Interest Rates for Funds Loaned to the Nonutility Money Pool	Minimum Interest Rates For Funds Loaned to the Nonutility Money Pool	Average Interest Rate for Funds Borrowed from the Nonutility Money Pool	Average Interest Rate for Funds Loaned to the Nonutility Money Pool
			(in percentage)			
2007	-	-	5.94	5.17	-	5.44
2006	5.39	5.34	5.37	5.28	5.36	5.33

Dividend Restrictions

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