# AEP Texas Central Company

# and Subsidiaries

2008 Annual Report

Consolidated Financial Statements

| TABLE OF CONTENTS | Page |
|---|---|


| | |
|---|---|
| Glossary of Terms | TCC-i |
| Independent Auditors' Report | TCC-1 |
| Consolidated Statements of Income | TCC-2 |
| Consolidated Statements of Changes in Common Shareholder’s Equity and Comprehensive Income (Loss) | TCC-3 |
| Consolidated Balance Sheets | TCC-4 |
| Consolidated Statements of Cash Flows | TCC-6 |
| Notes to Consolidated Financial Statements | TCC-7 |

## GLOSSARY OF TERMS

**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 East companies | APCo, CSPCo, I&M, KPCo and OPCo. |
| AEPEP | AEP Energy Partners, Inc., a subsidiary of AEP dedicated to wholesale marketing and trading, asset management and commercial and industrial sales in the deregulated Texas market. |
| AEPSC | American Electric Power Service Corporation, a service subsidiary providing management and professional services to AEP and its subsidiaries. |
| 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. |
| AFUDC | Allowance for Funds Used During Construction. |
| AOCI | Accumulated Other Comprehensive Income. |
| APCo | Appalachian Power Company, an AEP electric utility subsidiary. |
| ARO | Asset Retirement Obligations. |
| CAA | Clean Air Act. |
| $CO_2$ | Carbon Dioxide. |
| 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.). |
| CSW Operating Agreement | Agreement, dated January 1, 1997, by and among PSO, SWEPCo, TCC and TNC governing generating capacity allocation. This agreement was amended in May 2006 to remove TCC and TNC. AEPSC acts as the agent. |
| CTC | Competition Transition Charge. |
| CWIP | Construction Work in Progress. |
| EIS | Energy Insurance Services, Inc., a protected cell insurance company that AEP consolidates due to FIN 46. |
| EITF | Financial Accounting Standards Board's Emerging Issues Task Force. |
| EITF 06-10 | EITF Issue No. 06-10 "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements." |
| ERCOT | Electric Reliability Council of Texas. |
| ERISA | Employee Retirement Income Security Act of 1974, as amended. |
| ETT | Electric Transmission Texas, LLC, a 50% equity interest joint venture with MidAmerican Energy Holdings Company formed to own and operate electric transmission facilities in ERCOT. |
| FASB | Financial Accounting Standards Board. |
| Federal EPA | United States Environmental Protection Agency. |
| FERC | Federal Energy Regulatory Commission. |
| FIN | FASB Interpretation No. |
| FIN 46R | FIN 46R, "Consolidation of Variable Interest Entities." |
| 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." |
| FSP | FASB Staff Position. |
| GAAP | Accounting Principles Generally Accepted in the United States of America. |
| IRS | Internal Revenue Service. |

| Term | Meaning |
|---|---|
| I&M | Indiana Michigan Power Company, an AEP electric utility subsidiary. |
| KGPCo | Kingsport Power Company, an AEP electric distribution subsidiary. |
| KPCo | Kentucky Power Company, an AEP electric utility subsidiary. |
| kV | Kilovolt. |
| MTM | Mark-to-Market. |
| MW | Megawatt. |
| OATT | Open Access Transmission Tariff. |
| OCC | Corporation Commission of the State of Oklahoma. |
| OPCo | Ohio Power Company, an AEP electric utility subsidiary. |
| OPEB | Other Postretirement Benefit Plans. |
| OTC | Over the counter. |
| 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. |
| 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 107 | Statement of Financial Accounting Standards No. 107, "Disclosures about Fair Value of Financial Investments." |
| SFAS 109 | Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." |
| 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." |
| SIA | System Integration Agreement. |
| SPP | Southwest Power Pool. |
| Sweeny | Sweeny Cogeneration Limited Partnership, owner and operator of a four unit, 480 MW gas-fired generation facility, owned 50% by AEP. |
| SWEPCo | Southwestern Electric Power Company, an AEP electric utility subsidiary. |
| 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. |

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders of
AEP Texas Central Company:

We have audited the accompanying consolidated balance sheets of AEP Texas Central Company and subsidiaries (the "Company") as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in common shareholder's equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of AEP Texas Central Company and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 10 to the consolidated financial statements, the Company adopted FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes,” effective January 1, 2007. As discussed in Note 7 to the consolidated financial statements, the Company FASB Statement No. 158, “Accounting for Defined Benefit Pension and Other Postretirement Plans,” effective December 31, 2006.

/s/ Deloitte & Touche LLP

Columbus, Ohio
February 27, 2009

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF INCOME**
**For the Years Ended December 31, 2008, 2007 and 2006**
**(in thousands)**

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| **REVENUES** | | | |
| Electric Generation, Transmission and Distribution | $ 815,681 | $ 785,163 | $ 623,840 |
| Sales to AEP Affiliates | 5,930 | 5,690 | 6,403 |
| Other | 15,428 | 17,752 | 34,421 |
| **TOTAL** | 837,039 | 808,605 | 664,664 |
| **EXPENSES** | | | |
| Fuel and Other Consumables Used for Electric Generation | - | 287 | 6,668 |
| Purchased Electricity for Resale | 559 | 3,583 | 4,093 |
| Other Operation | 243,574 | 237,326 | 240,795 |
| Maintenance | 38,243 | 38,920 | 38,466 |
| Depreciation and Amortization | 219,309 | 214,470 | 164,773 |
| Taxes Other Than Income Taxes | 69,308 | 74,450 | 80,772 |
| **TOTAL** | 570,993 | 569,036 | 535,567 |
| **OPERATING INCOME** | 266,046 | 239,569 | 129,097 |
| **Other Income (Expense):** | | | |
| Interest Income | 32,659 | 15,629 | 7,488 |
| Carrying Costs Income | - | - | 69,080 |
| Allowance for Equity Funds Used During Construction | 3,162 | 3,232 | 2,688 |
| Interest Expense | (176,089) | (180,467) | (144,134) |
| **INCOME BEFORE INCOME TAX EXPENSE** | 125,778 | 77,963 | 64,219 |
| Income Tax Expense | 39,941 | 19,013 | 22,650 |
| **NET INCOME** | 85,837 | 58,950 | 41,569 |
| Preferred Stock Dividend Requirements | 240 | 240 | 241 |
| Gain on Reacquired Preferred Stock | - | - | 6 |
| **EARNINGS APPLICABLE TO COMMON STOCK** | $ 85,597 | $ 58,710 | $ 41,334 |

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

*See Notes to Consolidated Financial Statements.*

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY AND COMPREHENSIVE INCOME (LOSS)**
**For the Years Ended December 31, 2008, 2007 and 2006**
**(in thousands)**

| | 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 |
| Common Stock Dividends | | | (585,000) | | (585,000) |
| Preferred Stock Dividends | | | (241) | | (241) |
| Gain on Reacquired Preferred Stock | | | 6 | | 6 |
| **TOTAL** | | | | | 362,395 |
| **COMPREHENSIVE INCOME** | | | | | |
| **Other Comprehensive Income, Net of Taxes:** | | | | | |
| Cash Flow Hedges, Net of Tax of $121 | | | | 224 | 224 |
| Minimum Pension Liability, Net of Tax of $108 | | | | 200 | 200 |
| **NET INCOME** | | | 41,569 | | 41,569 |
| **TOTAL COMPREHENSIVE INCOME** | | | | | 41,993 |
| Minimum Pension Liability Elimination, Net of Tax of $392 | | | | 728 | 728 |
| **DECEMBER 31, 2006** | 55,292 | 132,606 | 217,218 | - | 405,116 |
| FIN 48 Adoption, Net of Tax | | | (2,187) | | (2,187) |
| Common Stock Dividends | | | (3,000) | | (3,000) |
| Preferred Stock Dividends | | | (240) | | (240) |
| Other | | 555 | | | 555 |
| **TOTAL** | | | | | 400,244 |
| **COMPREHENSIVE INCOME** | | | | | |
| **NET INCOME** | | | 58,950 | | 58,950 |
| **TOTAL COMPREHENSIVE INCOME** | | | | | 58,950 |
| **DECEMBER 31, 2007** | 55,292 | 133,161 | 270,741 | - | 459,194 |
| EITF 06-10 Adoption, Net of Tax of $402 | | | (748) | | (748) |
| Common Stock Dividends | | | (30,000) | | (30,000) |
| Preferred Stock Dividends | | | (240) | | (240) |
| **TOTAL** | | | | | (30,988) |
| **COMPREHENSIVE INCOME** | | | | | |
| **NET INCOME** | | | 85,837 | | 85,837 |
| **TOTAL COMPREHENSIVE INCOME** | | | | | 85,837 |
| **DECEMBER 31, 2008** | $ 55,292 | $ 133,161 | $ 325,590 | $ - | $ 514,043 |

*See Notes to Consolidated Financial Statements.*

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**
**ASSETS**
**December 31, 2008 and 2007**
**(in thousands)**

| | 2008 | 2007 |
|---|---|---|
| **CURRENT ASSETS** | | |
| Cash and Cash Equivalents | $ 203 | $ 101 |
| Other Cash Deposits | 172,939 | 192,725 |
| Advances to Affiliates | - | 180,926 |
| Accounts Receivable: | | |
| Customers | 61,769 | 54,355 |
| Affiliated Companies | 72,642 | 6,848 |
| Accrued Unbilled Revenues | 38,575 | 32,056 |
| Miscellaneous | 267 | 637 |
| Allowance for Uncollectible Accounts | (567) | (273) |
| Total Accounts Receivable | 172,686 | 93,623 |
| Materials and Supplies | 28,559 | 27,624 |
| Prepayments and Other | 10,456 | 4,813 |
| **TOTAL** | 384,843 | 499,812 |
| **PROPERTY, PLANT AND EQUIPMENT** | | |
| Electric: | | |
| Transmission | 1,085,999 | 962,859 |
| Distribution | 1,769,485 | 1,670,120 |
| Other | 231,899 | 231,571 |
| Construction Work in Progress | 110,690 | 122,666 |
| **Total** | 3,198,073 | 2,987,216 |
| Accumulated Depreciation and Amortization | 664,375 | 667,124 |
| **TOTAL - NET** | 2,533,698 | 2,320,092 |
| **OTHER NONCURRENT ASSETS** | | |
| Regulatory Assets | 314,029 | 167,991 |
| Securitized Transition Assets | 2,039,768 | 2,107,510 |
| Deferred Charges and Other | 39,863 | 94,592 |
| **TOTAL** | 2,393,660 | 2,370,093 |
| **TOTAL ASSETS** | $ 5,312,201 | $ 5,189,997 |

*See Notes to Consolidated Financial Statements.*

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**
**LIABILITIES AND SHAREHOLDERS' EQUITY**
**December 31, 2008 and 2007**

| | 2008 | 2007 |
|---|---|---|
| **CURRENT LIABILITIES** | (in thousands) | |
| Advances from Affiliates | $ 107,293 | $ - |
| Accounts Payable: | | |
| General | 22,198 | 21,629 |
| Affiliated Companies | 19,976 | 20,872 |
| Long-term Debt Due Within One Year – Nonaffiliated | 137,141 | 143,419 |
| Customer Deposits | 19,671 | 55,740 |
| Accrued Taxes | 36,451 | 31,344 |
| Accrued Interest | 65,674 | 69,595 |
| Provision for Revenue Refund | 33,400 | - |
| Other | 54,756 | 50,450 |
| **TOTAL** | 496,560 | 393,049 |
| | | |
| **NONCURRENT LIABILITIES** | | |
| Long-term Debt – Nonaffiliated | 2,657,156 | 2,794,134 |
| Deferred Income Taxes | 1,043,627 | 1,030,015 |
| Regulatory Liabilities and Deferred Investment Tax Credits | 444,134 | 454,528 |
| Deferred Credits and Other | 150,760 | 53,156 |
| **TOTAL** | 4,295,677 | 4,331,833 |
| | | |
| **TOTAL LIABILITIES** | 4,792,237 | 4,724,882 |
| | | |
| Cumulative Preferred Stock Not Subject to Mandatory Redemption | 5,921 | 5,921 |
| | | |
| Commitments and Contingencies (Note 5) | | |
| | | |
| **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 | 133,161 | 133,161 |
| Retained Earnings | 325,590 | 270,741 |
| **TOTAL** | 514,043 | 459,194 |
| | | |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | $ 5,312,201 | $ 5,189,997 |

*See Notes to Consolidated Financial Statements.*

**AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**For the Years Ended December 31, 2008, 2007 and 2006**
**(in thousands)**

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| **OPERATING ACTIVITIES** | | | |
| **Net Income** | $ 85,837 | $ 58,950 | $ 41,569 |
| **Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:** | | | |
| Depreciation and Amortization | 219,309 | 214,470 | 164,773 |
| Deferred Income Taxes | 31,824 | (390) | 24,200 |
| Provision For Revenue Refund | 33,400 | - | - |
| Carrying Costs on Stranded Cost Recovery | - | - | (69,080) |
| Allowance for Equity Funds Used During Construction | (3,162) | (3,232) | (2,688) |
| Mark-to-Market of Risk Management Contracts | - | - | 5,426 |
| Fuel Over/Under-Recovery, Net | (1,125) | (163,516) | (12,424) |
| Deferral of Storm Costs | (20,648) | - | - |
| Securitized Transition Assets | (60,720) | (61,164) | 59,242 |
| Change in Other Noncurrent Assets | (8,288) | (7,221) | (71,817) |
| Change in Other Noncurrent Liabilities | 1,755 | 5,141 | (60,394) |
| **Changes in Certain Components of Working Capital:** | | | |
| Accounts Receivable, Net | (79,062) | (43,751) | 209,034 |
| Fuel, Materials and Supplies | (935) | 358 | (15,303) |
| Accounts Payable | (4,796) | 1,244 | (105,537) |
| Customer Deposits | (36,068) | 36,998 | 8,084 |
| Accrued Taxes, Net | (1,872) | (36,157) | 19,933 |
| Accrued Interest | (3,921) | 22,989 | 12,215 |
| Revenue Refunds Accrued | (23,653) | 19,750 | - |
| Other Current Assets | (403) | 2,125 | 18,999 |
| Other Current Liabilities | 4,823 | (4,345) | (2,119) |
| **Net Cash Flows from Operating Activities** | 132,295 | 42,249 | 224,113 |
| | | | |
| **INVESTING ACTIVITIES** | | | |
| Construction Expenditures | (267,174) | (221,898) | (270,330) |
| Change in Other Cash Deposits | 19,786 | (66,972) | (37,407) |
| Change in Advances to Affiliates, Net | 180,926 | 213,078 | (394,004) |
| Acquisitions of Assets | (1,476) | - | - |
| Proceeds from Sale of Assets | 5,081 | 116,292 | 9,380 |
| Other | - | 2 | - |
| **Net Cash Flows from (Used for) Investing Activities** | (62,857) | 40,502 | (692,361) |
| | | | |
| **FINANCING ACTIVITIES** | | | |
| Issuance of Long-term Debt – Nonaffiliated | 159,288 | 5,264 | 1,715,285 |
| Issuance of Long-term Debt – Affiliated | - | - | 195,000 |
| Change in Advances from Affiliates, Net | 107,293 | - | (82,080) |
| Retirement of Long-term Debt – Nonaffiliated | (304,574) | (84,557) | (427,900) |
| Retirement of Long-term Debt – Affiliated | - | - | (345,000) |
| Retirement of Cumulative Preferred Stock | - | - | (13) |
| Principal Payments for Capital Lease Obligations | (1,614) | (1,451) | (1,024) |
| Dividends Paid on Common Stock | (30,000) | (3,000) | (585,000) |
| Dividends Paid on Cumulative Preferred Stock | (240) | (240) | (241) |
| Other | 511 | 555 | - |
| **Net Cash Flows from (Used for) Financing Activities** | (69,336) | (83,429) | 469,027 |
| | | | |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | 102 | (678) | 779 |
| **Cash and Cash Equivalents at Beginning of Period** | 101 | 779 | - |
| **Cash and Cash Equivalents at End of Period** | $ 203 | $ 101 | $ 779 |
| | | | |
| **SUPPLEMENTARY INFORMATION** | | | |
| Cash Paid for Interest, Net of Capitalized Amounts | $ 157,531 | $ 133,967 | $ 105,896 |
| Net Cash Paid (Received) for Income Taxes | 19,227 | 52,159 | (24,649) |
| Noncash Acquisitions Under Capital Leases | 1,155 | 948 | 3,572 |
| Construction Expenditures Included in Accounts Payable at December 31, | 11,711 | 9,591 | 16,502 |
| Revenue Refund Included in Accounts Receivable at December 31, | 68,055 | - | - |
| Cash Paid for CTC Refunds | 74,911 | 238,061 | 69,247 |

*See Notes to Consolidated Financial Statements.*

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. Organization and Summary of Significant Accounting Policies
2. New Accounting Pronouncements
3. Rate Matters
4. Effects of Regulation
5. Commitments, Guarantees and Contingencies
6. Dispositions
7. Benefit Plans
8. Business Segments
9. Derivatives, Hedging and Fair Value Measurements
10. Income Taxes
11. Leases
12. Financing Activities
13. Related Party Transactions
14. Property, Plant and Equipment
15. Unaudited Quarterly Financial Information

## 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### ORGANIZATION

As a public utility, TCC engages in the transmission and distribution of electric power to 761,000 retail customers through REPs in its service territory in southern and central Texas. TCC consolidates AEP Texas Central Transition Funding LLC and AEP Texas Central Transition Funding II LLC, its wholly-owned subsidiaries.

Under the Texas Restructuring Legislation, TCC exited the generation business and ceased serving retail load. Based on corporate separation and generation divestiture, the nature of TCC's business is no longer compatible with its participation in the CSW Operating Agreement and the SIA since these agreements involve the coordinated planning and operation of power supply facilities. Accordingly, TCC sought and received FERC approval to be removed from those agreements. TCC's sharing of margins under the CSW Operating Agreement ceased on May 1, 2006. The sharing of margins with AEP East companies under the SIA ceased on April 1, 2006.

Prior to May 1, 2006, as a member of the CSW Operating Agreement, TCC was compensated for energy delivered to other members based upon its incremental cost plus a portion of the savings realized by the purchasing member that avoids the use of more costly alternatives. The revenues and costs for sales to neighboring utilities and power marketers made by AEPSC on behalf of the AEP West companies were generally shared among the members based upon the relative magnitude of energy each member provided to make such sales.

Prior to April 1, 2006, under the SIA, AEPSC allocated physical and financial revenues and expenses from neighboring utilities, power marketers and other power and gas risk management activities among AEP East companies and AEP West companies based on an allocation methodology established at the time of the AEP-CSW merger. Sharing in a calendar year was based upon the level of such activities experienced for the twelve months ended June 30, 2000, which immediately preceded the merger. This activity resulted in an AEP East companies' and AEP West companies' allocation of approximately 91% and 9%, respectively, for revenues and expenses. Allocation percentages in any given calendar year were also based upon the relative generating capacity of the AEP East companies and AEP West companies in the event the pre-merger activity level was exceeded.

### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Rates and Service Regulation*

The PUCT approves rates and regulates the services and operations for a majority of TCC's transmission and distribution energy delivery services. TCC's affiliated transactions, including AEPSC intercompany service billings which are generally at cost, are regulated by the FERC under the 2005 Public Utility Holding Company Act, the Federal Power Act and by the PUCT. The FERC also has jurisdiction over the issuances and acquisitions of securities of the public utility holding company subsidiaries, such as TCC, the acquisition or sale of certain utility assets and mergers with another electric utility or holding company. A FERC order in 2008 pursuant to the Federal Power Act codified that for non-power goods and services, a non-regulated affiliate can bill a public utility company no more than market while a public utility must bill the higher of cost or market to a non-regulated affiliate.

TCC's wholesale transmission rates are regulated on a cost basis by the PUCT. TCC offers no retail transmission services.

In addition, the FERC regulates the SIA, the CSW Operating Agreement, the System Transmission Integration Agreement and the Transmission Coordination Agreement, all of which allocate shared system costs and revenues to the AEP subsidiaries that are parties to each agreement, including TCC. The sharing of margins with the AEP East companies under the SIA ceased on April 1, 2006. In May 2006, the FERC approved the removal of TCC from the CSW Operating Agreement.

The PUCT regulates all of TCC's public utility services/operations where transmission and distribution rates are regulated on a cost-basis and unbundled by function. TCC has no Texas jurisdictional retail generation/power supply operations. See Note 3 for further information on restructuring legislation and its effects on TCC.

Both the FERC and the PUCT are permitted to review and audit the books and records of TCC.

***Principles of Consolidation***

TCC's consolidated financial statements include TCC and its wholly-owned subsidiaries. Intercompany items are eliminated in consolidation. See "Variable Interest Entities" section of Note 13.

***Accounting for the Effects of Cost-Based Regulation***

As a cost-based rate-regulated electric transmission and distribution company, TCC's financial statements reflect the actions of regulators that result in the recognition of revenues and expenses in different time periods than enterprises that are not rate-regulated. In accordance with SFAS 71, regulatory assets (deferred expenses) and regulatory liabilities (future revenue reductions or refunds) are recorded to reflect the economic effects of regulation by matching expenses with their recovery through regulated revenues and income with its passage to customers through the reduction of regulated revenues. Due to the commencement of legislatively required restructuring and a transition to customer choice and market-based rates, TCC discontinued the application of SFAS 71, regulatory accounting, for the generation portion of its business in September 1999.

***Use of Estimates***

The preparation of these financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include, but are not limited to, inventory valuation, allowance for doubtful accounts, long-lived asset impairment, unbilled electricity revenue, valuation of long-term energy contracts, the effects of regulation, long-lived asset recovery, the effects of contingencies and certain assumptions made in accounting for pension and postretirement benefits. The estimates and assumptions used are based upon management's evaluation of the relevant facts and circumstances as of the date of the financial statements. Actual results could ultimately differ from those estimates.

***Property, Plant and Equipment and Equity Investments***

Electric utility property, plant and equipment are stated at original purchase cost. 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 cost-based rate-regulated 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 poles, transformers, etc. result in the original cost, less salvage, being charged to accumulated depreciation. These rates and the related lives are subject to periodic review. Removal costs are charged to regulatory liabilities. The costs of labor, materials and overhead incurred to operate and maintain the facilities 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.

***Allowance for Funds Used During Construction (AFUDC)***

AFUDC represents the estimated cost of borrowed and equity funds used to finance construction projects that is capitalized and recovered through depreciation over the service life of regulated electric utility plant.

***Valuation of Nonderivative Financial Instruments***

The book values of Cash and Cash Equivalents, Other Cash Deposits, Accounts Receivable and Accounts Payable approximate fair value because of the short-term maturity of these instruments.

***Cash and Cash Equivalents***

Cash and Cash Equivalents include temporary cash investments with original maturities of three months or less.

***Other Cash Deposits***

Other Cash Deposits include funds held by trustees primarily for the payment of debt and to secure the payments of the REPs.

***Inventory***

Materials and supplies inventories are carried at average cost.

***Accounts Receivable***

Customer accounts receivable primarily include receivables from wholesale and retail customers and customer receivables primarily related to other revenue-generating activities.

Revenue is recognized when power is delivered. To the extent that deliveries have occurred but a bill has not been issued, TCC accrues and recognizes, as Accrued Unbilled Revenues, an estimate of the revenues for deliveries since the last billing.

***Concentrations of Credit Risk and Significant Customers***

TCC has significant customers which on a combined basis account for the following percentages of total Operating Revenues for the periods ended and Accounts Receivable – Customers as of December 31:

| | **2008** | **2007** | **2006** |
|---|---|---|---|
| **TCC – Centrica and ERCOT (2006 only)** | | | |
| Percentage of Operating Revenues | 23% | 23% | 29% |
| Percentage of Accounts Receivable - Customers | 21% | 29% | 7% |

TCC monitors credit levels and the financial condition of its customers on a continuing basis to minimize credit risk. The PUCT allows recovery in rates for a reasonable level of bad debt costs. Management believes adequate provision for credit loss has been made in the accompanying financial statements.

***Revenue Recognition***

*Regulatory Accounting*

The financial statements for cost-based rate-regulated operations reflect the actions of regulators that can result in the recognition of revenues and expenses in different time periods than enterprises that are not rate-regulated. Regulatory assets (deferred expenses) and regulatory liabilities (deferred revenue reductions or refunds) are recorded to reflect the economic effects of regulation by matching expenses with their recovery through regulated revenues in the same accounting period and by matching income with its passage to customers in cost-based regulated rates.

When regulatory assets are probable of recovery through regulated rates, TCC records them as assets on the balance sheet. TCC tests for probability of recovery at each balance sheet date or whenever new events occur. Examples include the issuance of a regulatory commission order or passage of new legislation. If it is determined that recovery of a regulatory asset is no longer probable, TCC writes off that regulatory asset as a charge against income.

*Traditional Electricity Supply and Delivery Activities*

TCC recognizes revenues from wholesale electricity 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 includes unbilled as well as billed amounts. TCC records third party purchases as non-trading and these purchases are accounted for on a gross basis as Purchased Electricity for Resale in the Consolidated Statements of Income.

*Energy Marketing and Risk Management Activities*

Prior to TCC's FERC-approved removal from the SIA and CSW Operating Agreement, effective April 1, and May 1, 2006 respectively, AEPSC, on behalf of TCC, engaged in wholesale electricity, natural gas, coal and emission allowances marketing and risk management activities focused on wholesale markets where the AEP System owns assets and adjacent markets. These activities included the purchase and sale of energy under forward contracts at fixed and variable prices and the buying and selling of financial energy contracts which included exchange traded futures and options, and over-the-counter options and swaps. Certain energy marketing and risk management transactions were with RTOs.

TCC recognized revenues and expenses from wholesale marketing and risk management transactions that were not derivatives upon delivery of the commodity. TCC used MTM accounting for wholesale marketing and risk management transactions that were derivatives unless the derivative was designated in a qualifying cash flow hedge relationship or a normal purchase or sale. TCC recorded the unrealized and realized gains and losses on wholesale marketing and risk management transactions accounted for using MTM in Revenues in the Consolidated Statements of Income on a net basis.

Certain qualifying wholesale marketing and risk management derivative transactions were designated as hedges of future cash flows as a result of forecasted transactions (cash flow hedge). TCC initially recorded the effective portion of the cash flow hedge's gain or loss as a component of Accumulated Other Comprehensive Income (Loss). When the forecasted transaction was realized and affected earnings, TCC subsequently reclassified the gain or loss on the hedge from Accumulated Other Comprehensive Income into revenues or expenses on its Consolidated Statements of Income, within the same financial statement line item as the forecasted transaction. The ineffective portion of the gain or loss was recognized in revenues in the financial statements immediately.

*Construction Projects for Outside Parties*

TCC engages in construction projects for outside parties that are accounted for on the percentage-of-completion method of revenue recognition. This method recognizes revenue, including the related margin, as project costs are incurred. TCC includes such revenue and related expenses in Other revenue and Other Operation expense, respectively, in its Consolidated Statements of Income. TCC includes contractually billable expenses not yet billed in Current Assets in its Consolidated Balance Sheets.

***Maintenance***

Maintenance costs are expensed as incurred. If it becomes probable that TCC will recover specifically-incurred costs through future rates, a regulatory asset is established to match the expensing of those maintenance costs with their recovery in cost-based regulated revenues. Damages caused by hurricanes in excess of $500,000 per storm are deferred and recovered in rates.

### *Income Taxes and Investment Tax Credits*

TCC uses the liability method of accounting for income taxes. Under the liability method, deferred income taxes are provided for all temporary differences between the book and tax basis of assets and liabilities which will result in a future tax consequence.

When the flow-through method of accounting for temporary differences is reflected in regulated revenues (that is, when deferred taxes are not included in the cost of service for determining regulated rates for electricity), deferred income taxes are recorded and related regulatory assets and liabilities are established to match the regulated revenues and tax expense.

Investment tax credits are accounted for under the deferral basis and are being amortized over the life of the plant investment.

TCC accounts for uncertain tax positions in accordance with FIN 48. Effective with the adoption of FIN 48 beginning January 1, 2007, TCC classifies interest expense or income related to uncertain tax positions as interest expense or income as appropriate and classifies penalties as Other Operation.

### *Excise Taxes*

As an agent for some state and local governments, TCC collects from customers certain excise taxes levied by those state or local governments on customers. TCC does not record these taxes as revenue or expense.

### *Debt and Preferred Stock*

Gains and losses from the reacquisition of debt used to finance regulated electric utility plants are deferred and amortized over the remaining term of the reacquired debt in accordance with their rate-making treatment unless the debt is refinanced. If the reacquired debt associated with the regulated business is refinanced, the reacquisition costs attributable to the portions of the business that are subject to cost-based regulatory accounting are generally deferred and amortized over the term of the replacement debt consistent with its recovery in rates.

Debt discount or premium and debt issuance expenses are deferred and amortized generally utilizing the straight-line method over the term of the related debt. The straight-line method approximates the effective interest method and is consistent with the treatment in rates for regulated operations. The net amortization expense is included in Interest Expense.

The excess of par value over costs of preferred stock reacquired is credited to paid-in capital and reclassified to retained earnings upon the redemption of the entire preferred stock series. The excess of par value over the costs of reacquired preferred stock for nonregulated operations is credited to retained earnings upon reacquisition.

### *Comprehensive Income (Loss)*

Comprehensive income (loss) is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive income (loss) has two components: net income (loss) and other comprehensive income (loss).

### *Earnings Per Share (EPS)*

TCC is owned by a wholly-owned subsidiary of AEP. Therefore, TCC is not required to report EPS.

### *Reclassifications*

Certain prior period financial statement items have been reclassified to conform to current period presentation. These reclassifications had no impact on TCC’s previously reported net income or changes in shareholders’ equity.

## 2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of final pronouncements, management reviews the new accounting literature to determine the relevance, if any, to TCC's business. The following represents a summary of final pronouncements that management has determined relate to TCC's operations.

### Pronouncements Adopted in 2008

The following standards were effective during 2008. Consequently, the financial statements and footnotes reflect their impact.

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

TCC partially adopted SFAS 157 effective January 1, 2008. The statement defines fair value, establishes a fair value measurement framework and expands fair value disclosures.

In February 2008, the FASB issued FSP SFAS 157-1 "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" (SFAS 157-1) which amends SFAS 157 to exclude SFAS 13 "Accounting for Leases" and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under SFAS 13. SFAS 157-1 was effective upon issuance and had no impact on the financial statements

In February 2008, the FASB issued FSP SFAS 157-2 "Effective Date of FASB Statement No. 157" (SFAS 157-2) which delays the effective date of SFAS 157 to fiscal years beginning after November 15, 2008 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). TCC fully adopted SFAS 157 effective January 1, 2009 for items within the scope of SFAS 157-2. The adoption of SFAS 157-2 had no impact on the financial statements.

In October 2008, the FASB issued FSP SFAS 157-3 "Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active" which clarifies application of SFAS 157 in markets that are not active and provides an illustrative example. The FSP was effective upon issuance. The adoption of this standard had no impact on the financial statements.

See "SFAS 157 Fair Value Measurements" Section of Note 9 for further information.

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

The FASB permitted entities to choose to measure many financial instruments and certain other items at fair value. The standard also established presentation and disclosure requirements designed to facilitate comparison between entities that choose different measurement attributes for similar types of assets and liabilities. 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. The statement is applied prospectively upon adoption.

TCC adopted SFAS 159 effective January 1, 2008. At adoption, TCC did not elect the fair value option for any assets or liabilities.

***SFAS 162 "The Hierarchy of Generally Accepted Accounting Principles" (SFAS 162)***

In May 2008, the FASB issued SFAS 162, clarifying the sources of generally accepted accounting principles in descending order of authority. The statement specifies that the reporting entity, not its auditors, is responsible for its compliance with GAAP.

TCC adopted SFAS 162 in the fourth quarter of 2008. The adoption of this standard had no impact on the financial statements.

***EITF Issue No. 06-10 "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements" (EITF 06-10)***

In March 2007, the FASB ratified EITF 06-10, a consensus on collateral assignment split-dollar life insurance arrangements in which an employee owns and controls the insurance policy. Under EITF 06-10, an employer should recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement if the employer agreed to maintain a life insurance policy during the employee's retirement or to provide the employee with a death benefit based on a substantive arrangement with the employee. In addition, an employer should recognize and measure an asset based on the nature and substance of the collateral assignment split-dollar life insurance arrangement. EITF 06-10 requires recognition of the effects of its application as either (a) a cumulative effect adjustment to retained earnings or other components of equity or net assets in the statement of financial position at the beginning of the year of adoption or (b) retrospective application to all prior periods. TCC adopted EITF 06-10 effective January 1, 2008 with a cumulative effect reduction of $1.2 million ($748 thousand, net of tax) to beginning retained earnings.

***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 addressed the recognition of income tax benefits of dividends on employee share-based compensation. 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.

TCC adopted EITF 06-11 effective January 1, 2008. The adoption of this standard had an immaterial impact on the financial statements.

***FSP SFAS 133-1 and FIN 45-4 "Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161" (FSP SFAS 133-1 and FIN 45-4)***

In September 2008, the FASB issued FSP SFAS 133-1 and FIN 45-4 amending SFAS 133 and FIN 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." Under the SFAS 133 requirements, the seller of a credit derivative shall disclose the following information for each derivative, including credit derivatives embedded in a hybrid instrument, even if the likelihood of payment is remote:

(a) The nature of the credit derivative.
(b) The maximum potential amount of future payments.
(c) The fair value of the credit derivative.
(d) The nature of any recourse provisions and any assets held as collateral or by third parties.

Further, the standard requires the disclosure of current payment status/performance risk of all FIN 45 guarantees. In the event an entity uses internal groupings, the entity shall disclose how those groupings are determined and used for managing risk.

TCC adopted the standard effective December 31, 2008. The adoption of this standard had no impact on the financial statements but increased the guarantees disclosures in Note 5.

*FSP SFAS 140-4 and FIN 46R-8 "Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities" (FSP SFAS 140-4 and FIN 46R-8)*

In December 2008, the FASB issued FSP SFAS 140-4 and FIN 46R-8 amending SFAS 140 "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" and FIN 46R "Consolidation of Variable Interest Entities." Under the requirements, the transferor of financial assets in the securitization or asset-backed financing arrangement must disclose the following:

(a) Nature of any restrictions on assets reported by an entity in its balance sheet that relate to a transferred financial asset, including the carrying amounts of such assets.
(b) Method of reporting servicing assets and servicing liabilities.
(c) If reported as sales and the transferor has continuing involvement with the transferred financial assets and the transfers are accounted for as secured borrowings, how the transfer of financial assets affects the transferors' balance sheet, net income and cash flows.

The FIN 46R amendments contain disclosure requirements for a public enterprise that (a) is the primary beneficiary of a variable interest entity (VIE), (b) holds a significant variable interest in a VIE but is not the primary beneficiary or (c) is a sponsor that holds a variable interest in a VIE. The principle objectives of the disclosures required by this standard are to provide financial statement users an understanding of:

(a) Significant judgments and assumptions made to determine whether to consolidate a variable interest entity and/or disclose information about involvement with a variable interest entity.
(b) Nature of the restrictions on a consolidated variable interest entity's assets reported in the balance sheet, including the carrying amounts of such assets.
(c) Nature of, and changes in, risks associated with a company's involvement with a variable interest entity.
(d) A variable interest entity's effect on the balance sheet, net income and cash flows.
(e) The nature, purpose, size and activities of any variable interest equity, including how it is financed.

TCC adopted the standard effective December 31, 2008. The adoption of this standard had no impact on the financial statements but increased the footnote disclosures for variable interest entities. See "Variable Interest Entities" section of Note 13.

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

In April 2007, the FASB issued FSP FIN 39-1 amending FIN 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. The amendment 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.

TCC adopted the standard effective January 1, 2008. This standard changed the method of netting certain balance sheet amounts. It had no impact on TCC.

**Pronouncements Adopted During The First Quarter of 2009**

The following standards are effective during the first quarter of 2009. Consequently, their impact will be reflected in the first quarter of 2009 financial statements when filed. The following paragraphs discuss their expected impact on future financial statement and footnote disclosures.

*SFAS 141 (revised 2007) "Business Combinations" (SFAS 141R)*

In December 2007, the FASB issued SFAS 141R, improving financial reporting about business combinations and their effects. It established how the acquiring entity recognizes and measures the identifiable assets acquired, liabilities assumed, goodwill acquired, any gain on bargain purchases and any noncontrolling interest in the acquired entity. SFAS 141R no longer allows acquisition-related costs to be included in the cost of the business combination,

but rather expensed in the periods they are incurred, with the exception of the costs to issue debt or equity securities which shall be recognized in accordance with other applicable GAAP. The standard requires disclosure of information for a business combination that occurs during the accounting period or prior to the issuance of the financial statements for the accounting period. SFAS 141R can affect tax positions on previous acquisitions. TCC does not have any such tax positions that result in adjustments.

TCC adopted SFAS 141R effective January 1, 2009. It is effective prospectively for business combinations with an acquisition date on or after January 1, 2009. TCC will apply it to any future business combinations.

***SFAS 160 "Noncontrolling Interest in Consolidated Financial Statements" (SFAS 160)***

In December 2007, the FASB issued SFAS 160, modifying reporting for noncontrolling interest (minority interest) in consolidated financial statements. The statement requires noncontrolling interest be reported in equity and establishes a new framework for recognizing net income or loss and comprehensive income by the controlling interest. Upon deconsolidation due to loss of control over a subsidiary, the standard requires a fair value remeasurement of any remaining noncontrolling equity investment to be used to properly recognize the gain or loss. SFAS 160 requires specific disclosures regarding changes in equity interest of both the controlling and noncontrolling parties and presentation of the noncontrolling equity balance and income or loss for all periods presented.

TCC adopted SFAS 160 effective January 1, 2009. The adoption of this standard had no impact on TCC.

***SFAS 161 "Disclosures about Derivative Instruments and Hedging Activities" (SFAS 161)***

In March 2008, the FASB issued SFAS 161, enhancing disclosure requirements for derivative instruments and hedging activities. Affected entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how an entity accounts for derivative instruments and related hedged items and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. The standard requires that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation.

TCC adopted SFAS 161 effective January 1, 2009. This standard will increase the disclosure requirements related to derivative instruments and hedging activities in future reports.

***EITF Issue No. 08-5 "Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement" (EITF 08-5)***

In September 2008, the FASB ratified the consensus on liabilities with third-party credit enhancements when the liability is measured and disclosed at fair value. The consensus treats the liability and the credit enhancement as two units of accounting. Under the consensus, the fair value measurement of the liability does not include the effect of the third-party credit enhancement. Consequently, changes in the issuer's credit standing without the support of the credit enhancement affect the fair value measurement of the issuer's liability. Entities will need to provide disclosures about the existence of any third-party credit enhancements related to their liabilities. In the period of adoption, entities must disclose the valuation method(s) used to measure the fair value of liabilities within its scope and any change in the fair value measurement method that occurs as a result of its initial application.

TCC adopted EITF 08-5 effective January 1, 2009. It will be applied prospectively with the effect of initial application included as a change in fair value of the liability in the period of adoption. The adoption of this standard will impact the financial statements in the 2009 Annual Report as TCC reports fair value of long-term debt annually.

***EITF Issue No. 08-6 "Equity Method Investment Accounting Considerations" (EITF 08-6)***

In November 2008, the FASB ratified the consensus on equity method investment accounting including initial and allocated carrying values and subsequent measurements. It requires initial carrying value be determined using the SFAS 141R cost allocation method. When an investee issues shares, the equity method investor should treat the transaction as if the investor sold part of its interest.

TCC adopted EITF 08-6 effective January 1, 2009 with no impact on its financial statements. It was applied prospectively.

*FSP SFAS 142-3 "Determination of the Useful Life of Intangible Assets" (SFAS 142-3)*

In April 2008, the FASB issued SFAS 142-3 amending factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. The standard is expected to improve consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure its fair value.

TCC adopted SFAS 142-3 effective January 1, 2009. The guidance is prospectively applied to intangible assets acquired after the effective date. The standard's disclosure requirements are applied prospectively to all intangible assets as of January 1, 2009. The adoption of this standard had no impact on the financial statements.

**Pronouncements Effective in the Future**

The following standards will be effective in the future and their impacts disclosed at that time.

*FSP SFAS 132R-1 "Employers' Disclosures about Postretirement Benefit Plan Assets" (FSP SFAS 132R-1)*

In December 2008, the FASB issued FSP SFAS 132R-1 providing additional disclosure guidance for pension and OPEB plan assets. The rule requires disclosure of investment policy including target allocations by investment class, investment goals, risk management policies and permitted or prohibited investments. It specifies a minimum of investment classes by further dividing equity and debt securities by issuer grouping. The standard adds disclosure requirements including hierarchical classes for fair value and concentration of risk.

This standard is effective for fiscal years ending after December 15, 2009. Management expects this standard to increase the disclosure requirements related to AEP's benefit plans. TCC will adopt the standard effective for the 2009 Annual Report.

*Future Accounting Changes*

The FASB's standard-setting process is ongoing and until new standards have been finalized and issued, 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 revenue recognition, contingencies, liabilities and equity, emission allowances, leases, insurance, hedge accounting, trading inventory 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 net income and financial position.

## 3. RATE MATTERS

TCC is involved in rate and regulatory proceedings at the FERC and the PUCT. This note is a discussion of rate matters and industry restructuring related proceedings that could have a material effect on net income and cash flows.

For discussion of the FERC's November 2008 order on AEP's allocation of off-system sales, see "Allocation of Off-system Sales Margins" section within "FERC Rate Matters".

### TEXAS RESTRUCTURING

***Texas Restructuring Appeals***

Pursuant to PUCT orders, TCC securitized net recoverable stranded generation costs of $2.5 billion and is recovering the principal and interest on the securitization bonds through the end of 2020. TCC refunded net other true-up regulatory liabilities of $375 million during the period October 2006 through June 2008 via a CTC credit rate rider. Although earnings were not affected by this CTC refund, cash flow was adversely impacted for 2008, 2007 and 2006 by $75 million, $238 million and $69 million, respectively. TCC appealed the PUCT stranded costs true-up and related 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 were:

- 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 TCC 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 costs.
- Two federal matters regarding the allocation of off-system sales related to fuel recoveries and a potential tax normalization violation.

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 appeals of the true-up order affirmed the PUCT's April 2006 final true-up order for TCC with two significant exceptions. The judge determined that the PUCT erred by applying an invalid rule to determine the carrying cost rate for the true-up of stranded costs and remanded this matter to the PUCT for further consideration. The District Court judge also determined that the PUCT improperly reduced TCC's net stranded plant costs for commercial unreasonableness.

TCC, the PUCT and intervenors appealed the District Court decision to the Texas Court of Appeals. In May 2008, the Texas Court of Appeals affirmed the District Court decision in all but two major respects. It reversed the District Court's unfavorable decision which found that the PUCT erred by applying an invalid rule to determine the carrying cost rate. It also determined that the PUCT erred by not reducing stranded costs by the "excess earnings" that had already been refunded to affiliated retail electric providers. Management does not believe that TCC will be adversely affected by the Court of Appeals ruling on excess earning based upon the reasons discussed in the "TCC Excess Earnings" section below. The favorable commercial unreasonableness judgment entered by the District Court was not reversed. The Texas Court of Appeals denied intervenors' motion for rehearing. In May 2008, TCC, the PUCT and intervenors filed petitions for review with the Texas Supreme Court. Review is discretionary and the Texas Supreme Court has not determined if it will grant review.

Management cannot predict the outcome of these court proceedings and PUCT remand decisions. If TCC ultimately succeeds in its appeals, it could have a material favorable effect on future net income, cash flows and financial condition. If municipal customers and other intervenors succeed in their appeals, it could have a substantial adverse effect on future net income, cash flows and financial condition.

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

Appeals remain outstanding related to the stranded costs true-up and related orders regarding whether the PUCT may require TCC to refund certain tax benefits to customers. The PUCT reduced TCC's securitized stranded costs by certain tax benefits. Subsequent to the reduction, the PUCT allowed TCC to defer $103 million of ordered CTC refunds for other true-up items to negate the securitization reduction. Of the $103 million, $61 million relates to the present value of certain tax benefits applied to reduce the securitization stranded generating assets and $42 million relates to carrying costs. The deferral of the CTC refunds is pending resolution on whether the PUCT's securitization refund is an IRS normalization violation.

Evidence includes a March 2008 IRS issuance of final regulations addressing the normalization requirements for the treatment of Accumulated Deferred Investment Tax Credit (ADITC) and Excess Deferred Federal Income Tax (EDFIT) in a stranded cost determination. Consistent with a Private Letter Ruling TCC received in 2006, the regulations clearly state that TCC will sustain a normalization violation if the PUCT orders TCC to flow the tax benefits to customers as part of the stranded cost true-up. TCC notified the PUCT that the final regulations were issued and the PUCT made its request to the court. In May 2008, as requested by the PUCT, the Texas Court of Appeals ordered a remand of the tax normalization issue for the consideration of this additional evidence.

TCC expects that the PUCT will allow TCC to retain these amounts. This will have a favorable effect on future net income and cash flows as TCC will be free to amortize the deferred ADITC and EDFIT tax benefits due to the sale of the generating plants that generated the tax benefits. Since management expects that the PUCT will allow TCC to retain the deferred CTC refund amounts in order to avoid an IRS normalization violation, management has not accrued any related interest expense for refunds of these amounts. If accrued, management estimates interest expense would have been approximately $4 million higher for the period July 2008 through December 2008 based on a CTC interest rate of 7.5%.

If the PUCT orders TCC to return the tax benefits to customers, thereby causing TCC to violate the IRS' normalization regulations, it could result in TCC's repayment to the IRS, under the normalization rules, of ADITC on all property, including transmission and distribution property. This amount approximates $103 million as of December 31, 2008. It could also lead to a loss of TCC's right to claim accelerated tax depreciation in future tax returns. If TCC is required to repay to the IRS its ADITC and is also required to refund ADITC to customers, it would have an unfavorable effect on future net income and cash flows. Tax counsel advised management that a normalization violation should not occur until all remedies under law have been exhausted and the tax benefits are actually returned to ratepayers under a nonappealable order. Management intends to continue to work with the PUCT to favorably resolve the issue and avoid the adverse effects of a normalization violation on future net income, cash flows and financial condition.

### *TCC Excess Earnings*

In 2005, a Texas appellate court issued a decision finding that a PUCT order requiring TCC to refund to the REPs excess earnings prior to and outside of the true-up process was unlawful under the Texas Restructuring Legislation. From 2002 to 2005, TCC refunded $55 million of excess earnings, including interest, under the overturned PUCT order. On remand, the PUCT must determine how to implement the Court of Appeals decision given that the unauthorized refunds were made to the REPs in lieu of reducing stranded cost recoveries from REPs in the True-up Proceeding. It is possible that TCC's stranded cost recovery, which is currently on appeal, may be affected by a PUCT remedy.

In May 2008, the Texas Court of Appeals issued a decision in TCC's True-up Proceeding determining that even though excess earnings had been previously refunded to REPs, TCC still must reduce stranded cost recoveries in its True-up Proceeding. In 2005, TCC reflected the obligation to refund excess earnings to customers through the true-up process and recorded a regulatory asset of $55 million representing a receivable from the REPs for prior excess earnings refunds made to them by TCC. However, certain parties have taken positions that, if adopted, could result in TCC being required to refund additional amounts of excess earnings or interest through the true-up process without receiving a refund from the REPs. If this were to occur, it would have an adverse effect on future net income and cash flows. AEP sold its affiliate REPs in December 2002. While AEP owned the affiliate REPs, TCC refunded $11 million of excess earnings to the affiliate REPs. Management cannot predict the outcome of the excess earnings remand and whether it would have an adverse effect on future net income and cash flows.

***2008 Interim Transmission Rates***

In March 2008, TCC filed an application with the PUCT for an interim update of wholesale-transmission rates. The PUCT issued an order in May 2008 that provided for increased interim transmission rates for TCC, subject to review during the next TCC base rate case. This review could result in a refund if the PUCT finds that TCC has not prudently incurred the transmission investment. The FERC approved the new interim transmission rates in May 2008 which increased annual transmission revenues by $9 million. TCC has not recorded any provision for refund regarding the interim transmission rates because management believes these new rates are reasonable and necessary to recover costs associated with new transmission plant. Management cannot predict the outcome of future proceedings related to the interim transmission rates. A refund of the interim transmission rates would have an adverse impact on net income and cash flows.

***2009 Interim Transmission Rates***

In February 2009, TCC filed an application with the PUCT for an interim update of wholesale-transmission rates. The proposed new interim transmission rates are estimated to increase transmission revenues by $8 million on an annual basis, effective March 30, 2009. A decision is expected from the PUCT during the second quarter of 2009 with rates increasing shortly thereafter upon the FERC's concurrence. Management cannot predict the outcome of this interim transmission rates proceeding.

**OTHER TEXAS RATE MATTERS**

***Hurricanes Dolly and Ike***

In July and September 2008, TCC's service territory in south Texas was hit by Hurricanes Dolly and Ike, respectively. TCC incurred $23 million and $2 million in incremental maintenance costs related to service restoration efforts for Hurricanes Dolly and Ike, respectively. TCC has a PUCT approved catastrophe reserve which permits TCC to collect $1.3 million on an annual basis with authority to continue the collection until the catastrophe reserve reaches $13 million. Any incremental storm-related maintenance costs can be charged against the catastrophe reserve if the total incremental maintenance costs for a storm exceed $500 thousand. In June 2008, prior to these hurricanes, TCC had approximately $2 million recorded in the catastrophe reserve account. Therefore, TCC established a net regulatory asset for $23 million.

Under Texas law and as previously approved by the PUCT in prior base rate cases, the regulatory asset will be included in rate base in the next base rate filing. At that time, TCC will evaluate the existing catastrophe reserve amounts and review potential future events to determine the appropriate funding level to request to both recover the regulatory asset and fund a reserve for future storms.

***ETT***

In December 2007, TCC contributed $70 million of transmission facilities to ETT, an AEP joint venture accounted for using the equity method. The PUCT approved ETT's initial rates, its request for a transfer of facilities and a certificate of convenience and necessity to operate as a stand alone transmission utility in the ERCOT region. ETT was allowed a 9.96% after tax return on equity rate in those approvals. In 2008, intervenors filed a notice of appeal to the Travis County District Court. In October 2008, the court ruled that the PUCT exceeded its authority by approving ETT's application as a stand alone transmission utility without a service area under the wrong section of the statute. Management believes that ruling is incorrect. Moreover, ETT provided evidence in its application that ETT complied with what the court determined was the proper section of the statute. In January 2009, ETT and the PUCT filed appeals to the Texas Court of Appeals. As of December 31, 2008, AEP's net investment in ETT was $15 million. In January 2009, TCC sold $60 million of transmission facilities to ETT. See "Electric Transmission Texas LLC (ETT)" section of Note 6. Depending upon the ultimate outcome of the appeals and any resulting remands, TCC may be required to reacquire transferred assets and projects under construction by ETT.

ETT and TCC are involved in transactions relating to the transfer to ETT of other transmission assets, which are in various stages of review and approval. In September 2008, ETT and a group of other Texas transmission providers filed a comprehensive plan with the PUCT for completion of the Competitive Renewable Energy Zone (CREZ) initiative. The CREZ initiative is the development of 2,400 miles of new transmission lines to transport electricity from 18,000 megawatts of planned wind farm capacity in west Texas to rapidly growing cities in eastern Texas. In January 2009, the PUCT announced its decision to authorize ETT to construct CREZ related projects. ETT has estimated that the PUCT's decision authorizes ETT to construct $750 million to $850 million of new transmission assets.

## FERC Rate Matters

### *Allocation of Off-system Sales Margins*

In August 2008, the OCC filed a complaint at the FERC alleging that AEP inappropriately allocated off-system sales margins between the AEP East companies and the AEP West companies and did not properly allocate off-system sales margins within the AEP West companies. The PUCT intervened in this filing. In November 2008, the FERC issued a final order concluding that AEP inappropriately deviated from off-system sales margin allocation methods in the AEP SIA and the CSW Operating Agreement for the period June 2000 through March 2006. The FERC ordered AEP to recalculate and reallocate the off-system sales margins in compliance with the AEP SIA and to have the AEP East companies issue refunds to the AEP West companies. Although the FERC determined that AEP deviated from the CSW Operating Agreement, the FERC determined the allocation methodology to be reasonable. The FERC ordered AEP to submit a revised CSW Operating Agreement for the period June 2000 to March 2006. In December 2008, AEP filed a motion for rehearing and a revised CSW Operating Agreement for the period June 2000 to March 2006. The motion for rehearing is still pending. In January 2009, AEP filed a compliance filing with the FERC and refunded approximately $250 million from the AEP East companies to the AEP West companies. The AEP West companies were required to share a portion of such revenues with their wholesale and retail customers during this period. In December 2008, the AEP West companies recorded a provision for refund which had a $97 million unfavorable effect on AEP net income.

The table below lists the respective amounts the AEP East companies and the AEP West companies recorded in December 2008 including the net increase (decrease) to net income for the year ended December 31, 2008:

| AEP East Companies | Amounts to be (Transferred)/ Received Including Interest (in millions) | Increase/ (Decrease) to Net Income (in millions) |
|---|---|---|
| APCo | $ (77) | $ (50) |
| I&M | (48) | (32) |
| OPCo | (62) | (40) |
| CSPCo | (44) | (28) |
| KPCo | (19) | (12) |
| **Total – AEP East Companies** | (250) | (162) |
| **AEP West Companies** | | |
| PSO | 72 | 12 |
| SWEPCo | 85 | 20 |
| TCC | 68 | 23 |
| TNC | 25 | 10 |
| **Total – AEP West Companies** | 250 | 65 |
| **Total – AEP Consolidated** | $ - | $ (97) |

The table below shows the vintage year of the associated AEP SIA refunds:

| | For the Twelve Months Ended December 31, | | | |
|---|---|---|---|---|
| | 2006 and Prior | 2007 | 2008 | Total |
| **AEP East Companies** | (in millions) | | | |
| APCo | $ (66) | $ (6) | $ (5) | $ (77) |
| I&M | (41) | (4) | (3) | (48) |
| OPCo | (53) | (5) | (4) | (62) |
| CSPCo | (40) | (3) | (1) | (44) |
| KPCo | (17) | (1) | (1) | (19) |
| **Total – AEP East Companies** | (217) | (19) | (14) | (250) |
| **AEP West Companies** | | | | |
| PSO | 62 | 6 | 4 | 72 |
| SWEPCo | 74 | 6 | 5 | 85 |
| TCC | 59 | 5 | 4 | 68 |
| TNC | 22 | 2 | 1 | 25 |
| **Total – AEP West Companies** | 217 | 19 | 14 | 250 |
| **Total – AEP Consolidated** | $ - | $ - | $ - | $ - |

Management cannot predict the outcome of the requested FERC rehearing proceeding or any future regulatory proceedings but believes the provision regarding future regulatory proceedings is adequate.

## 4. EFFECTS OF REGULATION

Regulatory assets and liabilities are comprised of the following items:

| | December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | Notes |
| **Regulatory Assets:** | (in thousands) | | |
| **Noncurrent Regulatory Assets** | | | |
| SFAS 158 Regulatory Asset (See Note 7) | $ 231,976 | $ 89,377 | (a) (e) |
| Restructuring Transition Costs | 29,534 | 45,819 | (a) (g) |
| Hurricanes Dolly and Ike (See Note 3) | 22,997 | - | (b) (i) |
| Unamortized Loss on Reacquired Debt | 20,999 | 20,523 | (b) (h) |
| Other | 8,523 | 12,272 | (a) (e) |
| **Total Noncurrent Regulatory Assets** | $ 314,029 | $ 167,991 | |
| **Regulatory Liabilities:** | | | |
| **Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits** | | | |
| Asset Removal Costs | $ 261,347 | $ 246,247 | (d) |
| Deferred Investment Tax Credits | 102,841 | 103,663 | (a) (f) |
| SFAS 109 Regulatory Liability, Net (See Note 10) | 58,906 | 72,235 | (c) (e) |
| Other | 21,040 | 32,383 | (c) (e) |
| **Total Noncurrent Regulatory Liabilities and Deferred Investment Tax Credits** | $ 444,134 | $ 454,528 | |

(a) Amount does not earn a return.
(b) Amount earns a return.
(c) A portion of this amount earns a return.
(d) The liability for removal costs, which reduces rate base and the resultant return, will be discharged as removal costs are incurred.
(e) Recovery/refund period – various periods.
(f) Recovery/refund period – up to 54 years.
(g) Recovery/refund period – up to 7 years.
(h) Recovery/refund period – up to 28 years.
(i) Recovery method and timing to be determined in future proceedings.

## 5. COMMITMENTS, GUARANTEES AND CONTINGENCIES

TCC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, TCC's 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.

### *Insurance and Potential Losses*

TCC maintains insurance coverage normal and customary for an electric utility, subject to various deductibles. The insurance includes coverage for all risks of physical loss or damage to assets, subject to insurance policy conditions and exclusions. Covered property generally includes substations, facilities and inventories. Excluded property generally includes transmission and distribution lines, poles and towers. The insurance programs also generally provide coverage against loss arising from certain claims made by third parties and are in excess of TCC's retentions. Coverage is generally provided by a combination of a South Carolina domiciled insurance company, EIS, together with and/or in addition to various industry mutual and commercial insurance carriers.

Some potential losses or liabilities may not be insurable or the amount of insurance carried may not be sufficient to meet potential losses and liabilities. Future losses or liabilities, if they occur, which are not completely insured, unless recovered from customers, could have a material adverse effect on net income, cash flows and financial condition.

### COMMITMENTS

TCC has substantial construction commitments to support its operations and environmental investments. In managing the overall construction program and in the normal course of business, TCC contractually commits to third-party construction vendors for certain material purchases and other construction services. Budgeted construction expenditures for 2009 are $289.9 million. Budgeted construction expenditures are subject to periodic review and modification and may vary based on the ongoing effects of regulatory constraints, environmental regulations, business opportunities, market volatility, economic trends, weather, legal reviews and the ability to access capital.

TCC purchases materials, supplies, services and property, plant and equipment under contract as part of its normal course of business. Certain supply contracts contain penalty provisions for early termination. Management does not expect to incur penalty payments under these provisions that would materially affect net income, cash flows or financial condition.

The following table summarizes TCC's actual contractual commitments at December 31, 2008:

| Contractual Commitments | Less Than 1 year | 2-3 years | 4-5 years | After 5 years | Total |
|---|---|---|---|---|---|
| | | | (in millions) | | |
| Construction Contracts for Capital Assets (a) | $ 20.1 | $ 18.2 | $ 1.1 | $ - | $ 39.4 |

(a) Represents only capital assets that are contractual commitments.

### 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." In addition, TCC adopted FSP SFAS 133-1 and FIN 45-4 "Disclosures about Credit Derivatives and Certain Guarantees: An amendment of FSB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161" effective December 31, 2008. 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 December 31, 2008, TCC entered into sale agreements including indemnifications with a maximum exposure of $13 million related to the sale price of generation assets and ETT. See “Texas Plants – Oklaunion Power Station” and “Electric Transmission Texas LLC (ETT)” sections of Note 6. There are no material liabilities recorded for any indemnifications and the risk of payment/performance is remote.

Lease Obligations

TCC leases certain equipment under master lease agreements. See “Master Lease Agreements” section of Note 11 for disclosure of lease residual value guarantees.

**CONTINGENCIES**

***Carbon Dioxide 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 dismissal of this lawsuit was appealed to the Second Circuit Court of Appeals. Briefing and oral argument concluded in 2006. In April 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 which were provided in 2007. Management believes the actions are without merit and intends to defend against the claims.

***Alaskan Villages’ Claims***

In February 2008, the Native Village of Kivalina and the City of Kivalina, Alaska filed a lawsuit in federal court in the Northern District of California against AEP, AEPSC and 22 other unrelated defendants including oil & gas companies, a coal company, and other electric generating companies. The complaint alleges that the defendants' emissions of $CO_2$ contribute to global warming and constitute a public and private nuisance and that the defendants are acting together. The complaint further alleges that some of the defendants, including AEP, conspired to create a false scientific debate about global warming in order to deceive the public and perpetuate the alleged nuisance. The plaintiffs also allege that the effects of global warming will require the relocation of the village at an alleged cost of $95 million to $400 million. The defendants filed motions to dismiss the action. The motions are pending before the court. Management believes the action is without merit and intends to defend against the claims.

***The Comprehensive Environmental Response Compensation and Liability Act (Superfund) and State Remediation***

The transmission and distribution facilities have used asbestos, polychlorinated biphenyls (PCBs) and other hazardous and nonhazardous materials. TCC currently incurs costs to safely dispose of these substances.

Superfund addresses clean-up of hazardous substances that have been released to the environment. The Federal EPA administers the clean-up programs. Several states have enacted similar laws. At December 31, 2008, TCC has been named potentially liable at one site under state law. In the instance where TCC has been named a defendant, disposal or recycling activities were in accordance with the then-applicable laws and regulations. Superfund does not recognize compliance as a defense, but imposes strict liability on parties who fall within its broad statutory categories. Liability has been resolved for a number of sites with no significant effect on net income.

Management evaluates the potential liability for each site separately, but several general statements can be made regarding potential future liability. Disposal of materials at a particular site is often unsubstantiated and the quantity of materials deposited at a site was small and often nonhazardous. Although Superfund liability has been interpreted by the courts as joint and several, typically many parties are named for each site and several of the parties are financially sound enterprises. At present, management's estimates do not anticipate material cleanup costs for identified sites.

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

In July 2007, the City of Brownsville, Texas filed an original petition in litigation pending in the District Court of Dallas County, Texas. The petition seeks 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. In 2007 and early 2008, the court heard various motions for partial summary judgment. In February 2009, the court granted TCC's motion for summary judgment. 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. In 2003, the FERC rejected the complaint. In 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. That decision was appealed to the U.S. Supreme Court. In June 2008, the U.S. Supreme Court affirmed the validity of contractually-agreed rates except in cases of serious harm to the public. The U.S. Supreme Court affirmed the Ninth Circuit's remand on two issues, market manipulation and excessive burden on consumers. The FERC initiated remand procedures and gave the parties time to attempt to settle the issues. Management believes a provision recorded in 2008 should be sufficient. 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 that may be owed to the Nevada utilities. Management is unable to predict the ultimate outcome of these proceedings or their impact on future net income and cash flows.

## 6. DISPOSITIONS

**2009**

***Electric Transmission Texas LLC (ETT)***

In January 2009, TCC sold $60 million of transmission facilities to ETT. See the 2007 activity for ETT below.

**2008**

None

**2007**

***Electric Transmission Texas LLC (ETT)***

In December 2007, TCC contributed $70 million of transmission facilities to ETT, a newly-formed affiliated entity which will own and operate transmission assets in ERCOT. Through a series of transactions, TCC received a cash distribution from ETT of $42 million and sold a 50% interest, at net book value, for $14 million to MidAmerican Energy Holdings Company. TCC then distributed its remaining 50% interest (book value of $14 million) in ETT to, its parent, AEP Utilities, Inc., the holding company for AEP's ERCOT investments.

*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 $43 million plus adjustments. The sale did not have a material effect on TCC's net income. Management does not expect that the remaining litigation will have a significant impact on future net income. See "Claims by the City of Brownsville, Texas Against TCC" section of Note 5.

**2006**

None

## 7. BENEFIT PLANS

TCC participates in AEP sponsored qualified pension plans (merged at December 31, 2008) and unfunded nonqualified pension plans. A substantial majority of employees are covered by either one qualified plan or both a qualified and a nonqualified pension plan. TCC participates in OPEB plans sponsored by AEP to provide medical and life insurance benefits for retired employees.

TCC adopted SFAS 158 in December 2006 and recognized the obligations associated with defined benefit pension plans and OPEB plans in the balance sheets. TCC recognizes an asset for a plan's overfunded status or a liability for a plan's underfunded status and recognize, as a component of other comprehensive income, the changes in the funded status of the plan that arise during the year that are not recognized as a component of net periodic benefit cost. TCC records a SFAS 71 regulatory asset for qualifying SFAS 158 costs of regulated operations that for ratemaking purposes are deferred for future recovery. The effect of this standard on the 2006 financial statements was a pretax AOCI adjustment that was fully offset by a SFAS 71 regulatory asset.

SFAS 158 requires adjustment of pretax AOCI at the end of each year, for both underfunded and overfunded defined benefit pension and OPEB plans, to an amount equal to the remaining unrecognized deferrals for unamortized actuarial losses or gains, prior service costs and transition obligations, such that remaining deferred costs result in an AOCI equity reduction and deferred gains result in an AOCI equity addition. The year-end AOCI measure can be volatile based on fluctuating market conditions, investment returns and discount rates.

The following tables provide a reconciliation of the changes in projected benefit obligations and fair value of assets for AEP's plans over the two-year period ending at the plan's measurement date of December 31, 2008, and their funded status as of December 31 for each year:

***Projected Plan Obligations, Plan Assets, Funded Status as of December 31, 2008 and 2007***

| | Pension Plans | | Other Postretirement Benefit Plans | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| **Change in Projected Benefit Obligation** | | (in millions) | | |
| Projected Obligation at January 1 | $ 4,109 | $ 4,108 | $ 1,773 | $ 1,818 |
| Service Cost | 100 | 96 | 42 | 42 |
| Interest Cost | 249 | 235 | 113 | 104 |
| Actuarial Loss (Gain) | 139 | (64) | 2 | (91) |
| Plan Amendments | - | 18 | - | - |
| Benefit Payments | (296) | (284) | (120) | (130) |
| Participant Contributions | - | - | 24 | 22 |
| Medicare Subsidy | - | - | 9 | 8 |
| **Projected Obligation at December 31** | $ 4,301 | $ 4,109 | $ 1,843 | $ 1,773 |
| | | | | |
| **Change in Fair Value of Plan Assets** | | | | |
| Fair Value of Plan Assets at January 1 | $ 4,504 | $ 4,346 | $ 1,400 | $ 1,302 |
| Actual Gain (Loss) on Plan Assets | (1,054) | 435 | (368) | 115 |
| Company Contributions | 7 | 7 | 82 | 91 |
| Participant Contributions | - | - | 24 | 22 |
| Benefit Payments | (296) | (284) | (120) | (130) |
| **Fair Value of Plan Assets at December 31** | $ 3,161 | $ 4,504 | $ 1,018 | $ 1,400 |
| | | | | |
| **Funded (Underfunded) Status at December 31** | $ (1,140) | $ 395 | $ (825) | $ (373) |

AEP has significant investments in several trust funds to provide for future pension and OPEB payments. All of the trust funds' investments are diversified and managed in compliance with all laws and regulations. The value of the investments in these trusts declined substantially in 2008 due to decreases in domestic and international equity markets. Although the asset values are lower, this decline has not affected the funds' ability to make their required payments.

***Amounts Recognized on AEP's Balance Sheets as of December 31, 2008 and 2007***

| | Pension Plans | | Other Postretirement Benefit Plans | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| | | (in millions) | | |
| Employee Benefits and Pension Assets – Prepaid Benefit Costs | $ - | $ 482 | $ - | $ - |
| Other Current Liabilities – Accrued Short-term Benefit Liability | (9) | (8) | (4) | (4) |
| Employee Benefits and Pension Obligations – Accrued Long-term Benefit Liability | (1,131) | (79) | (821) | (369) |
| **Funded (Underfunded) Status** | $ (1,140) | $ 395 | $ (825) | $ (373) |

***SFAS 158 Amounts Recognized in AEP's Accumulated Other Comprehensive Income (AOCI) as of December 31, 2008, 2007 and 2006***

| | Pension Plans | | | Other Postretirement Benefit Plans | | |
|---|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2008 | 2007 | 2006 |
| **Components** | | | (in millions) | | | |
| Net Actuarial Loss | $ 2,024 | $ 534 | $ 759 | $ 715 | $ 231 | $ 354 |
| Prior Service Cost (Credit) | 13 | 14 | (5) | 3 | 4 | 4 |
| Transition Obligation | - | - | - | 70 | 97 | 124 |
| **Pretax AOCI** | $ 2,037 | $ 548 | $ 754 | $ 788 | $ 332 | $ 482 |
| **Recorded as** | | | | | | |
| Regulatory Assets | $ 1,660 | $ 453 | $ 582 | $ 502 | $ 204 | $ 293 |
| Deferred Income Taxes | 132 | 33 | 60 | 100 | 45 | 66 |
| Net of Tax AOCI | 245 | 62 | 112 | 186 | 83 | 123 |
| **Pretax AOCI** | $ 2,037 | $ 548 | $ 754 | $ 788 | $ 332 | $ 482 |

Components of the Change in AEP's Plan Assets and Benefit Obligations Recognized in Pretax AOCI during the years ended December 31, 2008 and 2007 are as follows:

| | Pensions Plans | | Other Postretirement Benefit Plans | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| **Components** | | (in millions) | | |
| Actuarial Loss (Gain) During the Year | $ 1,527 | $ (166) | $ 492 | $ (111) |
| Amortization of Actuarial Loss | (37) | (59) | (9) | (12) |
| Prior Service Cost (Credit) | (1) | 19 | - | - |
| Amortization of Transition Obligation | - | - | (27) | (27) |
| **Total Pretax AOCI Change for the Year** | $ 1,489 | $ (206) | $ 456 | $ (150) |

***Pension and Other Postretirement Plans' Assets***

The asset allocations for AEP's pension plans at the end of 2008 and 2007, and the target allocation for 2009, by asset category, are as follows:

| | Target Allocation | Percentage of Plan Assets at Year End | |
|---|---|---|---|
| | 2009 | 2008 | 2007 |
| **Asset Category** | | | |
| Equity Securities | 55% | 47% | 57% |
| Real Estate | 5% | 6% | 6% |
| Debt Securities | 39% | 42% | 36% |
| Cash and Cash Equivalents | 1% | 5% | 1% |
| **Total** | 100% | 100% | 100% |

The asset allocations for AEP's OPEB plans at the end of 2008 and 2007, and target allocation for 2009, by asset category, are as follows:

| | Target Allocation | Percentage of Plan Assets at Year End | |
|---|---|---|---|
| | 2009 | 2008 | 2007 |
| **Asset Category** | | | |
| Equity Securities | 65% | 53% | 62% |
| Debt Securities | 34% | 43% | 35% |
| Cash and Cash Equivalents | 1% | 4% | 3% |
| **Total** | 100% | 100% | 100% |

AEP's investment strategy for the employee benefit trust funds is to use a diversified portfolio of investments to achieve an acceptable rate of return while managing the interest rate sensitivity of the plans' assets relative to the plans' liabilities. To minimize investment risk, AEP's employee benefit trust funds are broadly diversified among classes of assets, investment strategies and investment managers. AEP regularly reviews the actual asset allocation and periodically rebalances the investments to AEP's targeted allocation when considered appropriate. AEP's investment policies and guidelines allow investment managers in approved strategies to use financial derivatives to obtain or manage market exposures and to hedge assets and liabilities. AEP's investment policies prohibit the benefit trust funds from purchasing AEP securities (with the exception of proportionate and immaterial holdings of AEP securities in passive index strategies). However, AEP's investment policies do not preclude the benefit trust funds from receiving contributions in the form of AEP securities, provided that the AEP securities acquired by each plan may not exceed the limitations imposed by law, including the Employee Retirement Income Security Act (ERISA).

The value of the pension plans' assets decreased substantially to $3.2 billion at December 31, 2008 from $4.5 billion at December 31, 2007. The qualified plans paid $289 million in benefits to plan participants during 2008 (nonqualified plans paid $7 million in benefits). The value of AEP's OPEB plans' assets decreased substantially to $1 billion at December 31, 2008 from $1.4 billion at December 31, 2007. The OPEB plans paid $120 million in benefits to plan participants during 2008.

AEP bases the determination of pension expense or income on a market-related valuation of assets which reduces year-to-year volatility. This market-related valuation recognizes investment gains or losses over a five-year period from the year in which they occur. Investment gains or losses for this purpose are the difference between the expected return calculated using the market-related value of assets and the actual return based on the market-related value of assets. Since the market-related value of assets recognizes gains or losses over a five-year period, the future value of assets will be impacted as previously deferred gains or losses are recorded.

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| **Accumulated Benefit Obligation** | (in millions) | |
| Qualified Pension Plans | $ 4,119 | $ 3,914 |
| Nonqualified Pension Plans | 80 | 77 |
| **Total** | $ 4,199 | $ 3,991 |

For the underfunded pension plans that had an accumulated benefit obligation in excess of plan assets, the projected benefit obligation, accumulated benefit obligation, and fair value of plan assets of these plans at December 31, 2008 and 2007 were as follows:

| | Underfunded Pension Plans | |
|---|---|---|
| | December 31, | |
| | 2008 | 2007 |
| | (in millions) | |
| **Projected Benefit Obligation** | $ 4,301 | $ 81 |
| | | |
| Accumulated Benefit Obligation | $ 4,199 | $ 77 |
| Fair Value of Plan Assets | 3,161 | - |
| **Underfunded Accumulated Benefit Obligation** | $ 1,038 | $ 77 |

*Actuarial Assumptions for Benefit Obligations*

The weighted-average assumptions as of December 31, used in the measurement of AEP's benefit obligations are shown in the following tables:

| Assumption | Pension Plans 2008 | Pension Plans 2007 | Other Postretirement Benefit Plans 2008 | Other Postretirement Benefit Plans 2007 |
|---|---|---|---|---|
| Discount Rate | 6.00% | 6.00% | 6.10% | 6.20% |
| Rate of Compensation Increase | 5.90% (a) | 5.90% (a) | N/A | N/A |

(a) Rates are for base pay only. In addition, an amount is added to reflect target incentive compensation for exempt employees and overtime and incentive pay for nonexempt employees.

N/A = Not Applicable

To determine a discount rate, AEP uses a duration-based method by constructing a hypothetical portfolio of high quality corporate bonds similar to those included in the Moody's Aa bond index with a duration matching the benefit plan liability. The composite yield on the hypothetical bond portfolio is used as the discount rate for the plan.

For 2008, the rate of compensation increase assumed varies with the age of the employee, ranging from 5% per year to 11.5% per year, with an average increase of 5.9%.

***Estimated Future Benefit Payments and Contributions***

Information about the 2009 expected cash flows for the pension (qualified and nonqualified) and OPEB plans is as follows:

| Employer Contributions | Pension Plans | Other Postretirement Benefit Plans |
|---|---|---|
| | (in millions) | |
| Required Contributions (a) | $ 9 | $ 4 |
| Additional Discretionary Contributions | - | 158 |

(a) Contribution required to meet minimum funding requirement under ERISA plus direct payments for unfunded benefits.

The contribution to the pension plans is based on the minimum amount required by ERISA plus the amount to pay unfunded nonqualified benefits. The contribution to the OPEB plans is generally based on the amount of the OPEB plans' periodic benefit cost for accounting purposes as provided for in agreements with state regulatory authorities, plus the additional discretionary contribution of AEP's Medicare subsidy receipts.

The table below reflects the total benefits expected to be paid from the plan or from the employer's assets, including both the employer's share of the benefit cost and the participants' share of the cost, which is funded by participant contributions to the plan. Medicare subsidy receipts are shown in the year of the corresponding benefit payments, even though actual cash receipts are expected early in the following year. Future benefit payments are dependent on the number of employees retiring, whether the retiring employees elect to receive pension benefits as annuities or as lump sum distributions, future integration of the benefit plans with changes to Medicare and other legislation, future levels of interest rates, and variances in actuarial results. The estimated payments for AEP's pension benefits and other postretirement benefits are as follows:

| | Pension Plans | Other Postretirement Benefit Plans | |
|---|---|---|---|
| | Pension Payments | Benefit Payments | Medicare Subsidy Receipts |
| | | (in millions) | |
| 2009 | $ 378 | $ 116 | $ (10) |
| 2010 | 379 | 126 | (11) |
| 2011 | 377 | 136 | (12) |
| 2012 | 378 | 143 | (13) |
| 2013 | 384 | 151 | (14) |
| Years 2014 to 2018, in Total | 1,920 | 876 | (87) |

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

The following table provides the components of AEP's net periodic benefit cost for the plans for the years ended December 31, 2008, 2007 and 2006:

| | Pension Plans | | | Other Postretirement Benefit Plans | | |
|---|---|---|---|---|---|---|
| | Years Ended December 31, | | | | | |
| | 2008 | 2007 | 2006 | 2008 | 2007 | 2006 |
| | | | (in millions) | | | |
| Service Cost | $ 100 | $ 96 | $ 97 | $ 42 | $ 42 | $ 39 |
| Interest Cost | 249 | 235 | 231 | 113 | 104 | 102 |
| Expected Return on Plan Assets | (336) | (340) | (335) | (111) | (104) | (94) |
| Amortization of Transition Obligation | - | - | - | 27 | 27 | 27 |
| Amortization of Prior Service Cost (Credit) | 1 | - | (1) | - | - | - |
| Amortization of Net Actuarial Loss | 37 | 59 | 79 | 9 | 12 | 22 |
| **Net Periodic Benefit Cost** | 51 | 50 | 71 | 80 | 81 | 96 |
| Capitalized Portion | (16) | (14) | (21) | (25) | (25) | (27) |
| **Net Periodic Benefit Cost Recognized as Expense** | $ 35 | $ 36 | $ 50 | $ 55 | $ 56 | $ 69 |

Estimated amounts expected to be amortized to net periodic benefit costs for AEP's plans during 2009 are shown in the following table:

| Components | Pension Plans | Other Postretirement Benefit Plans |
|---|---|---|
| | (in millions) | |
| Net Actuarial Loss | $ 56 | $ 46 |
| Prior Service Cost | 1 | 1 |
| Transition Obligation | - | 27 |
| **Total Estimated 2009 Pretax AOCI Amortization** | $ 57 | $ 74 |
| **Expected to be Recorded as** | | |
| Regulatory Asset | $ 46 | $ 48 |
| Deferred Income Taxes | 4 | 9 |
| Net of Tax AOCI | 7 | 17 |
| **Total** | $ 57 | $ 74 |

The following table provides TCC's net periodic benefit cost for the plans for the years ended December 31, 2008, 2007 and 2006:

| | Pension Plans | | | Other Postretirement Benefit Plans | | |
|---|---|---|---|---|---|---|
| | Years Ended December 31, | | | | | |
| | 2008 | 2007 | 2006 | 2008 | 2007 | 2006 |
| | (in thousands) | | | | | |
| Benefit Cost | $ 832 | $ 404 | $ 3,091 | $ 6,046 | $ 6,298 | $ 6,787 |

***Actuarial Assumptions for Net Periodic Benefit Costs***

The weighted-average assumptions as of January 1, used in the measurement of AEP's benefit costs are shown in the following tables:

| | Pension Plans | | | Other Postretirement Benefit Plans | | |
|---|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2008 | 2007 | 2006 |
| Discount Rate | 6.00% | 5.75% | 5.50% | 6.20% | 5.85% | 5.65% |
| Expected Return on Plan Assets | 8.00% | 8.50% | 8.50% | 8.00% | 8.00% | 8.00% |
| Rate of Compensation Increase | 5.90% | 5.90% | 5.90% | N/A | N/A | N/A |

N/A = Not Applicable

The expected return on plan assets for 2008 was determined by evaluating historical returns, the current investment climate (yield on fixed income securities and other recent investment market indicators), rate of inflation, and current prospects for economic growth.

The health care trend rate assumptions as of January 1, used for OPEB plans measurement purposes are shown below:

| Health Care Trend Rates | 2008 | 2007 |
|---|---|---|
| Initial | 7.0% | 7.5% |
| Ultimate | 5.0% | 5.0% |
| Year Ultimate Reached | 2012 | 2012 |

Assumed health care cost trend rates have a significant effect on the amounts reported for the OPEB health care plans. A 1% change in assumed health care cost trend rates would have the following effects:

| | 1% Increase | 1% Decrease |
|---|---|---|
| | (in millions) | |
| Effect on Total Service and Interest Cost Components of Net Periodic Postretirement Health Care Benefit Cost | $ 20 | $ (16) |
| Effect on the Health Care Component of the Accumulated Postretirement Benefit Obligation | 196 | (163) |

***American Electric Power System Retirement Savings Plan***

TCC participates in an AEP sponsored defined contribution retirement savings plan, the American Electric Power System Retirement Savings Plan, for substantially all employees. This qualified plan offers participants an opportunity to contribute a portion of their pay, includes features under Section 401(k) of the Internal Revenue Code and provides for company matching contributions. The matching contributions to the plan was 75% of the first 6% of eligible compensation contributed by the employee in 2008. Effective January 1, 2009, the match is 100% of the first 1% of eligible employee contributions and 70% of the next 5% of contributions. The cost for contributions to the plan totaled $3.5 million in 2008, $3.3 million in 2007 and $3.1 million in 2006.

## 8. BUSINESS SEGMENTS

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

## 9. DERIVATIVES, HEDGING AND FAIR VALUE MEASUREMENTS

### DERIVATIVES AND HEDGING

SFAS 133 requires recognition of all qualifying derivative instruments as either assets or liabilities in the statement of financial position at fair value. The fair values of derivative instruments accounted for using MTM accounting or hedge accounting are based on exchange prices and broker quotes. If a quoted market price is not available, the estimate of fair value is based on the best information available including valuation models that estimate future energy prices based on existing market and broker quotes and supply and demand market data and assumptions. The fair values determined are reduced by the appropriate valuation adjustments for items such as discounting, liquidity and credit quality. Credit risk is the risk that the counterparty to the contract will fail to perform or fail to pay amounts due. Liquidity risk represents the risk that imperfections in the market will cause the price to be less than or more than what the price should be based purely on supply and demand. Since energy markets are imperfect and volatile, there are inherent risks related to the underlying assumptions in models used to fair value open long-term risk management contracts. Unforeseen events can and will cause reasonable price curves to differ from actual prices throughout a contract's term and at the time a contract settles. Therefore, there could be significant adverse or favorable effects on future net income and cash flows if market prices are not consistent with the approach at estimating current market consensus for forward prices in the current period. This is particularly true for long-term contracts.

Certain qualifying derivative instruments have been designated as normal purchases or normal sales contracts, as provided in SFAS 133. Derivative contracts that have been designated as normal purchases or normal sales under SFAS 133 are not subject to MTM accounting treatment and are recognized in the Consolidated Statements of Income on an accrual basis.

TCC's accounting for the changes in the fair value of a derivative instrument depends on whether it qualifies for and has been designated as part of a hedging relationship and further, on the type of hedging relationship. For cash flow hedges (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), TCC initially reports the effective portion of the gain or loss on the derivative instrument as a component of Accumulated Other Comprehensive Income (Loss) until the period the hedged item affects earnings. TCC recognizes any hedge ineffectiveness in earnings immediately during the period of change.

For contracts that have not been designated as part of a hedging relationship, the accounting for changes in fair value depends on whether the derivative instrument is held for trading purposes. Unrealized and realized gains and losses on derivative instruments held for trading purposes are included in Revenues on a net basis in TCC's Consolidated Statements of Income. Unrealized and realized gains and losses on derivative instruments not held for trading purposes are included in Revenues or Expenses on the Consolidated Statements of Income depending on the relevant facts and circumstances.

#### *Cash Flow Hedging Strategies*

Prior to TCC's FERC-approved removal from the SIA and CSW Operating Agreement in 2006, TCC entered into, and designated as cash flow hedges, certain derivative transactions for the purchase and sale of electricity and natural gas in order to manage the variable price risk related to the forecasted purchase and sale of these commodities. At various times during 2006, TCC designated cash flow hedge relationships using these commodities. Management closely monitored the potential impacts of commodity price changes, and where appropriate, entered into derivative transactions to protect margins for a portion of future electricity sales and fuel purchases. Realized gains and losses on these derivatives designated as cash flow hedges were included in Revenues, Fuel and Other Consumables Used for Electric Generation or Purchased Electricity for Resale on the Consolidated Statements of Income, depending on the specific nature of the risk being hedged. TCC did not hedge all variable price risk exposure related to energy commodities. At various times during 2006, TCC recognized immaterial amounts in net income related to hedge ineffectiveness.

The following table represents the activity in Accumulated Other Comprehensive Income (Loss) for derivative contracts that qualify as cash flow hedges at December 31, 2008:

| | (in thousands) |
|---|---|
| **Balance at December 31, 2005** | $ (224) |
| Effective Portion of Changes in Fair Value | - |
| Impact Due to Changes in SIA | 218 |
| Reclasses from AOCI to Net Income | 6 |
| **Balance at December 31, 2006** | - |
| Effective Portion of Changes in Fair Value | - |
| Reclasses from AOCI to Net Income | - |
| **Balance at December 31, 2007** | - |
| Effective Portion of Changes in Fair Value | - |
| Reclasses from AOCI to Net Income | - |
| **Balance at December 31, 2008** | $ - |

**FAIR VALUE MEASUREMENTS**

***SFAS 107 Fair Value Measurements***

The fair values of Long-term Debt are based on quoted market prices for the same or similar issues and the current interest rates offered for instruments with similar maturities. These instruments are not marked-to-market. The estimates presented are not necessarily indicative of the amounts that could be realized in a current market exchange. The book values and fair values of TCC's Long-term Debt at December 31, 2008 and 2007 are summarized in the following table.

| | December 31, | | | |
|---|---|---|---|---|
| | 2008 | | 2007 | |
| | Book Value | Fair Value | Book Value | Fair Value |
| | (in thousands) | | | |
| Long-term Debt | $ 2,794,297 | $ 2,706,381 | $ 2,937,553 | $ 2,922,875 |

***SFAS 157 Fair Value Measurements***

As described in Note 2, TCC completed the adoption of SFAS 157 effective January 1, 2009. The statement defines fair value, establishes a fair value measurement framework and expands fair value disclosures. The adoption of SFAS 157 had an immaterial impact on the financial statements. Due to TCC's removal from the CSW Operating Agreement and the SIA in 2006, TCC no longer has Risk Management Assets or Liabilities. The provisions of SFAS 157 are applied prospectively, except for a) changes in fair value measurements of existing derivative financial instruments measured initially using the transaction price under EITF Issue No. 02-3 "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" (EITF 02-3), b) existing hybrid financial instruments measured initially at fair value using the transaction price and c) blockage discount factors. Although the statement is applied prospectively upon adoption, in accordance with the provisions of SFAS 157 related to EITF 02-3, amounts for transition adjustment are recorded to beginning retained earnings. The impact of considering AEP's own credit risk when measuring the fair value of liabilities, including derivatives, had an immaterial impact on TCC's fair value measurements upon adoption.

In accordance with SFAS 157, assets and liabilities are classified based on the inputs utilized in the fair value measurement. SFAS 157 provides definitions for two types of inputs: observable and unobservable. Observable inputs are valuation inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Unobservable inputs are valuation inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information in the circumstances.

As defined in SFAS 157, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). SFAS 157 establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurement) and the lowest priority to unobservable inputs (level 3 measurement).

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 inputs primarily consist of exchange traded contracts, listed equities and U.S. government treasury securities that exhibit sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs primarily consist of OTC broker quotes in moderately active or less active markets, exchange traded contracts where there was not sufficient market activity to warrant inclusion in level 1, OTC broker quotes that are corroborated by the same or similar transactions that have occurred in the market and certain non-exchange-traded debt securities.

Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that the observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Level 3 inputs primarily consist of unobservable market data or are valued based on models and/or assumptions.

The following table sets forth, by level within the fair value hierarchy, TCC's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2008. As required by SFAS 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Management's assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

**Assets and Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2008**

| | Level 1 | Level 2 | Level 3 | Other | Total |
|---|---|---|---|---|---|
| **Assets:** | | | **(in thousands)** | | |
| Other Cash Deposits (a) | $ 172,923 | $ - | $ - | $ 16 | $ 172,939 |

(a) Amounts in "Other" column primarily represent cash deposits with third-parties. Level 1 amounts primarily represent investments in money market funds.

## 10. INCOME TAXES

The details of income taxes as reported are as follows:

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| | (in thousands) | | |
| Income Tax Expense (Credit): | | | |
| Current | $ 8,938 | $ 20,004 | $ (680) |
| Deferred | 31,824 | (390) | 24,200 |
| Deferred Investment Tax Credits | (821) | (601) | (870) |
| **Total Income Tax** | $ 39,941 | $ 19,013 | $ 22,650 |

Shown below is a reconciliation of the difference between the amount of federal income taxes computed by multiplying book income before income taxes by the federal statutory rate and the amount of income taxes reported.

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| | (in thousands) | | |
| Net Income | $ 85,837 | $ 58,950 | $ 41,569 |
| Income Taxes | 39,941 | 19,013 | 22,650 |
| **Pretax Income** | $ 125,778 | $ 77,963 | $ 64,219 |
| | | | |
| Income Tax on Pretax Income at Statutory Rate (35%) | $ 44,022 | $ 27,287 | $ 22,477 |
| Increase (Decrease) in Income Tax resulting from the following items: | | | |
| Depreciation | (169) | (457) | (453) |
| Tax Adjustments | 1,739 | (7,350) | (677) |
| Investment Tax Credits, Net | (821) | (601) | (870) |
| State and Local Income Taxes | (3,166) | 1,974 | 3,782 |
| Other | (1,664) | (1,840) | (1,609) |
| **Total Income Taxes** | $ 39,941 | $ 19,013 | $ 22,650 |
| | | | |
| **Effective Income Tax Rate** | 31.8% | 24.4% | 35.3% |

The following table shows the elements of the net deferred tax liability and the significant temporary differences:

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| | (in thousands) | |
| Deferred Tax Assets | $ 143,958 | $ 159,203 |
| Deferred Tax Liabilities | (1,206,328) | (1,187,481) |
| **Net Deferred Tax Liabilities** | $ (1,062,370) | $ (1,028,278) |
| | | |
| Property Related Temporary Differences | $ (300,958) | $ (251,246) |
| Amounts Due From Customers For Future Federal Income Taxes | 1,378 | 6,062 |
| Deferred State Income Taxes | - | (1,466) |
| Transition Regulatory Assets | 19,239 | 19,239 |
| Accrued Nuclear Decommissioning Expense | (928) | (928) |
| Deferred Fuel and Purchased Power | 1,005 | (25,456) |
| Accrued Pensions | 24,158 | (20,401) |
| Provision for Refund | (11,906) | 9,193 |
| Regulatory Assets | (29,789) | 20,376 |
| Securitized Transition Assets | (776,255) | (806,141) |
| All Other, Net | 11,686 | 22,490 |
| **Net Deferred Tax Liabilities** | $ (1,062,370) | $ (1,028,278) |

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 tax 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 reflects a separate return result for each company in the consolidated group.

TCC and other AEP Subsidiaries are no longer subject to U.S. federal examination for years before 2000. TCC and other AEP Subsidiaries have completed the exam for the years 2001 through 2003 and have issues that are being pursued at the appeals level. The returns for the years 2004 through 2006 are presently under audit by the IRS. Although the outcome of tax audits is uncertain, in management's opinion, adequate provisions for income taxes have been made for potential liabilities resulting from such matters. In addition, TCC accrues interest on these uncertain tax positions. Management is not aware of any issues for open tax years that upon final resolution are expected to have a material adverse effect on net income.

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

Prior to the adoption of FIN 48, TCC recorded interest and penalty expense related to uncertain tax positions in tax expense accounts. With the adoption of FIN 48 on January 1, 2007, TCC began recognizing interest accruals related to uncertain tax positions in interest income or expense as applicable, and penalties in Other Operation. The impact of this interpretation was an unfavorable adjustment to the 2007 opening balance of retained earnings of $2.2 million. In 2008, TCC reported $2.4 million of interest expense, $1.7 million of interest income and reversed $1.7 million of prior period interest expense. In 2007, TCC reported $550 thousand of interest expense and reversed $1.4 million of prior period interest expense. TCC had approximately $2.6 million for the receipt of interest accrued at December 31, 2008 and approximately $3.9 million and $2.4 million for the payment of interest and penalties accrued at December 31, 2008 and 2007, respectively.

The reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| | 2008 | 2007 |
|---|---|---|
| | (in thousands) | |
| **Balance at January 1,** | $ 17,973 | $ 20,681 |
| Increase - Tax Positions Taken During a Prior Period | 9,047 | 157 |
| Decrease - Tax Positions Taken During a Prior Period | (13,755) | (3,203) |
| Increase - Tax Positions Taken During the Current Year | 2,639 | 489 |
| Decrease - Tax Positions Taken During the Current Year | (302) | - |
| Decrease - Settlements with Taxing Authorities | - | (151) |
| Decrease - Lapse of the Applicable Statute of Limitations | - | - |
| **Balance at December 31,** | $ 15,602 | $ 17,973 |

The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate is $453 thousand and $9.4 million in 2008 and 2007, respectively. Management believes there will be no significant net increase or decrease in unrecognized tax benefits within 12 months of the reporting date.

*Federal Tax Legislation*

Several tax bills and other legislation with tax-related sections were enacted in 2006 and 2007, including the Pension Protection Act of 2006, the Tax Relief and Health Care Act of 2006, the Tax Technical Corrections Act of 2007, the Tax Increase Prevention Act of 2007 and the Energy Independence and Security Act of 2007. The tax law changes enacted in 2006 and 2007 did not materially affect TCC's net income, cash flows or financial condition.

The Economic Stimulus Act of 2008 was signed into law by the President in February 2008. It provided enhanced expensing provisions for certain assets placed in service in 2008 and a 50% bonus depreciation provision similar to the one in effect in 2003 through 2004 for assets placed in service in 2008. The enacted provisions did not have a material impact on net income or financial condition, but provided a material favorable cash flow benefit of approximately $5 million.

In October 2008, the Emergency Economic Stabilization Act of 2008 (the 2008 Act) was signed into law. The 2008 Act extended several expiring tax provisions and added new energy incentive provisions. The legislation impacted the availability of research credits, accelerated depreciation of smart meters, production tax credits, and energy efficient commercial building deductions. Management has evaluated the impact of the law change and the application of the law change will not materially impact TCC's net income, cash flows or financial condition.

In February 2009, the American Recovery and Reinvestment Tax Act of 2009 (the 2009 Act) was signed into law. The 2009 Act extended the bonus depreciation deduction for one year and provides for a long-term extension of the renewable production tax credit for wind energy and other properties. The 2009 Act also establishes a new investment tax credit for the manufacture of advanced energy property as well as appropriations for advanced energy research projects, carbon capture and storage and gridSMART technology. Management has evaluated the impact of the law change and the application of the law change will not materially impact net income or financial condition, but is expected to have a positive material impact on cash flows.

## 11. LEASES

Leases of property, plant and equipment are for periods up to 10 years and require payments of related property taxes, maintenance and operating costs. The majority of the leases have purchase or renewal options and will be renewed or replaced by other leases.

Lease rentals for both operating and capital leases are generally charged to Other Operation and Maintenance expense in accordance with rate-making treatment for regulated operations. The components of rental costs are as follows:

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| **Lease Rental Costs** | | (in thousands) | |
| Net Lease Expense on Operating Leases | $ 6,330 | $ 6,759 | $ 6,091 |
| Amortization of Capital Leases | 1,613 | 1,453 | 1,024 |
| Interest on Capital Leases | 128 | 267 | 223 |
| **Total Lease Rental Costs** | $ 8,071 | $ 8,479 | $ 7,338 |

The following table shows the property, plant and equipment under capital leases and related obligations recorded on TCC's Consolidated Balance Sheets. Capital lease obligations are included in Current Liabilities – Other and Noncurrent Liabilities – Deferred Credits and Other on TCC's Consolidated Balance Sheets.

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| | (in thousands) | |
| **Property, Plant and Equipment Under Capital Leases** | | |
| Total Property, Plant and Equipment Under Capital Leases – Other | $ 6,798 | $ 5,981 |
| Accumulated Amortization | 3,698 | 2,409 |
| **Net Property, Plant and Equipment Under Capital Leases** | $ 3,100 | $ 3,572 |
| **Obligations Under Capital Leases** | | |
| Noncurrent Liability | $ 1,734 | $ 2,021 |
| Liability Due Within One Year | 1,366 | 1,551 |
| **Total Obligations Under Capital Leases** | $ 3,100 | $ 3,572 |

Future minimum lease payments consisted of the following at December 31, 2008:

| Future Minimum Lease Payments | Capital Leases | Noncancelable Operating Leases |
|---|---|---|
| | (in thousands) | |
| 2009 | $ 1,410 | $ 5,825 |
| 2010 | 798 | 5,740 |
| 2011 | 704 | 14,955 |
| 2012 | 71 | 373 |
| 2013 | 70 | 289 |
| Later Years | 145 | 471 |
| **Total Future Minimum Lease Payments** | $ 3,198 | $ 27,653 |
| Less Estimated Interest Element | 98 | |
| **Estimated Present Value of Future Minimum Lease Payments** | $ 3,100 | |

***Master Lease Agreements***

TCC leases certain equipment under master lease agreements. GE Capital Commercial Inc. (GE) notified management in November 2008 that they elected to terminate the Master Leasing Agreements in accordance with the termination rights specified within the contract. In 2010 and 2011, TCC will be required to purchase all equipment under the lease and pay GE an amount equal to the unamortized value of all equipment then leased. As a result, the unamortized value of this equipment of $12 million is reflected in TCC's future minimum lease payments for 2011. In addition, an immaterial amount for the unamortized value of the equipment is included in TCC's future minimum lease payments for 2010. In December 2008, management signed new master lease agreements with one-year commitment periods that include lease terms of up to 10 years. Management expects to enter into replacement leasing arrangements for the equipment affected by this notification prior to the termination dates of 2010 and 2011.

For equipment under the GE master lease agreements that expire prior to 2011, the lessor is guaranteed receipt of 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 is 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. Under the new master lease agreements, the lessor is guaranteed receipt of up to 68% of the unamortized balance at the end of the lease term. If the actual fair market value of the leased equipment is below the unamortized balance at the end of the lease term, TCC is committed to pay the difference between the actual fair market value and unamortized balance, with the total guarantee not to exceed 68% of the unamortized balance. At December 31, 2008, the maximum potential loss for these lease agreements was approximately $1 million assuming the fair market value of the equipment is zero at the end of the lease term. Historically, at the end of the lease term the fair market value has been in excess of the unamortized balance.

## 12. FINANCING ACTIVITIES

### *Preferred Stock*

| Par Value | Authorized Shares | Shares Outstanding at December 31, 2008 | Call Price at December 31, 2008(a) | Series | Redemption | December 31, 2008 | 2007 |
|---|---|---|---|---|---|---|---|
| | | | | | | (in thousands) | |
| $ 100 | (b) | 41,912 | $ 105.75 | 4.00% | Any time | $ 4,191 | $ 4,191 |
| 100 | (b) | 17,301 | 103.75 | 4.20% | Any time | 1,730 | 1,730 |

(a) The cumulative preferred stock is callable at the price indicated plus accrued dividends.
(b) TCC has 3,035,000 authorized shares in total.

| Series | Number of Shares Redeemed for the Year Ended December 31, 2008 | 2007 | 2006 |
|---|---|---|---|
| 4.00% | - | - | 10 |
| 4.20% | - | - | 175 |

### *Long-term Debt*

There are certain limitations on establishing liens against TCC's assets under its indentures. None of the long-term debt obligations of TCC have been guaranteed or secured by AEP or any of its affiliates.

The following details long-term debt outstanding as of December 31, 2008 and 2007:

| Type of Debt | Maturity | Weighted Average Interest Rate at December 31, 2008 | Interest Rate Ranges at December 31, 2008 | 2007 | Outstanding at December 31, 2008 | 2007 |
|---|---|---|---|---|---|---|
| | | | | | (in thousands) | |
| Senior Unsecured Notes | 2033 | 6.65% | 6.65% | 6.65% | $ 275,000 | $ 275,000 |
| Pollution Control Bonds (a) | 2015-2030 (b) | 4.90% | 4.40%-5.625% | 4.00%-5.20% | 389,185 | 389,185 |
| First Mortgage Bonds (c) | 2008 | - | - | 7.125% | - | 18,581 |
| Securitization Bonds (d) | 2008-2020 (e) | 5.34% | 4.98%-6.25% | 4.98%-6.25% | 2,132,162 | 2,257,000 |
| Unamortized Discount (net) | | | | | (2,050) | (2,213) |
| **Total Long-term Debt** | | | | | 2,794,297 | 2,937,553 |
| **Less: Long-term Debt Due Within One Year** | | | | | 137,141 | 143,419 |
| **Long-term Debt** | | | | | $ 2,657,156 | $ 2,794,134 |

(a) Under the terms of the pollution control bonds, TCC is required to pay amounts sufficient to enable the payment of interest on and the principal of (at stated maturities and upon mandatory redemptions) related pollution control revenue bonds issued to finance the construction of pollution control facilities at certain plants. For certain series of pollution control bonds, interest rates are subject to periodic adjustment. Interest payments range from weekly to semi-annually. Letters of credit from banks, standby bond purchase agreements and insurance policies support certain series.
(b) Certain pollution control bonds are subject to mandatory redemption earlier than the maturity date. Consequently, these bonds have been classified for maturity and repayment purposes based on the mandatory redemption date.
(c) In May 2004, cash and treasury securities were deposited with a trustee to defease all of TCC's outstanding first mortgage bonds. The defeased TCC first mortgage bonds had a balance of $19 million in 2007. The defeased TCC first mortgage bonds were retired in February 2008. Trust fund assets related to this obligation of $22 are included in Other Cash Deposits on TCC's Consolidated Balance Sheets at December 31, 2007.
(d) In October 2006, AEP Texas Central Transition Funding II LLC (TFII), a subsidiary of TCC, issued $1.7 billion in securitization bonds. TFII is the sole owner of the transition charges and the original transition property. The holders of the securitization bonds do not have recourse to any assets or revenues of TCC. The creditors of TCC do not have recourse to any assets or revenues of TFII, including, without limitation, the original transition property.
(e) Dates represent the scheduled final payment dates for this class of TCC's securitization bonds. The maturity date is one to two years later. These bonds have been classified for maturity and repayment purposes based on the scheduled final payment date.

At December 31, 2008 future annual long-term debt payments are as follows:

| | 2009 | 2010 | 2011 | 2012 | 2013 | After 2013 | Total |
|---|---|---|---|---|---|---|---|
| | | | | (in thousands) | | | |
| Principal Amount | $ 137,141 | $ 147,833 | $ 279,709 | $ 171,574 | $ 184,518 | $ 1,875,572 | $ 2,796,347 |
| Unamortized Discount | | | | | | | (2,050) |
| **Total Long-term Debt** | | | | | | | $ 2,794,297 |

In January 2009, TCC retired $50 million of 4.98% and $31 million of 5.56% Securitization Bonds due in 2010.

In the first quarter of 2008, TCC had $161 million of tax-exempt long-term debt (Pollution Control Bonds) sold at auction rates that reset every 7 or 35 days. This debt is insured by Financial Guaranty Insurance Co., which was previously AAA-rated. Due to the exposure that this bond insurer had in connection with recent developments in the subprime credit market, the credit rating of this insurer was downgraded or placed on negative outlook. These market factors contributed to higher interest rates in successful auctions and increasing occurrences of failed auctions, including auctions of TCC's tax-exempt long-term debt. The instruments under which the bonds are issued allow for conversion to other short-term variable-rate structures, term-put structures and fixed-rate structures. As of December 31, 2008, all $161 million of the prior auction-rate debt was issued at fixed rates ranging from 5.125% to 5.625%.

***Utility Money Pool – AEP System***

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 December 31, 2008 and 2007 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 years ended December 31, 2008 and 2007 are described in the following table:

| Year | 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 (Borrowings) to/from Utility Money Pool as of December 31, | Authorized Short-Term Borrowing Limit |
|---|---|---|---|---|---|---|
| | | | (in thousands) | | | |
| 2008 | $ 111,363 | $ 183,166 | $ 42,550 | $ 80,300 | $ (107,293) | $ 200,000 (a) |
| 2007 | - | 394,180 | - | 188,278 | 180,926 | 600,000 |

(a) In August 2008, TCC's short-term borrowing limit reduced to $200,000 under FERC authorization to allow the issuance of commercial paper, promissory notes and other forms of short-term indebtedness.

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the years ended December 31, 2008, 2007 and 2006 are summarized in the following table:

| Years Ended December 31, | 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 Rates for Funds Borrowed from the Utility Money Pool | Average Interest Rates for Funds Loaned to the Utility Money Pool |
|---|---|---|---|---|---|---|
| 2008 | 5.47% | 2.28% | 5.37% | 2.91% | 3.46% | 4.09% |
| 2007 | -% | -% | 5.94% | 5.16% | -% | 5.41% |
| 2006 | 5.39% | 4.37% | 5.41% | 3.32% | 4.79% | 4.24% |

Interest expense and interest income related to the Utility Money Pool are included in Interest Expense and Interest Income, respectively, in TCC's Consolidated Statements of Income. For amounts borrowed from and advanced to the Utility Money Pool, TCC incurred the following amounts of interest expense and earned the following amounts of interest income for the years ended December 31, 2008, 2007 and 2006:

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2008** | **2007** | **2006** |
| | | **(in thousands)** | |
| Interest Expense | $ 741 | $ - | $ 724 |
| Interest Income | 1,697 | 10,606 | 5,591 |

***Dividend Restrictions***

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

***Credit Facilities***

In April 2008, TCC and certain other companies in the AEP System entered into a $650 million 3-year credit agreement and a $350 million 364-day credit agreement which were reduced by Lehman Brothers Holdings Inc.'s commitment amount of $23 million and $12 million, respectively, following its bankruptcy. Under the facilities, letters of credit may be issued. As of December 31, 2008, there were no outstanding amounts for TCC under either facility.

## 13. RELATED PARTY TRANSACTIONS

For other related party transactions, also see "Utility Money Pool – AEP System" section of Note 12.

***CSW Operating Agreement***

PSO, SWEPCo and AEPSC are parties to a Restated and Amended Operating Agreement originally dated as of January 1, 1997 (CSW Operating Agreement), which was approved by the FERC. In February 2006, AEP filed with the FERC a proposed amendment to the CSW Operating Agreement to remove TCC and TNC as parties to the agreement. Pursuant to Texas electric restructuring law, those companies exited the generation and load-servicing businesses. AEP made a similar filing to remove these two companies as parties to the SIA. The filings were approved effective May 1, 2006 and April 1, 2006, respectively.

The CSW Operating Agreement requires the parties to maintain adequate annual planning reserve margins and requires that capacity in excess of the required margins be made available for sale to other operating companies as capacity commitments. Parties are compensated for energy delivered to recipients based upon the deliverer's incremental cost plus a portion of the recipient's savings realized by the purchaser that avoids the use of more costly alternatives. Revenues and costs arising from third party sales are generally shared based on the amount of energy parties contribute that is sold to third parties.

***System Integration Agreement (SIA)***

The SIA provides for the integration and coordination of AEP East companies and AEP West companies zones. This includes joint dispatch of generation within the AEP System, and the distribution, between the two zones, of costs and benefits associated with the transfers of power between the two zones (including sales to third parties and risk management and trading activities). It is designed to function as an umbrella agreement in addition to the Interconnection Agreement and the CSW Operating Agreement, each of which controls the distribution of costs and benefits within a zone.

In November 2005, AEP filed with the FERC a proposed amendment to the SIA to change the method of allocating profits from off-system electricity sales between the East and West zones. The proposed method causes such profits to be allocated generally on the basis of the zone in which the underlying transactions occur or originate. The filing was made in accordance with a provision of the agreement that called for a re-evaluation of the allocation method effective January 1, 2006 and was approved as filed effective April 1, 2006. As discussed earlier, TCC is no longer a party to the SIA.

Power generated, allocated or provided under the Interconnection Agreement or CSW Operating Agreement to TCC was primarily sold to REPs at market rates.

Under both the Interconnection Agreement and CSW Operating Agreement, power generated that is not needed to serve the AEP System native load is sold in the wholesale market by AEPSC on behalf of the generating subsidiary.

***Affiliated Revenues***

TCC's other revenues derived from sales to affiliates for the years ended December 31, 2008, 2007 and 2006 were $5.9 million, $5.7 million and $6.4 million, respectively. These related party revenues are reported as Sales to AEP Affiliates on TCC's Consolidated Statements of Income.

***AEP System Transmission Pool***

AEP's System Transmission Integration Agreement provides for the integration and coordination of the planning, operation and maintenance of the transmission facilities of AEP East companies and AEP West companies zones. The System Transmission Integration Agreement functions as an umbrella agreement in addition to the Transmission Equalization Agreement (TEA) and the Transmission Coordination Agreement (TCA). The System Transmission Integration Agreement contains two service schedules that govern:

- The allocation of transmission costs and revenues and
- The allocation of third-party transmission costs and revenues and AEP System dispatch costs.

The Transmission Integration Agreement anticipates that additional service schedules may be added as circumstances warrant.

APCo, CSPCo, I&M, KPCo and OPCo are parties to the TEA, dated April 1, 1984, as amended, defining how they share the costs associated with their relative ownership of the extra-high-voltage transmission system (facilities rated 345 kV and above) and certain facilities operated at lower voltages (138 kV and above).

PSO, SWEPCo, TCC, TNC and AEPSC are parties to the TCA, originally dated January 1, 1997. The TCA has been approved by the FERC and establishes a coordinating committee, which is charged with overseeing the coordinated planning of the transmission facilities of the AEP West companies, including the performance of transmission planning studies, the interaction of such companies with independent system operators (ISO) and other regional bodies interested in transmission planning and compliance with the terms of the OATT filed with the FERC and the rules of the FERC relating to such tariff.

Under the TCA, the AEP West companies delegated to AEPSC the responsibility of monitoring the reliability of their transmission systems and administering the OATT on their behalf. The allocations have been governed by the FERC-approved OATT for the SPP (with respect to PSO and SWEPCo) and PUCT-approved protocols for ERCOT (with respect to TCC and TNC).

TCC's net charges allocated under the TCA pursuant to the ERCOT protocols as described above during the years ended December 31, 2008, 2007 and 2006 were $1.5 million, $1.1 million and $1.1 million, respectively. The net charges are recorded in Other Operation on TCC's Consolidated Statements of Income.

***Assignment from SWEPCo, TCC and TNC to AEPEP***

On March 1, 2008, SWEPCo, TCC and TNC assigned a 20-year Purchase Power Agreement (PPA) to AEPEP. In addition to the PPA assignment, an intercompany agreement was executed between AEPEP and SWEPCo to provide SWEPCo with future margins related to its share. The PPA and intercompany agreements are effective through 2019.

***Jointly-Owned Electric Utility Plant***

PSO and TNC jointly own the Oklaunion Plant along with two nonaffiliated companies. TCC sold its share to one of the nonaffiliated owners in February 2007. The costs of operating the facility are apportioned between owners based on ownership interests. Each company's share of these costs is included in the appropriate expense accounts on its respective income statements.

***Purchased Power from Sweeny***

On behalf of the AEP West companies, CSPCo entered into a ten year Power Purchase Agreement (PPA) with Sweeny, which was 50% owned by AEP. The PPA was for unit contingent power up to a maximum of 315 MW from January 1, 2005 through December 31, 2014. The delivery point for the power under the PPA was in TCC's system. The power was sold in ERCOT. Prior to May 1, 2006, the purchase of Sweeny power and its sale to nonaffiliates were shared among the AEP West companies under the CSW Operating Agreement. After May 1, 2006, the purchases and sales were shared between PSO and SWEPCo. See "CSW Operating Agreement" section of this note. In April 2007, AEP Energy Partners (AEPEP) was assigned the Sweeny PPA from CSPCo and became responsible for purchasing the Sweeny power instead of PSO and SWEPCo. In October 2007, AEP sold its 50% interest in the Sweeny facility along with the ten year PPA to Conoco Phillips. TCC's purchases from Sweeny were $703 thousand for the year ended December 31, 2006. This amount is recorded in Purchased Electricity for Resale on TCC's 2006 Consolidated Statement of Income.

***Sales and Purchases of Property***

TCC had affiliated sales and purchases of electric property individually amounting to $100 thousand or more for the years ended December 31, 2008, 2007 and 2006 as shown in the following table:

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| Companies | | (in thousands) | |
| TCC to APCo | $ 220 | $ - | $ - |
| TNC to TCC | - | 2,300 | - |

In addition, TCC had aggregate affiliated sales and purchases of meters and transformers for the years ended December 31, 2008, 2007 and 2006 as shown in the following table:

| | APCo | CSPCo | I&M | KGPCo | KPCo | OPCo | PSO | SWEPCo | TNC | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Sales | | | | | (in thousands) | | | | | |
| 2008 | $ 1 | $ - | $ - | $ - | $ - | $ 1 | $ 9 | $ 535 | $ 494 | $ 1,040 |
| 2007 | 20 | 13 | - | - | - | 40 | 1 | 76 | 763 | 913 |
| 2006 | 12 | - | - | 36 | - | 18 | 10 | 50 | 1,266 | 1,392 |
| Purchases | | | | | | | | | | |
| 2008 | $ 73 | $ - | $ 5 | $ - | $ 33 | $ 14 | $ - | $ 13 | $ 334 | $ 472 |
| 2007 | 61 | - | 4 | - | - | 6 | - | 26 | 199 | 296 |
| 2006 | 1,631 | - | 2 | 179 | 3 | 1 | 30 | 37 | 209 | 2,092 |

The amounts above are recorded in Property, Plant and Equipment. Transfers are performed at cost.

***AEPSC***

AEPSC provides certain managerial and professional services to AEP System companies. The costs of the services are billed to TCC by AEPSC on a direct-charge basis, whenever possible, and on reasonable bases of proration for services that benefit multiple companies. The billings for services are made at cost and include no compensation for the use of equity capital, which is furnished to AEPSC by AEP. Billings from AEPSC are capitalized or expensed depending on the nature of the services rendered and are recoverable from customers. AEPSC and its billings are subject to regulation by the FERC.

### *Intercompany Billings*

TCC performs certain utility services for other AEP subsidiaries when necessary or practical. The costs of these services are billed on a direct-charge basis, whenever possible, or on reasonable bases of proration for services that benefit multiple companies. The billings for services are made at cost and include no compensation for the use of equity capital. Billings are capitalized or expensed depending on the nature of the services rendered.

### *Variable Interest Entities*

FIN 46R is a consolidation model that considers risk absorption of a variable interest entity (VIE), also referred to as variability. Entities are required to consolidate a VIE when it is determined that they are the primary beneficiary of that VIE, as defined by FIN 46R. In determining whether TCC is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of variability of the VIE TCC absorbs, guarantees of indebtedness, voting rights including kick-out rights, the power to direct the VIE and other factors. Management believes that the significant assumptions and judgments were applied consistently and that there are no other reasonable judgments or assumptions that would result in a different conclusion. There have been no changes to the reporting of VIEs in the financial statements where it is concluded that TCC is the primary beneficiary. In addition, TCC has not provided financial or other support that was not previously contractually required to any VIE.

As of December 31, 2008, TCC holds a significant variable interest in AEPSC. AEPSC provides certain managerial and professional services to TCC. AEP is the sole equity owner of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to TCC at AEPSC’s costs. TCC has not provided financial or other support outside the reimbursement of costs for services rendered. The cost reimbursement nature of AEPSC finances its operations. There are no other terms or arrangements between AEPSC and TCC that could require additional financial support from TCC or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. TCC is exposed to losses to the extent it cannot recover the cost of AEPSC through its normal business operations. TCC is considered to have a significant interest in the variability of AEPSC due to its activity in AEPSC’s cost reimbursement structure. AEPSC is consolidated by AEP. In the event AEPSC would require financing or other support outside the cost reimbursement billings, this financing would be provided by AEP. Total billings from AEPSC for the years ended December 31, 2008 and 2007 were $84.4 million and $87.3 million, respectively. The carrying amount of liabilities associated with AEPSC for the years ended December 31, 2008 and 2007 were $8 million and $13 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

## 14. PROPERTY, PLANT AND EQUIPMENT

### *Depreciation*

TCC provides for depreciation of Property, Plant and Equipment on a straight-line basis over the estimated useful lives of property, generally using composite rates by functional class. The following table provides the annual composite depreciation rates by functional class:

| 2008 | Regulated | | | | Nonregulated | | | |
|---|---|---|---|---|---|---|---|---|
| Functional Class of Property | Property, Plant and Equipment | Accumulated Depreciation | Annual Composite Depreciation Rate | Depreciable Life Ranges | Property, Plant and Equipment | Accumulated Depreciation | Annual Composite Depreciation Rate | Depreciable Life Ranges |
| | (in thousands) | | | (in years) | (in thousands) | | | (in years) |
| Transmission | $ 1,085,999 | $ 216,049 | 1.4% | 50-81 | $ - | $ - | - | - |
| Distribution | 1,769,485 | 350,504 | 3.0% | 22-64 | - | - | - | - |
| CWIP | 110,690 | (1,663) | N.M. | N.M. | - | - | - | - |
| Other | 228,921 | 98,428 | 6.8% | N.M. | 2,978 | 1,057 | N.M. | N.M. |
| **Total** | $ 3,195,095 | $ 663,318 | | | $ 2,978 | $ 1,057 | | |

| 2007 | Regulated | | | | Nonregulated | | | |
|---|---|---|---|---|---|---|---|---|
| Functional Class of Property | Property, Plant and Equipment | Accumulated Depreciation | Annual Composite Depreciation Rate | Depreciable Life Ranges | Property, Plant and Equipment | Accumulated Depreciation | Annual Composite Depreciation Rate | Depreciable Life Ranges |
| | (in thousands) | | | (in years) | (in thousands) | | | (in years) |
| Transmission | $ 962,859 | $ 215,553 | 1.6% | 50-81 | $ - | $ - | - | - |
| Distribution | 1,670,120 | 354,803 | 3.2% | 22-64 | - | - | - | - |
| CWIP | 122,666 | (3,684) | N.M. | N.M. | - | - | - | - |
| Other | 228,593 | 99,417 | 6.0% | N.M. | 2,978 | 1,035 | N.M. | N.M. |
| **Total** | $ 2,984,238 | $ 666,089 | | | $ 2,978 | $ 1,035 | | |

| 2006 | Regulated | | Nonregulated | |
|---|---|---|---|---|
| Functional Class of Property | Annual Composite Depreciation Rate Ranges | Depreciable Life Ranges | Annual Composite Depreciation Rate Ranges | Depreciable Life Ranges |
| | | (in years) | | (in years) |
| Transmission | 1.6% | 40-71 | - | - |
| Distribution | 3.3% | 15-62 | - | - |
| Other | 6.8% | N.M. | N.M. | N.M. |

N.M. = Not Meaningful

The composite depreciation rate generally includes a component for nonasset retirement obligation (non-ARO) removal costs, which is credited to Accumulated Depreciation and Amortization. Actual removal costs incurred are charged to Accumulated Depreciation and Amortization. Any excess of accrued non-ARO removal costs over actual removal costs incurred is reclassified from Accumulated Depreciation and Amortization and reflected as a regulatory liability.

### *Asset Retirement Obligations (ARO)*

TCC records ARO in accordance with SFAS 143 "Accounting for Asset Retirement Obligations" and FIN 47 "Accounting for Conditional Asset Retirement Obligations" for asbestos removal. TCC has identified, but not recognized, ARO liabilities related to electric transmission and distribution assets, as a result of certain easements on property on which assets are owned. Generally, such easements are perpetual and require only the retirement and removal of assets upon the cessation of the property's use. The retirement obligation is not estimable for such easements since TCC plans to use its facilities indefinitely. The retirement obligation would only be recognized if and when TCC abandons or ceases the use of specific easements, which is not expected.

The following is a reconciliation of the 2008 and 2007 aggregate carrying amounts of ARO for TCC:

| Year | ARO at January 1, | Accretion Expense | Liabilities Incurred | Liabilities Settled | Revisions in Cash Flow Estimates | ARO at December 31, |
|---|---|---|---|---|---|---|
| | | | (in thousands) | | | |
| 2008 | $ 1,330 | $ 85 | $ - | $ (13) | $ - | $ 1,402 |
| 2007 | 1,239 | 79 | 12 | - | - | 1,330 |

### *Allowance for Funds Used During Construction (AFUDC) and Interest Capitalization*

TCC's amounts of allowance for borrowed and equity funds used during construction are summarized in the following table:

| | Years Ended December 31, 2008 | 2007 | 2006 |
|---|---|---|---|
| | | (in thousands) | |
| Allowance for Equity Funds Used During Construction | $ 3,162 | $ 3,232 | $ 2,688 |
| Allowance for Borrowed Funds Used During Construction | 2,896 | 2,683 | 2,609 |

### *Jointly-owned Electric Utility Plant*

In February 2007, TCC sold its 7.8% ownership share of Unit No. 1 at the Oklaunion Generating Station that was jointly-owned with PSO, TNC and various nonaffiliated companies. Each of the participating companies was obligated to pay its share of the costs in the same proportion as its ownership interest. TCC's proportionate share of the operating costs associated with this facility is included in its Consolidated Statements of Income.

## 15. UNAUDITED QUARTERLY FINANCIAL INFORMATION

In management's opinion, the unaudited quarterly information reflects all normal and recurring accruals and adjustments necessary for a fair presentation of net income for interim periods. Quarterly results are not necessarily indicative of a full year's operations because of various factors. TCC's unaudited quarterly financial information is as follows:

| | 2008 Quarterly Periods Ended March 31 | June 30 | September 30 | December 31 |
|---|---|---|---|---|
| | | (in thousands) | | |
| Revenues | $ 181,042 | $ 212,989 | $ 231,673 | $ 211,335 (a) |
| Operating Income | 50,456 | 66,270 | 75,037 | 74,283 (a) |
| Net Income | 7,366 | 18,195 | 23,300 | 36,976 (a) |

| | 2007 Quarterly Periods Ended March 31 | June 30 | September 30 | December 31 |
|---|---|---|---|---|
| | | (in thousands) | | |
| Revenues | $ 176,931 | $ 202,743 | $ 235,649 | $ 193,282 |
| Operating Income | 44,872 | 60,048 | 87,464 | 47,185 |
| Net Income | 3,538 | 12,124 | 29,958 | 13,330 |

(a) See "Allocation of Off-system Sales Margins" section of Note 3 for discussion of the financial statement impact of the FERC's November 2008 order related to the SIA.

There were no significant events in the fourth quarter of 2007.