

# **AEP Texas North Company**

2008 Second Quarter Report

Consolidated Financial Statements



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## 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.
AEP System or the System	American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.
AEP West companies	PSO, SWEPCo, TCC and TNC.
AEPSC	American Electric Power Service Corporation, a service subsidiary providing management and professional services to AEP and its subsidiaries.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
CAA	Clean Air Act.
CSPCo	Columbus Southern Power Company, an AEP electric utility subsidiary.
CSW	Central and South West Corporation, a subsidiary of AEP (Effective January 21, 2003, the legal name of Central and South West Corporation was changed to AEP Utilities, Inc.).
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."
FASB	Financial Accounting Standards Board.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FIN	FASB Interpretation No.
FIN 48	FIN 48, "Accounting for Uncertainty in Income Taxes" and FASB Staff Position FIN 48-1 "Definition of <i>Settlement</i> in FASB Interpretation No. 48."
FSP	FASB Staff Position.
GAAP	Accounting Principles Generally Accepted in the United States of America.
IRS	Internal Revenue Service.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
Nonutility Money Pool	AEP System's Nonutility Money Pool.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
OPEB	Other Postretirement Benefit Plans.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
PUCT	Public Utility Commission of Texas.
SFAS	Statement of Financial Accounting Standards issued by the Financial Accounting Standards Board.
SFAS 133	Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities."
SWEPCo	Southwestern Electric Power Company, an AEP electric utility subsidiary.
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
TNC	AEP Texas North Company, an AEP electric utility subsidiary.
Utility Money Pool	AEP System's Utility Money Pool.

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
**For the Three and Six Months Ended June 30, 2008 and 2007**  
**(in thousands)**  
**(Unaudited)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>REVENUES</b>				
Electric Generation, Transmission and Distribution	\$ 40,508	\$ 45,497	\$ 81,320	\$ 83,576
Sales to AEP Affiliates	24,762	28,098	47,926	52,752
Other	359	285	601	515
<b>TOTAL</b>	<b>65,629</b>	<b>73,880</b>	<b>129,847</b>	<b>136,843</b>
<b>EXPENSES</b>				
Fuel and Other Consumables Used for Electric Generation	10,693	15,578	20,141	21,854
Purchased Electricity for Resale	(6)	1,647	1,249	4,449
Other Operation	18,924	17,314	37,114	36,877
Maintenance	4,768	4,262	11,735	11,729
Depreciation and Amortization	11,216	10,427	23,143	20,773
Taxes Other Than Income Taxes	5,289	5,281	10,119	10,122
<b>TOTAL</b>	<b>50,884</b>	<b>54,509</b>	<b>103,501</b>	<b>105,804</b>
<b>OPERATING INCOME</b>	14,745	19,371	26,346	31,039
<b>Other Income (Expense):</b>				
Other Income	881	187	1,211	372
Interest Expense	(5,067)	(4,330)	(9,389)	(8,676)
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	10,559	15,228	18,168	22,735
Income Tax Expense	3,329	5,104	5,813	7,334
<b>NET INCOME</b>	7,230	10,124	12,355	15,401
Preferred Stock Dividend Requirements	26	26	52	52
<b>EARNINGS APPLICABLE TO COMMON STOCK</b>	<b>\$ 7,204</b>	<b>\$ 10,098</b>	<b>\$ 12,303</b>	<b>\$ 15,349</b>

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

*See Condensed Notes to Condensed Consolidated Financial Statements.*

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S**  
**EQUITY AND COMPREHENSIVE INCOME (LOSS)**  
**For the Six Months Ended June 30, 2008 and 2007**  
**(in thousands)**  
**(Unaudited)**

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
<b>DECEMBER 31, 2006</b>	\$ 137,214	\$ 2,351	\$ 176,950	\$ (10,159)	\$ 306,356
FIN 48 Adoption, Net of Tax			(557)		(557)
Preferred Stock Dividends			(52)		(52)
<b>TOTAL</b>					<u>305,747</u>
<b>COMPREHENSIVE INCOME</b>					
<b>Other Comprehensive Income, Net of Taxes:</b>					
Cash Flow Hedges, Net of Tax of \$378				702	702
<b>NET INCOME</b>			15,401		<u>15,401</u>
<b>TOTAL COMPREHENSIVE INCOME</b>					<u>16,103</u>
<b>JUNE 30, 2007</b>	<u>\$ 137,214</u>	<u>\$ 2,351</u>	<u>\$ 191,742</u>	<u>\$ (9,457)</u>	<u>\$ 321,850</u>
<b>DECEMBER 31, 2007</b>	\$ 137,214	\$ 2,351	\$ 201,639	\$ (9,309)	\$ 331,895
EITF 06-10 Adoption, Net of Tax of \$153			(285)		(285)
Common Stock Dividends			(15,000)		(15,000)
Preferred Stock Dividends			(52)		(52)
<b>TOTAL</b>					<u>316,558</u>
<b>COMPREHENSIVE INCOME</b>					
<b>Other Comprehensive Income, Net of Taxes:</b>					
Amortization of Pension and OPEB					
Deferred Costs, Net of Tax of \$174				323	323
<b>NET INCOME</b>			12,355		<u>12,355</u>
<b>TOTAL COMPREHENSIVE INCOME</b>					<u>12,678</u>
<b>JUNE 30, 2008</b>	<u>\$ 137,214</u>	<u>\$ 2,351</u>	<u>\$ 198,657</u>	<u>\$ (8,986)</u>	<u>\$ 329,236</u>

*See Condensed Notes to Condensed Consolidated Financial Statements.*

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY  
CONDENSED CONSOLIDATED BALANCE SHEETS**

**ASSETS**

**June 30, 2008 and December 31, 2007**

(in thousands)

(Unaudited)

	<b>2008</b>	<b>2007</b>
<b>CURRENT ASSETS</b>		
Advances to Affiliates	\$ 29,305	\$ -
Accounts Receivable:		
Customers	12,095	10,255
Affiliated Companies	37,726	37,999
Accrued Unbilled Revenues	3,417	4,053
Miscellaneous	51	47
Allowance for Uncollectible Accounts	(45)	(25)
Total Accounts Receivable	53,244	52,329
Fuel	11,264	11,575
Materials and Supplies	11,031	9,994
Prepayments and Other	8,524	5,534
<b>TOTAL</b>	<b>113,368</b>	<b>79,432</b>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Electric:		
Production	293,348	292,109
Transmission	369,591	344,339
Distribution	534,363	523,248
Other	108,523	160,494
Construction Work in Progress	70,200	66,761
<b>Total</b>	1,376,025	1,386,951
Accumulated Depreciation and Amortization	455,185	498,590
<b>TOTAL - NET</b>	<b>920,840</b>	<b>888,361</b>
<b>OTHER NONCURRENT ASSETS</b>		
Regulatory Assets	33,920	36,536
Deferred Charges and Other	28,005	18,160
<b>TOTAL</b>	<b>61,925</b>	<b>54,696</b>
<b>TOTAL ASSETS</b>	<b>\$ 1,096,133</b>	<b>\$ 1,022,489</b>

*See Condensed Notes to Condensed Consolidated Financial Statements.*

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY  
CONDENSED CONSOLIDATED BALANCE SHEETS  
LIABILITIES AND SHAREHOLDERS' EQUITY  
June 30, 2008 and December 31, 2007  
(Unaudited)**

	<b>2008</b>	<b>2007</b>
<b>CURRENT LIABILITIES</b>	<b>(in thousands)</b>	
Advances from Affiliates	\$ -	\$ 33,511
Accounts Payable:		
General	10,818	11,651
Affiliated Companies	46,839	46,855
Accrued Taxes	18,852	18,941
Accrued Interest	5,929	4,024
Other	8,929	9,688
<b>TOTAL</b>	<b>91,367</b>	<b>124,670</b>
<b>NONCURRENT LIABILITIES</b>		
Long-term Debt – Nonaffiliated	368,920	268,875
Deferred Income Taxes	132,696	126,667
Regulatory Liabilities and Deferred Investment Tax Credits	129,366	128,139
Deferred Credits and Other	42,199	39,894
<b>TOTAL</b>	<b>673,181</b>	<b>563,575</b>
<b>TOTAL LIABILITIES</b>	<b>764,548</b>	<b>688,245</b>
Cumulative Preferred Stock Not Subject to Mandatory Redemption	2,349	2,349
Commitments and Contingencies (Note 4)		
<b>COMMON SHAREHOLDER'S EQUITY</b>		
Common Stock – Par Value – \$25 Per Share:		
Authorized – 7,800,000 Shares		
Outstanding – 5,488,560 Shares	137,214	137,214
Paid-in Capital	2,351	2,351
Retained Earnings	198,657	201,639
Accumulated Other Comprehensive Income (Loss)	(8,986)	(9,309)
<b>TOTAL</b>	<b>329,236</b>	<b>331,895</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 1,096,133</b>	<b>\$ 1,022,489</b>

*See Condensed Notes to Condensed Consolidated Financial Statements.*

**AEP TEXAS NORTH COMPANY AND SUBSIDIARY**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Six Months Ended June 30, 2008 and 2007**  
(in thousands)  
(Unaudited)

	2008	2007
<b>OPERATING ACTIVITIES</b>		
<b>Net Income</b>	\$ 12,355	\$ 15,401
<b>Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:</b>		
Depreciation and Amortization	23,143	20,773
Deferred Income Taxes	2,217	(895)
Allowance for Equity Funds Used During Construction	(348)	(44)
Deferred Property Taxes	(7,713)	(7,242)
Change in Other Noncurrent Assets	(3,656)	(3,964)
Change in Other Noncurrent Liabilities	2,316	(4,656)
<b>Changes in Certain Components of Working Capital:</b>		
Accounts Receivable, Net	(915)	(5,263)
Fuel, Materials and Supplies	(726)	(2,932)
Accounts Payable	416	(10,648)
Accrued Taxes, Net	(89)	2,209
Other Current Assets	(179)	114
Other Current Liabilities	1,327	(2,804)
<b>Net Cash Flows from Operating Activities</b>	28,148	49
<b>INVESTING ACTIVITIES</b>		
Construction Expenditures	(51,975)	(36,161)
Change in Other Cash Deposits, Net	-	(36,175)
Change in Advances to Affiliates, Net	(29,305)	13,543
Proceeds from Sales of Assets	2,625	12,014
<b>Net Cash Flows Used for Investing Activities</b>	(78,655)	(46,779)
<b>FINANCING ACTIVITIES</b>		
Issuance of Long-term Debt – Nonaffiliated	99,346	43,731
Change in Advances from Affiliates, Net	(33,511)	11,375
Retirement of Long-term Debt – Nonaffiliated	-	(8,151)
Principal Payments for Capital Lease Obligations	(276)	(257)
Dividends Paid on Common Stock	(15,000)	-
Dividends Paid on Cumulative Preferred Stock	(52)	(52)
<b>Net Cash Flows from Financing Activities</b>	50,507	46,646
<b>Net Decrease in Cash and Cash Equivalents</b>	-	(84)
<b>Cash and Cash Equivalents at Beginning of Period</b>	-	84
<b>Cash and Cash Equivalents at End of Period</b>	\$ -	\$ -
<b>SUPPLEMENTARY INFORMATION</b>		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 7,065	\$ 7,789
Net Cash Paid for Income Taxes	5,472	3,915
Noncash Acquisitions Under Capital Leases	258	133
Construction Expenditures Included in Accounts Payable at June 30,	6,005	3,996

*See Condensed Notes to Condensed Consolidated Financial Statements.*



**CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

1. Significant Accounting Matters
2. New Accounting Pronouncements
3. Rate Matters
4. Commitments, Guarantees and Contingencies
5. Disposition
6. Benefit Plans
7. Business Segments
8. Income Taxes
9. Financing Activities

## 1. SIGNIFICANT ACCOUNTING MATTERS

### *General*

The accompanying unaudited condensed consolidated financial statements and footnotes were prepared in accordance with GAAP for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete annual financial statements.

In the opinion of management, the unaudited condensed consolidated interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the results of operations, financial position and cash flows for the interim periods. The results of operations for the three and six months ended June 30, 2008 are not necessarily indicative of results that may be expected for the year ending December 31, 2008. The accompanying condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2007 financial statements and notes thereto, which are included in TNC's 2007 Annual Report.

### *Accounting for Asset Retirement Obligations (ARO)*

As a result of SFAS 143 "Accounting for Asset Retirement Obligations" (SFAS 143) and FASB Interpretation No. 47 "Accounting for Conditional Asset Retirement Obligations" (FIN 47), TNC records a liability at fair value for any legal obligations for future asset retirements when the related assets are acquired or constructed. Upon establishment of a legal liability, SFAS 143 requires a corresponding ARO asset to be established, which will be depreciated over its useful life. Upon final settlement of an ARO, any difference between the ARO liability and actual costs is recognized as income or expense.

In February 2008, TNC sold the Fort Phantom, Lake Pauline, Rio Pecos and San Angelo Plants. As part of the sale, the buyer assumed all environmental liabilities existing prior to and after the sale. As a result, the related ARO balances were reversed. The following is a reconciliation of the June 30, 2008 aggregate carrying amount of ARO for TNC:

<u>ARO at January 1, 2008</u>	<u>Accretion Expense</u>	<u>Liabilities Settled</u>	<u>ARO at June 30, 2008</u>
(in thousands)			
\$ 10,659	\$ 220	\$ (5,525)	\$ 5,354

TNC's aggregate carrying amount includes ARO related to asbestos removal.

### *Reclassifications*

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

## 2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of final pronouncements, management thoroughly reviews the new accounting literature to determine the relevance, if any, to TNC's business. The following represents a summary of new pronouncements issued or implemented in 2008 and standards issued but not implemented that management has determined relate to TNC's operations.

### *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 establishes 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. SFAS 141R 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 is effective prospectively for business combinations with an acquisition date on or after the beginning of the first annual reporting period after December 15, 2008. Early adoption is prohibited. TNC will adopt SFAS 141R effective January 1, 2009 and apply it to any business combinations on or after that date.

### ***SFAS 157 “Fair Value Measurements” (SFAS 157)***

In September 2006, the FASB issued SFAS 157, enhancing existing guidance for fair value measurement of assets and liabilities and instruments measured at fair value that are classified in shareholders’ equity. The statement defines fair value, establishes a fair value measurement framework and expands fair value disclosures. It emphasizes that fair value is market-based with the highest measurement hierarchy level being market prices in active markets. The standard requires fair value measurements be disclosed by hierarchy level, an entity includes its own credit standing in the measurement of its liabilities and modifies the transaction price presumption. The standard also nullifies the consensus reached in 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) that prohibited the recognition of trading gains or losses at the inception of a derivative contract, unless the fair value of such derivative is supported by observable market data.

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” (SFAS 13) and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under SFAS 13.

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).

TNC partially adopted SFAS 157 effective January 1, 2008. TNC will fully adopt SFAS 157 effective January 1, 2009 for items within the scope of FSP SFAS 157-2. 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 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 consideration of AEP’s own credit risk when measuring the fair value of liabilities, including derivatives, impacts fair value measurements upon adoption. The adoption of this standard had no impact on TNC’s financial statements.

### ***SFAS 159 “The Fair Value Option for Financial Assets and Financial Liabilities” (SFAS 159)***

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

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

### ***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. It 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.

SFAS 160 is effective for interim and annual periods in fiscal years beginning after December 15, 2008. The statement is applied prospectively upon adoption. Early adoption is prohibited. Upon adoption, prior period financial statements will be restated for the presentation of the noncontrolling interest for comparability. Although management has not completed its analysis, management expects that the adoption of this standard will have an immaterial impact on the financial statements. TNC will adopt SFAS 160 effective January 1, 2009.

#### ***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 derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. SFAS 161 requires that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation. This standard is intended to improve upon the existing disclosure framework in SFAS 133.

SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Management expects this standard to increase the disclosure requirements related to derivative instruments and hedging activities. It encourages retrospective application to comparative disclosure for earlier periods presented. TNC will adopt SFAS 161 effective January 1, 2009.

#### ***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.

SFAS 162 is effective 60 days after the SEC approves the Public Company Accounting Oversight Board’s amendments to AU Section 411, “The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles.” Management expects the adoption of this standard will have no impact on the financial statements. TNC will adopt SFAS 162 when it becomes effective.

#### ***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 in accordance with SFAS 106 “Employers’ Accounting for Postretirement Benefits Other Than Pension” or Accounting Principles Board Opinion No. 12 “Omnibus Opinion – 1967” if the employer has 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 change in accounting principle through 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) a change in accounting principle through retrospective application to all prior periods. TNC adopted EITF 06-10 effective January 1, 2008 with a cumulative effect reduction of \$438 thousand (\$285 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 ratified the EITF consensus on the treatment of income tax benefits of dividends on employee share-based compensation. The issue is how a company should recognize the income tax benefit received on dividends that are paid to employees holding equity-classified nonvested shares, equity-classified nonvested share units or equity-classified outstanding share options and charged to retained earnings under SFAS 123R, “Share-Based Payments.” Under EITF 06-11, a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity-classified nonvested equity shares, nonvested equity share units and outstanding equity share options should be recognized as an increase to additional paid-in capital. EITF 06-11 is applied prospectively to the income tax benefits of dividends on equity-classified employee share-based payment awards that are declared in fiscal years after December 15, 2007.

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

***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 under SFAS 142, “Goodwill and Other Intangible Assets.” 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.

SFAS 142-3 is effective for interim and annual periods in fiscal years beginning after December 15, 2008. Early adoption is prohibited. Upon adoption, the guidance within SFAS 142-3 will be prospectively applied to intangible assets acquired after the effective date. Management expects that the adoption of this standard will have an immaterial impact on the financial statements. TNC will adopt SFAS 142-3 effective January 1, 2009.

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

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

TNC adopted FIN 39-1 effective January 1, 2008. This standard changed the method of netting certain balance sheet amounts. It requires retrospective application as a change in accounting principle for all periods presented. It had no impact on TNC.

***Future Accounting Changes***

The FASB’s standard-setting process is ongoing and until new standards have been finalized and issued by the FASB, management cannot determine the impact on the reporting of operations and financial position that may result from any such future changes. The FASB is currently working on several projects including revenue recognition, contingencies, liabilities and equity, emission allowances, leases, 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 results of operations and financial position.

### **3. RATE MATTERS**

As discussed in TNC's 2007 Annual Report, TNC is involved in rate and regulatory proceedings at the FERC and the PUCT. The Rate Matters note within the 2007 Annual Report should be read in conjunction with this report to gain a complete understanding of material rate matters still pending that could impact results of operations, cash flows and possibly financial condition. The following discusses ratemaking developments in 2008 and updates the 2007 Annual Report.

#### ***Deferred Fuel***

TNC and the PUCT have been involved in litigation in the federal courts concerning whether the PUCT has the right to order reallocation of off-system sales margins thereby reducing recoverable fuel costs. In 2005, TNC recorded provisions for refunds after the PUCT ordered such reallocation. After receipt of favorable federal court decisions and the refusal of the U.S. Supreme Court to hear a PUCT appeal, TNC reversed its provision in the third quarter of 2007 of \$9 million.

The PUCT or another interested party could file a complaint at the FERC to challenge the allocation of off-system sales margins under the FERC-approved allocation agreement. In December 2007, some cities served by TNC requested the PUCT to initiate, or order TNC to initiate a proceeding at the FERC to determine if TNC misapplied its allocation under the FERC-approved agreement. In January 2008, TNC filed a response with the PUCT recommending the cities' request be denied. Although management cannot predict if a complaint will be filed at the FERC, management believes its allocations were in accordance with the then-existing FERC-approved allocation agreement and additional off-system sales margins should not be retroactively reallocated to the AEP West companies including TNC.

#### ***Texas Interim Transmission Rates***

In March 2008, TNC 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 TNC, subject to review during the next TNC base rate case. This review could result in a refund if the PUCT finds that TNC has not prudently incurred the transmission investment. The FERC also approved the new rates in May 2008. The new transmission rates, effective May 2008, are estimated to increase annual transmission revenues by \$4 million TNC has not recorded any provision for refund. Management believes these new rates are reasonable and necessary to recover costs associated with new transmission plant; however, 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 results of operations and cash flows.

### **4. COMMITMENTS, GUARANTEES AND CONTINGENCIES**

TNC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation cannot be predicted. For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material adverse effect on the financial statements. The Commitments, Guarantees and Contingencies note within the 2007 Annual Report should be read in conjunction with this report.

#### **GUARANTEES**

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

## ***Indemnifications and Other Guarantees***

### **Contracts**

TNC enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. Prior to June 30, 2008, TNC entered into sale agreements including indemnifications with a maximum exposure of \$3 million related to the sale price of certain generation assets in Texas. There are no material liabilities recorded for any indemnifications.

### **Master Operating Lease**

TNC leases certain equipment under a master operating lease. Under the lease agreement, the lessor is guaranteed to receive up to 87% of the unamortized balance of the equipment at the end of the lease term. If the fair market value of the leased equipment is below the unamortized balance at the end of the lease term, TNC has committed to pay the difference between the fair market value and the unamortized balance, with the total guarantee not to exceed 87% of the unamortized balance. Historically, at the end of the lease term the fair market value has been in excess of the unamortized balance. Assuming the fair market value of the equipment is zero at the end of the lease term, the maximum potential loss for these lease agreements was approximately \$3 million as of June 30, 2008.

## **CONTINGENCIES**

### ***Carbon Dioxide (CO<sub>2</sub>) 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<sub>2</sub> 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 have concluded. In April 2007, the U.S. Supreme Court issued a decision holding that the Federal EPA has authority to regulate emissions of CO<sub>2</sub> and other greenhouse gases under the CAA, which may impact the Second Circuit's analysis of these issues. The Second Circuit requested supplemental briefs addressing the impact of the Supreme Court's decision on this case. Management believes the actions are without merit and intends to defend against the claims.

### ***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<sub>2</sub> 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. Management believes the action is without merit and intends to defend against the claims.

### ***FERC Long-term Contracts***

In 2002, the FERC held a hearing related to a complaint filed by Nevada Power Company and Sierra Pacific Power Company (the Nevada utilities). The complaint sought to break long-term contracts entered during the 2000 and 2001 California energy price spike which the customers alleged were "high-priced." The complaint alleged that TNC and 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. Management is unable to predict the outcome of these proceedings or their impact on future results of operations and cash flows. Management asserted claims against certain companies that sold power to TNC and other AEP subsidiaries, which was resold to the Nevada utilities, seeking to recover a portion of any amounts that may be owed to the Nevada utilities.

## 5. DISPOSITION

### *Texas Plants*

In February 2008, TNC sold the mothballed Fort Phantom, Lake Pauline, Rio Pecos and San Angelo Plants for approximately \$2.5 million to a nonaffiliated entity. In 2002, the book values of the plants and the land were impaired to \$434 thousand. As part of the sale, the buyer assumed all environmental liabilities existing prior to and after the sale. As a result, the related ARO balances were reversed. Additionally, TNC recorded sales and related expenses and the impact of a settlement agreement with the City of San Angelo related to a purchase power contract between the City of San Angelo and TNC.

TNC also conveyed the Oak Creek Plant and related land at no cost to the City of Sweetwater. The plant and land assets were impaired to \$89 thousand in 2002.

As a result of these dispositions, TNC recognized an immaterial loss in the first quarter of 2008.

## 6. BENEFIT PLANS

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

### *Components of Net Periodic Benefit Cost*

The following tables provide the components of AEP's net periodic benefit cost for the plans for the three and six months ended June 30, 2008 and 2007:

	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>Three Months Ended June 30,</u>		<u>Three Months Ended June 30,</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
	(in millions)			
Service Cost	\$ 25	\$ 23	\$ 11	\$ 11
Interest Cost	62	57	28	26
Expected Return on Plan Assets	(84)	(82)	(28)	(26)
Amortization of Transition Obligation	-	-	7	7
Amortization of Net Actuarial Loss	10	14	2	3
<b>Net Periodic Benefit Cost</b>	<b>\$ 13</b>	<b>\$ 12</b>	<b>\$ 20</b>	<b>\$ 21</b>

	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>Six Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
	(in millions)			
Service Cost	\$ 50	\$ 47	\$ 21	\$ 21
Interest Cost	125	116	56	52
Expected Return on Plan Assets	(168)	(167)	(56)	(52)
Amortization of Transition Obligation	-	-	14	14
Amortization of Net Actuarial Loss	19	29	5	6
<b>Net Periodic Benefit Cost</b>	<b>\$ 26</b>	<b>\$ 25</b>	<b>\$ 40</b>	<b>\$ 41</b>



The following table provides TNC's net periodic benefit cost for the plans for the three and six months ended June 30, 2008 and 2007:

	<u>Pension Plans</u>		<u>Other Postretirement Benefit Plans</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
	(in thousands)			
Three Months Ended June 30,	\$ 90	\$ 70	\$ 602	\$ 630
Six Months Ended June 30,	180	140	1,204	1,261

## 7. BUSINESS SEGMENTS

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

## 8. INCOME TAXES

TNC adopted FIN 48 as of January 1, 2007. As a result, TNC recognized an increase in the liabilities for unrecognized tax benefits, as well as related interest expense and penalties, which was accounted for as a reduction to the January 1, 2007 balance of retained earnings.

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

TNC and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2000. However, TNC and other AEP subsidiaries have filed refund claims with the IRS for years 1997 through 2000 for the CSW pre-merger tax period, which are currently being reviewed. TNC and other AEP subsidiaries have completed the exam for the years 2001 through 2003 and have issues that will be 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, TNC 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 results of operations.

TNC, along with other AEP subsidiaries, files income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns and TNC and other AEP subsidiaries are currently under examination in several state and local jurisdictions. Management believes that TNC 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 results of operations. With few exceptions, TNC is no longer subject to state or local income tax examinations by tax authorities for years before 2000.

## 9. FINANCING ACTIVITIES

### *Long-term Debt*

Long-term debt and other securities issued during the first six months of 2008 were:

	<u>Type of Debt</u>	<u>Principal Amount</u>	<u>Interest Rate</u>	<u>Due Date</u>
		(in thousands)		
<b>Issuances:</b>	Senior Unsecured Notes	\$ 30,000	5.89%	2018
	Senior Unsecured Notes	70,000	6.76%	2038

## Lines of Credit

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of its subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds the utility subsidiaries, and a Nonutility Money Pool, which funds the majority of the nonutility subsidiaries. The AEP System corporate borrowing program operates in accordance with the terms and conditions approved in a regulatory order. The amount of outstanding loans to/borrowings from the Utility Money Pool and the Nonutility Money Pool are shown as either a net loan or a net borrowing position as of June 30, 2008 and December 31, 2007 and are included in either Advances to Affiliates or Advances from Affiliates on TNC's balance sheets. TNC's Utility Money Pool activity and corresponding authorized borrowing limit for the six months ended June 30, 2008 are described on the following table:

<b>Maximum Borrowings from Utility Money Pool</b>	<b>Maximum Loans to Utility Money Pool</b>	<b>Average Borrowings From Utility Money Pool</b>	<b>Average Loans to Utility Money Pool</b>	<b>Loans to Utility Money Pool as of June 30, 2008</b>	<b>Authorized Short-Term Borrowing Limit</b>
(in thousands)					
\$ 88,094	\$ 18,701	\$ 67,856	\$ 9,772	\$ 11,153	\$ 250,000

The activity in the above table does not include short-term lending activity of TNC's wholly-owned subsidiary, AEP Texas North Generation Company LLC (TNGC), who is a participant in the Nonutility Money Pool. For the six months ended June 30, 2008, TNGC had the following activity in the Nonutility Money Pool:

<b>Maximum Borrowings from Nonutility Money Pool</b>	<b>Maximum Loans to Nonutility Money Pool</b>	<b>Average Borrowings from Nonutility Money Pool</b>	<b>Average Loans to Nonutility Money Pool</b>	<b>Loans to Nonutility Money Pool as of June 30, 2008</b>
(in thousands)				
\$ -	\$ 18,656	\$ -	\$ 17,569	\$ 18,152

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the six months ended June 30, 2008 and 2007 are summarized in the following table:

	<b>Maximum Interest Rates for Funds Borrowed from the Utility Money Pool</b>	<b>Minimum Interest Rates for Funds Borrowed from the Utility Money Pool</b>	<b>Maximum Interest Rates for Funds Loaned to the Utility Money Pool</b>	<b>Minimum Interest Rates For Funds Loaned to the Utility Money Pool</b>	<b>Average Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Average Interest Rate for Funds Loaned to the Utility Money Pool</b>
2008	5.37%	2.92%	3.41%	2.91%	4.06%	3.10%
2007	5.46%	5.30%	5.35%	5.34%	5.36%	5.35%

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Nonutility Money Pool for the six months ended June 30, 2008 and 2007 are summarized in the following table:

	<b>Maximum Interest Rates for Funds Borrowed from the Nonutility Money Pool</b>	<b>Minimum Interest Rates for Funds Borrowed from the Nonutility Money Pool</b>	<b>Maximum Interest Rates for Funds Loaned to the Nonutility Money Pool</b>	<b>Minimum Interest Rates For Funds Loaned to the Nonutility Money Pool</b>	<b>Average Interest Rate for Funds Borrowed from the Nonutility Money Pool</b>	<b>Average Interest Rate for Funds Loaned to the Nonutility Money Pool</b>
2008	-%	-%	5.37%	2.87%	-%	3.55%
2007	-%	-%	5.46%	5.17%	-%	5.33%

## Credit Facilities

In April 2008, the Parent, the AEP East companies and the AEP West companies entered into a \$650 million 3-year credit agreement and a \$350 million 364-day credit agreement. Under the facilities, letters of credit may be issued. As of June 30, 2008, there were no outstanding amounts for TNC under either facility.