

AEP Texas North Company

2009 First 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 Consolidated	AEP and its majority owned consolidated subsidiaries and consolidated affiliates.
AEP East Companies	APCo, CSPCo, I&M, KPCo and OPCo.
AEP 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.
AOCI	Accumulated Other Comprehensive Income.
APB	Accounting Principles Board Opinion.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
ARO	Asset Retirement Obligations.
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.).
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.
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.
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 <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 Consolidated's Nonutility Money Pool.
OCC	Corporation Commission of the State of Oklahoma.
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.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
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."
SFAS 157	Statement of Financial Accounting Standards No. 157, "Fair Value Measurements."
SIA	System Integration Agreement.
SWEPCo	Southwestern Electric Power Company, an AEP electric utility subsidiary.

Term	Meaning
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
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 Months Ended March 31, 2009 and 2008
(in thousands)
(Unaudited)

	2009	2008
REVENUES		
Electric Generation, Transmission and Distribution	\$ 43,368	\$ 40,812
Sales to AEP Affiliates	20,105	23,164
Other	273	242
TOTAL	63,746	64,218
EXPENSES		
Fuel and Other Consumables Used for Electric Generation	4,195	9,448
Purchased Electricity for Resale	-	1,255
Other Operation	18,440	18,190
Maintenance	8,036	6,967
Depreciation and Amortization	12,047	11,927
Taxes Other Than Income Taxes	4,461	4,830
TOTAL	47,179	52,617
OPERATING INCOME	16,567	11,601
Other Income (Expense):		
Other Income	159	330
Interest Expense	(5,087)	(4,322)
INCOME BEFORE INCOME TAX EXPENSE	11,639	7,609
Income Tax Expense	3,649	2,484
NET INCOME	7,990	5,125
Preferred Stock Dividend Requirements	26	26
EARNINGS ATTRIBUTABLE TO COMMON STOCK	\$ 7,964	\$ 5,099

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 Three Months Ended March 31, 2009 and 2008
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
DECEMBER 31, 2007	\$ 137,214	\$ 2,351	\$ 201,639	\$ (9,309)	\$ 331,895
EITF 06-10 Adoption, Net of Tax of \$153			(285)		(285)
Common Stock Dividends			(5,000)		(5,000)
Preferred Stock Dividends			(26)		(26)
TOTAL					326,584
COMPREHENSIVE INCOME					
Other Comprehensive Income, Net of Taxes:					
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$87				161	161
NET INCOME			5,125		5,125
TOTAL COMPREHENSIVE INCOME					5,286
MARCH 31, 2008	\$ 137,214	\$ 2,351	\$ 201,453	\$ (9,148)	\$ 331,870
DECEMBER 31, 2008	\$ 137,214	\$ 2,351	\$ 200,167	\$ (16,256)	\$ 323,476
Common Stock Dividends			(8,000)		(8,000)
Preferred Stock Dividends			(26)		(26)
Other		1,089	(1,089)		-
TOTAL					315,450
COMPREHENSIVE INCOME					
Other Comprehensive Income (Loss), Net of Taxes:					
Cash Flow Hedges, Net of Tax of \$8				(14)	(14)
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$79				146	146
NET INCOME			7,990		7,990
TOTAL COMPREHENSIVE INCOME					8,122
MARCH 31, 2009	\$ 137,214	\$ 3,440	\$ 199,042	\$ (16,124)	\$ 323,572

See Condensed Notes to Condensed Consolidated Financial Statements.

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

ASSETS

March 31, 2009 and December 31, 2008

(in thousands)

(Unaudited)

	2009	2008
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 200	\$ 200
Accounts Receivable:		
Customers	8,591	9,674
Affiliated Companies	35,285	65,731
Accrued Unbilled Revenues	5,549	4,289
Miscellaneous	53	55
Allowance for Uncollectible Accounts	(44)	(47)
Total Accounts Receivable	49,434	79,702
Fuel	8,363	9,808
Materials and Supplies	10,180	10,339
Deferred Tax Benefits	6,667	-
Prepayments and Other	1,375	1,367
TOTAL	76,219	101,416
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Production	295,343	295,065
Transmission	421,596	411,839
Distribution	552,398	548,424
Other	107,426	107,844
Construction Work in Progress	93,566	82,283
Total	1,470,329	1,445,455
Accumulated Depreciation and Amortization	467,188	458,868
TOTAL - NET	1,003,141	986,587
OTHER NONCURRENT ASSETS		
Regulatory Assets	66,930	67,943
Deferred Charges and Other	14,360	3,076
TOTAL	81,290	71,019
TOTAL ASSETS	\$ 1,160,650	\$ 1,159,022

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
LIABILITIES AND SHAREHOLDERS' EQUITY
March 31, 2009 and December 31, 2008
(Unaudited)

	2009	2008
CURRENT LIABILITIES	(in thousands)	
Advances from Affiliates	\$ 33,068	\$ 28,686
Accounts Payable:		
General	6,731	7,236
Affiliated Companies	37,981	47,572
Risk Management Liabilities	3	-
Accrued Taxes	28,978	16,714
Accrued Interest	4,938	5,914
Provision for Revenue Refund	9,400	9,400
Other	14,991	21,231
TOTAL	136,090	136,753
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	368,987	368,965
Deferred Income Taxes	126,920	124,071
Regulatory Liabilities and Deferred Investment Tax Credits	130,829	131,022
Employee Benefits and Pension Obligations	41,872	42,596
Deferred Credits and Other	30,031	29,790
TOTAL	698,639	696,444
TOTAL LIABILITIES	834,729	833,197
Cumulative Preferred Stock Not Subject to Mandatory Redemption	2,349	2,349
Commitments and Contingencies (Note 4)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – \$25 Per Share:		
Authorized – 7,800,000 Shares		
Outstanding – 5,488,560 Shares	137,214	137,214
Paid-in Capital	3,440	2,351
Retained Earnings	199,042	200,167
Accumulated Other Comprehensive Income (Loss)	(16,124)	(16,256)
TOTAL	323,572	323,476
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 1,160,650	\$ 1,159,022

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS NORTH COMPANY AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Three Months Ended March 31, 2009 and 2008
(in thousands)
(Unaudited)

	2009	2008
OPERATING ACTIVITIES		
Net Income	\$ 7,990	\$ 5,125
Adjustments to Reconcile Net Income to Net Cash Flows from (Used for) Operating Activities:		
Depreciation and Amortization	12,047	11,927
Deferred Income Taxes	(7,298)	843
Mark-to-Market of Risk Management Contracts	(16)	-
Deferred Property Taxes	(11,280)	(11,570)
Change in Other Noncurrent Assets	145	(2,840)
Change in Other Noncurrent Liabilities	1,057	891
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	30,268	912
Fuel, Materials and Supplies	1,604	(402)
Accounts Payable	(8,939)	(2,435)
Accrued Taxes, Net	12,485	1,455
Accrued Interest	(976)	(2,320)
Other Current Assets	(230)	(304)
Other Current Liabilities	(4,223)	(2,945)
Net Cash Flows from (Used for) Operating Activities	32,634	(1,663)
INVESTING ACTIVITIES		
Construction Expenditures	(29,638)	(25,502)
Proceeds from Sales of Assets	810	2,521
Net Cash Flows Used for Investing Activities	(28,828)	(22,981)
FINANCING ACTIVITIES		
Change in Advances from Affiliates, Net	4,382	29,806
Principal Payments for Capital Lease Obligations	(162)	(136)
Dividends Paid on Common Stock	(8,000)	(5,000)
Dividends Paid on Cumulative Preferred Stock	(26)	(26)
Net Cash Flows from (Used for) Financing Activities	(3,806)	24,644
Net Change in Cash and Cash Equivalents	-	-
Cash and Cash Equivalents at Beginning of Period	200	-
Cash and Cash Equivalents at End of Period	\$ 200	\$ -
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 9,231	\$ 6,423
Net Cash Paid for Income Taxes	-	1,453
Noncash Acquisitions Under Capital Leases	43	27
Construction Expenditures Included in Accounts Payable at March 31,	4,179	3,158

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. Derivatives, Hedging and Fair Value Measurements
9. Income Taxes
10. 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 net income, financial position and cash flows for the interim periods. The net income for the three months ended March 31, 2009 are not necessarily indicative of results that may be expected for the year ending December 31, 2009. The accompanying condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2008 financial statements and notes thereto, which are included in TNC's 2008 Annual Report.

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 TNC is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE's variability TNC 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 TNC is the primary beneficiary. In addition, TNC has not provided financial or other support to any VIE that was not previously contractually required.

TNC holds a significant variable interest in AEPSC. AEPSC provides certain managerial and professional services to TNC. 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 TNC at AEPSC's cost. TNC 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 TNC that could require additional financial support from TNC or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. TNC is exposed to losses to the extent it cannot recover the costs of AEPSC through its normal business operations. TNC 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 three months ended March 31, 2009 and 2008 were \$7 million and \$9 million, respectively. The carrying amount of liabilities associated with AEPSC for the three months ended March 31, 2009 and for the year ended December 31, 2008 were \$2 million and \$4 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

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 March 31, 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 March 31, 2008</u>
(in thousands)			
\$ 10,659	\$ 138	\$ (5,518)	\$ 5,279

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

2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of final pronouncements, management 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 2009 and standards issued but not implemented that management has determined relate to TNC’s operations.

Pronouncements Adopted During the First Quarter of 2009

The following standards were effective during the first quarter of 2009. Consequently, the financial statements and footnotes reflect their impact.

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. TNC does not have any such tax positions that result in adjustments.

In April 2009, the FASB issued FSP SFAS 141(R)-1 “Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies.” The standard clarifies accounting and disclosure for contingencies arising in business combinations. It was effective January 1, 2009.

TNC adopted SFAS 141R, including the FSP, effective January 1, 2009. It is effective prospectively for business combinations with an acquisition date on or after January 1, 2009. TNC 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. 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.

TNC adopted SFAS 160 effective January 1, 2009 with no impact on its financial statements or footnote disclosures.

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 the primary underlying risk and accounting designation.

TNC adopted SFAS 161 effective January 1, 2009. This standard increased the disclosures related to derivative instruments and hedging activities. See “Derivatives and Hedging ” section of Note 8 for further information.

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.

TNC 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.

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.

TNC adopted EITF 08-6 effective January 1, 2009 with no impact on the 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.

TNC 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.

FSP SFAS 157-2 “Effective Date of FASB Statement No. 157” (SFAS 157-2)

In February 2008, the FASB issued 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). 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. The fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. 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.

TNC adopted SFAS 157-2 effective January 1, 2009. TNC will apply these requirements to applicable fair value measurements which include new asset retirement obligations and impairment analysis related to long-lived assets, equity investments, goodwill and intangibles. TNC did not record any fair value measurements for nonrecurring nonfinancial assets and liabilities in the first quarter of 2009.

Pronouncements Effective in the Future

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

FSP SFAS 107-1 and APB 28-1 “Interim Disclosures about Fair Value of Financial Instruments” (FSP SFAS 107-1 and APB 28-1)

In April 2009, the FASB issued FSP SFAS 107-1 and APB 28-1 requiring disclosure about the fair value of financial instruments in all interim reporting periods. The standard requires disclosure of the method and significant assumptions used to determine the fair value of financial instruments.

This standard is effective for interim periods ending after June 15, 2009. Management expects this standard to increase the disclosure requirements related to financial instruments. TNC will adopt the standard effective second quarter of 2009.

FSP SFAS 115-2 and SFAS 124-2 “Recognition and Presentation of Other-Than-Temporary Impairments” (FSP SFAS 115-2 and SFAS 124-2)

In April 2009, the FASB issued FSP SFAS 115-2 and SFAS 124-2 amending the other-than-temporary impairment (OTTI) recognition and measurement guidance for debt securities. For both debt and equity securities, the standard requires disclosure for each interim reporting period of information by security class similar to previous annual disclosure requirements.

This standard is effective for interim periods ending after June 15, 2009. Management does not expect a material impact as a result of the new OTTI evaluation method for debt securities, but expects this standard to increase the disclosure requirements related to financial instruments. TNC will adopt the standard effective second quarter of 2009.

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. TNC will adopt the standard effective for the 2009 Annual Report.

FSP SFAS 157-4 "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" (FSP SFAS 157-4)

In April 2009, the FASB issued FSP SFAS 157-4 providing additional guidance on estimating fair value when the volume and level of activity for an asset or liability has significantly decreased, including guidance on identifying circumstances indicating when a transaction is not orderly. Fair value measurements shall be based on the price that would be received to sell an asset or paid to transfer a liability in an orderly (not a distressed sale or forced liquidation) transaction between market participants at the measurement date under current market conditions. The standard also requires disclosures of the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, for both interim and annual periods.

This standard is effective for interim and annual periods ending after June 15, 2009. Management expects this standard to have no impact on the financial statement but will increase disclosure requirements. TNC will adopt the standard effective second quarter of 2009.

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, insurance, hedge accounting, discontinued operations, 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

As discussed in TNC's 2008 Annual Report, TNC is involved in rate and regulatory proceedings at the FERC and the PUCT. The Rate Matters note within TNC's 2008 Annual Report should be read in conjunction with this report to gain a complete understanding of material rate matters still pending that could impact net income, cash flows and possibly financial condition. The following discusses ratemaking developments in 2009 and updates TNC's 2008 Annual Report.

Texas Restructuring Appeal

TNC received its final true-up order in May 2005 that resulted in refunds via a CTC which have been completed. The appeal brought by TNC of the final true-up order remains pending in state court. Management cannot predict the outcome of this court proceeding. If TNC ultimately succeeds in its appeal, it could have a material favorable effect on future net income, cash flows and financial condition. If TNC does not succeed in its appeal, it could have a material adverse effect on future net income, cash flows and possibly financial condition.

2008 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 approved the new interim transmission rates in May 2008 which increased annual transmission revenues by \$4 million. TNC 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, TNC filed an application with the PUCT for an interim update of wholesale-transmission rates. The proposed new interim transmission rates are estimated to increase annual transmission revenues by \$9 million. In April 2009, the PUCT staff recommended the applications be approved as filed. 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 the interim transmission rates proceeding.

Advanced Metering System

In 2007, the governor of Texas signed legislation directing the PUCT to establish a surcharge for electric utilities relating to advanced meters. In April 2009, TCC and TNC filed their Advanced Metering System (AMS) with the PUCT proposing to invest approximately \$223 million and \$61 million, respectively, to be recovered through customer surcharges beginning in October 2009. The TCC and TNC filing is modeled on similar filings by other Texas ERCOT Investor Owned Utilities who have already received PUCT approval for their plans. In the filing TCC and TNC propose to apply customer refunds related to the FERC SIA ruling to reduce the AMS investment and associated customer surcharge. As of March 31, 2009, TNC has \$0.5 million recorded on its balance sheet related to advanced meters.

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, the APSC and the Oklahoma Industrial Energy Consumers 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 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 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 was 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 shared a portion of such revenues with their wholesale and retail customers during the period June 2000 to March 2006. In December 2008, the AEP West companies recorded a provision for refund. TNC filed an application in April 2009 to initiate a proceeding as a result of the FERC ruling. TNC proposes to use the refund to reduce its AMS investment as discussed in the "Advanced Metering System" section above. Management cannot predict the outcome of the requested FERC rehearing proceeding or any future state regulatory proceedings but believes the AEP West companies' provision for refund regarding future regulatory proceedings is adequate.

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 2008 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." In addition, TNC 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

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 March 31, 2009, 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 and the risk of payment/performance is remote.

Master Lease Agreements

TNC 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 2011, TNC 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. 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 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, TNC 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, TNC 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 March 31, 2009, the maximum potential loss for these lease agreements was approximately \$751 thousand 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.

CONTINGENCIES

Carbon Dioxide (CO₂) 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 CO₂ 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 CO₂ 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 CO₂ 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.

Rail Transportation Litigation

In October 2008, the Oklahoma Municipal Power Authority and the Public Utilities Board of the City of Brownsville, Texas, as co-owners of Oklaunion Plant, filed a lawsuit in United States District Court, Western District of Oklahoma against AEP alleging breach of contract and breach of fiduciary duties related to negotiations for rail transportation services for the plant. The plaintiffs allege that AEP assumed the duties of the project manager, PSO, and operated the plant for the project manager and is therefore responsible for the alleged breaches. TNC is also a co-owner of the Oklaunion Plant. In December 2008, the court denied AEP's motion to dismiss the case. Management intends to vigorously defend against these allegations. Management believes a provision recorded in 2008 should be sufficient.

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. 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 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. Management is unable to predict the outcome of these proceedings or their impact on future net income and cash flows.

5. DISPOSITION

2009

None

2008

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 table provides the components of AEP's net periodic benefit cost for the plans for the three months ended March 31, 2009 and 2008:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
	(in millions)			
Service Cost	\$ 26	\$ 25	\$ 10	\$ 10
Interest Cost	63	63	27	28
Expected Return on Plan Assets	(80)	(84)	(20)	(28)
Amortization of Transition Obligation	-	-	7	7
Amortization of Net Actuarial Loss	15	9	11	3
Net Periodic Benefit Cost	\$ 24	\$ 13	\$ 35	\$ 20

The following table provides TNC's net periodic benefit cost for the plans for the three months ended March 31, 2009 and 2008:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
	(in thousands)			
Net Periodic Benefit Cost	\$ 150	\$ 90	\$ 979	\$ 602

AEP sponsors several trust funds with significant investments intended to provide for future pension and OPEB payments. All of the trust funds' investments are well-diversified and managed in compliance with all laws and regulations. The value of the investments in these trusts has declined from the December 31, 2008 balances due to decreases in the equity and fixed income markets. Although the asset values are currently lower than at year end, this decline has not affected the funds' ability to make their required payments.

7. BUSINESS SEGMENTS

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

8. DERIVATIVES, HEDGING AND FAIR VALUE MEASUREMENTS

Beginning in 2009, AEPSC, on behalf of TNC, executed financial heating oil and gasoline derivative contracts to hedge the price risk of diesel fuel and gasoline purchases. The amount of AOCI, net of taxes, reported in TNC's Condensed Consolidated Balance Sheet for these hedges is \$14 thousand as of March 31, 2009. Not all fuel price risk exposure is hedged. During the first quarter of 2009, TNC recognized no hedge ineffectiveness related to this hedge strategy. The maximum term for exposure to variability of these cash flows is 10 months.

9. INCOME TAXES

TNC and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2000. TNC and other AEP subsidiaries have completed the exam for the years 2001 through 2006 and have issues that are being pursued at the appeals level. 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 net income.

10. FINANCING ACTIVITIES

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, and a Nonutility Money Pool, which funds the majority of the nonutility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions approved in a regulatory order. The amount of outstanding loans (borrowings) to/from the Utility Money Pool and the Nonutility Money Pool are shown as a net borrowing position as of March 31, 2009 and December 31, 2008 and are included in Advances from Affiliates on TNC's balance sheets. TNC's Utility Money Pool activity and corresponding authorized borrowing limits for the three months ended March 31, 2009 are described on the following table:

<u>Maximum Borrowings from Utility Money Pool</u>	<u>Maximum Loans to Utility Money Pool</u>	<u>Average Borrowings From Utility Money Pool</u>	<u>Average Loans to Utility Money Pool</u>	<u>Borrowings from Utility Money Pool as of March 31, 2009</u>	<u>Authorized Short-Term Borrowing Limit</u>
(in thousands)					
\$ 57,321	\$ -	\$ 46,216	\$ -	\$ 45,899	\$ 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 three months ended March 31, 2009, TNGC had the following activity in the Nonutility Money Pool:

<u>Maximum Borrowings from Nonutility Money Pool</u>	<u>Maximum Loans to Nonutility Money Pool</u>	<u>Average Borrowings from Nonutility Money Pool</u>	<u>Average Loans to Nonutility Money Pool</u>	<u>Loans to Nonutility Money Pool as of March 31, 2009</u>
(in thousands)				
\$ -	\$ 12,843	\$ -	\$ 11,982	\$ 12,831

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool for the three months ended March 31, 2009 and 2008 are summarized in the following table:

	<u>Maximum Interest Rates for Funds Borrowed from the Utility Money Pool</u>	<u>Minimum Interest Rates for Funds Borrowed from the Utility Money Pool</u>	<u>Maximum Interest Rates for Funds Loaned to the Utility Money Pool</u>	<u>Minimum Interest Rates For Funds Loaned to the Utility Money Pool</u>	<u>Average Interest Rate for Funds Borrowed from the Utility Money Pool</u>	<u>Average Interest Rate for Funds Loaned to the Utility Money Pool</u>
2009	2.28%	1.22%	-%	-%	1.68%	-%
2008	5.37%	3.39%	-%	-%	4.06%	-%

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Nonutility Money Pool for the three months ended March 31, 2009 and 2008 are summarized in the following table:

	Maximum Interest Rates for Funds Borrowed from the Nonutility Money Pool	Minimum Interest Rates for Funds Borrowed from the Nonutility Money Pool	Maximum Interest Rates for Funds Loaned to the Nonutility Money Pool	Minimum Interest Rates For Funds Loaned to the Nonutility Money Pool	Average Interest Rate for Funds Borrowed from the Nonutility Money Pool	Average Interest Rate for Funds Loaned to the Nonutility Money Pool
2009	-%	-%	2.28%	1.22%	-%	1.69%
2008	-%	-%	5.37%	3.39%	-%	4.09%

Credit Facilities

TNC and certain other companies in the AEP System have 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 March 31, 2009, there were no outstanding amounts for TNC under either facility. In April 2009, the \$350 million 364-day credit agreement expired.