AEP Texas North Company

2007 Second Quarter Report

Consolidated Financial Statements

TABLE OF CONTENTS	Page

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

Term	Meaning
AEP or Parent	American Electric Power Company, Inc.
AEP System or the System	American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.
AEP East companies	APCo, CSPCo, I&M, KPCo and OPCo.
AEP West companies	PSO, SWEPCo, TCC and TNC.
AEPSC	American Electric Power Service Corporation, a service subsidiary providing management and professional services to AEP and its subsidiaries.
ALJ	Administrative Law Judge.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
CAA	Clean Air Act.
CSPCo	Columbus Southern Power Company, an AEP electric utility subsidiary.
CSW	Central and South West Corporation, a subsidiary of AEP (Effective January 21, 2003, the legal name of Central and South West Corporation was changed to AEP Utilities, Inc.).
EITF	Financial Accounting Standards Board's Emerging Issues Task Force.
ERCOT	Electric Reliability Council of Texas.
FASB	Financial Accounting Standards Board.
Federal EPA	United States Environmental Protection Agency.
FERC	Federal Energy Regulatory Commission.
FIN	FASB Interpretation No.
FIN 48	FIN 48, "Accounting for Uncertainty in Income Taxes" and FASB Staff Position FIN 48-1 "Definition of *Settlement* in FASB Interpretation No. 48."
GAAP	Accounting Principles Generally Accepted in the United States of America.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
IRS	Internal Revenue Service.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
MTM	Mark-to-Market.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
PSO	Public Service Company of Oklahoma, an AEP electric utility subsidiary.
PUCT	Public Utility Commission of Texas.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
SEC	United States Securities and Exchange Commission.
SFAS	Statement of Financial Accounting Standards issued by the Financial Accounting Standards Board.
SFAS 71	Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation."
SFAS 133	Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities."
SFAS 157	Statement of Financial Accounting Standards No. 157, "Fair Value Measurements."
SFAS 158	Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans."
SFAS 159	Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities."
SIA	System Integration Agreement.
SPP	Southwest Power Pool.
SWEPCo	Southwestern Electric Power Company, an AEP electric utility subsidiary.
TCC	AEP Texas Central Company, an AEP electric utility subsidiary.
Texas Restructuring Legislation	Legislation enacted in 1999 to restructure the electric utility industry in Texas.
TNC	AEP Texas North Company, an AEP electric utility subsidiary.
True-up Proceeding	A filing made under the Texas Restructuring Legislation to finalize the amount of stranded costs and other true-up items and the recovery of such amounts.
Utility Money Pool	AEP System's Utility Money Pool.

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

	Three Months Ended 2007	Three Months Ended 2006	Six Months Ended 2007	Six Months Ended 2006
REVENUES				
Electric Generation, Transmission and Distribution	$ 45,497	$ 71,051	$ 83,576	$ 139,876
Sales to AEP Affiliates	28,098	11,860	52,752	17,885
Other	285	87	515	(97)
TOTAL	73,880	82,998	136,843	157,664
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	15,578	7,044	21,854	19,159
Purchased Electricity for Resale	1,647	32,883	4,449	47,279
Other Operation	17,314	21,417	36,877	39,895
Maintenance	4,262	5,216	11,729	10,417
Depreciation and Amortization	10,427	10,398	20,773	20,699
Taxes Other Than Income Taxes	5,281	5,856	10,122	11,396
TOTAL	54,509	82,814	105,804	148,845
OPERATING INCOME	19,371	184	31,039	8,819
Other Income (Expense):				
Interest Income	195	120	328	339
Allowance for Equity Funds Used During Construction	(8)	108	44	490
Interest Expense	(4,330)	(4,517)	(8,676)	(8,879)
INCOME (LOSS) BEFORE INCOME TAXES	15,228	(4,105)	22,735	769
Income Tax Expense (Credit)	5,104	(3,513)	7,334	(2,473)
NET INCOME (LOSS)	10,124	(592)	15,401	3,242
Preferred Stock Dividend Requirements	26	26	52	52
Gain on Reacquired Preferred Stock	-	-	-	2
EARNINGS (LOSS) APPLICABLE TO COMMON STOCK	$ 10,098	$ (618)	$ 15,349	$ 3,192

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, 2007 and 2006
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
DECEMBER 31, 2005	$ 137,214	$ 2,351	$ 174,858	$ (504)	$ 313,919
Common Stock Dividends			(12,750)		(12,750)
Preferred Stock Dividends			(52)		(52)
Gain on Reacquired Preferred Stock			2		2
TOTAL					301,119
COMPREHENSIVE INCOME					
Other Comprehensive Income, Net of Taxes:					
Cash Flow Hedges, Net of Tax of $1,368				2,540	2,540
NET INCOME			3,242		3,242
TOTAL COMPREHENSIVE INCOME					5,782
JUNE 30, 2006	$ 137,214	$ 2,351	$ 165,300	$ 2,036	$ 306,901
DECEMBER 31, 2006	$ 137,214	$ 2,351	$ 176,950	$ (10,159)	$ 306,356
FIN 48 Adoption, Net of Tax			(557)		(557)
Preferred Stock Dividends			(52)		(52)
TOTAL					305,747
COMPREHENSIVE INCOME					
Other Comprehensive Income, Net of Taxes:					
Cash Flow Hedges, Net of Tax of $378				702	702
NET INCOME			15,401		15,401
TOTAL COMPREHENSIVE INCOME					16,103
JUNE 30, 2007	$ 137,214	$ 2,351	$ 191,742	$ (9,457)	$ 321,850

See Condensed Notes to Condensed Consolidated Financial Statements.

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

	2007	2006
CURRENT ASSETS		
Cash and Cash Equivalents	$ -	$ 84
Other Cash Deposits	45,038	8,863
Advances to Affiliates	-	13,543
Accounts Receivable:		
Customers	11,236	21,677
Affiliated Companies	15,524	5,634
Accrued Unbilled Revenues	3,394	2,292
Miscellaneous	4,785	65
Allowance for Uncollectible Accounts	(17)	(9)
Total Accounts Receivable	34,922	29,659
Fuel	11,253	8,559
Materials and Supplies	9,557	9,319
Prepayments and Other	2,325	1,681
TOTAL	103,095	71,708
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Production	292,165	290,485
Transmission	332,150	327,845
Distribution	513,364	512,265
Other	161,237	159,451
Construction Work in Progress	38,976	38,847
Total	1,337,892	1,328,893
Accumulated Depreciation and Amortization	487,275	486,961
TOTAL - NET	850,617	841,932
OTHER NONCURRENT ASSETS		
Regulatory Assets	39,940	38,402
Employee Benefits and Pension Assets	12,783	12,867
Deferred Charges and Other	10,296	2,605
TOTAL	63,019	53,874
TOTAL ASSETS	$ 1,016,731	$ 967,514

See Condensed Notes to Condensed Consolidated Financial Statements.

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

	2007	2006
CURRENT LIABILITIES	(in thousands)	
Advances from Affiliates	$ 11,375	$ -
Accounts Payable:		
General	6,456	4,448
Affiliated Companies	34,016	43,993
Long-term Debt Due Within One Year – Nonaffiliated	44,310	8,151
Accrued Taxes	22,678	21,782
Accrued Interest	4,335	4,455
Other	7,172	10,479
TOTAL	130,342	93,308
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	268,830	268,785
Long-term Risk Management Liabilities	-	1,081
Deferred Income Taxes	120,644	124,048
Regulatory Liabilities and Deferred Investment Tax Credits	133,698	139,429
Deferred Credits and Other	39,018	32,158
TOTAL	562,190	565,501
TOTAL LIABILITIES	692,532	658,809
Cumulative Preferred Stock Not Subject to Mandatory Redemption	2,349	2,349
Commitments and Contingencies (Note 4)		
COMMON SHAREHOLDER'S EQUITY		
Common Stock – Par Value – $25 Per Share:		
Authorized – 7,800,000 Shares		
Outstanding – 5,488,560 Shares	137,214	137,214
Paid-in Capital	2,351	2,351
Retained Earnings	191,742	176,950
Accumulated Other Comprehensive Income (Loss)	(9,457)	(10,159)
TOTAL	321,850	306,356
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 1,016,731	$ 967,514

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, 2007 and 2006
(in thousands)
(Unaudited)

	2007	2006
OPERATING ACTIVITIES		
Net Income	$ 15,401	$ 3,242
Adjustments for Noncash Items:		
Depreciation and Amortization	20,773	20,699
Deferred Income Taxes	(895)	(3,183)
Mark-to-Market of Risk Management Contracts	-	2,698
Deferred Property Taxes	(7,242)	(8,408)
Change in Other Noncurrent Assets	(4,008)	(3,596)
Change in Other Noncurrent Liabilities	(4,656)	1,904
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	(5,263)	71,587
Fuel, Materials and Supplies	(2,932)	(5,249)
Accounts Payable	(10,648)	(62,323)
Customer Deposits	128	(3,571)
Accrued Taxes, Net	2,209	(4,046)
Other Current Assets	(14)	2,845
Other Current Liabilities	(2,804)	(4,582)
Net Cash Flows From Operating Activities	49	8,017
INVESTING ACTIVITIES		
Construction Expenditures	(36,161)	(36,675)
Change in Other Cash Deposits, Net	(36,175)	1,073
Change In Advances to Affiliates, Net	13,543	34,286
Proceeds from Sales of Assets	12,014	250
Net Cash Flows Used For Investing Activities	(46,779)	(1,066)
FINANCING ACTIVITIES		
Issuance of Long-term Debt – Nonaffilated	43,731	-
Change in Advances from Affiliates, Net	11,375	6,005
Retirement of Long-term Debt – Nonaffiliated	(8,151)	-
Retirement of Cumulative Preferred Stock	-	(6)
Principal Payments for Capital Lease Obligations	(257)	(148)
Dividends Paid on Common Stock	-	(12,750)
Dividends Paid on Cumulative Preferred Stock	(52)	(52)
Net Cash Flows From (Used For) Financing Activities	46,646	(6,951)
Net Decrease in Cash and Cash Equivalents	(84)	-
Cash and Cash Equivalents at Beginning of Period	84	-
Cash and Cash Equivalents at End of Period	$ -	$ -
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 7,789	$ 7,809
Net Cash Paid for Income Taxes	3,915	6,079
Noncash Acquisitions Under Capital Leases	133	749
Construction Expenditures Included in Accounts Payable at June 30,	3,996	2,037

See Condensed Notes to Condensed Consolidated Financial Statements.

CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING MATTERS

General

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

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

Revenue Recognition

Traditional Electricity Supply and Delivery Activities

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

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

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

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

Related Party Transactions

Oklaunion PPA between TNC and AEP Energy Partners

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

TNC recorded revenue of $27.3 million and $50.7 million from AEPEP for the three months and six months ended June 30, 2007, respectively. These amounts are included in Sales to AEP Affiliates on its 2007 Condensed Consolidated Statement of Income.

Texas Restructuring – SPP

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

Reclassifications

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

2. NEW ACCOUNTING PRONOUNCEMENTS

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

SFAS 157 "Fair Value Measurements" (SFAS 157)

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

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

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

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

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

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

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

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

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

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

FIN 48 requires that the cumulative effect of applying this interpretation be reported and disclosed as an adjustment to the opening balance of retained earnings for that fiscal year and presented separately. TNC adopted FIN 48 effective January 1, 2007. The impact of this interpretation was an unfavorable adjustment to retained earnings of $557,000.

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

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

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

Future Accounting Changes

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

3. RATE MATTERS

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

Deferred Fuel

In 2002, TNC filed with the PUCT seeking to reconcile fuel costs and establish its final deferred fuel balance. In its final fuel reconciliation order, the PUCT ordered substantial reductions in TNC's recoverable fuel costs for, among other things, the reallocation of additional AEP System off-system sales margins to TNC under a FERC-approved tariff. TNC appealed the PUCT's ruling regarding a number of issues in the fuel order in state court and challenged the jurisdiction of the PUCT over the allocation of off-system sales margins in the federal court. Intervenors also appealed the PUCT's final fuel rulings in state court seeking to increase the various allowances.

In 2006, the Federal District Court issued an order precluding the PUCT from enforcing the off-system sales reallocation portion of its ruling in the final TNC fuel reconciliation proceeding. The Federal court ruled that the FERC, not the PUCT, has jurisdiction over the allocation. The PUCT appealed both Federal District Court decisions to the United States Court of Appeals. The Court of Appeals affirmed the District Court's decision. In April 2007, the PUCT petitioned the United States Supreme Court for a review of the Court of Appeals' order. If the PUCT's appeals are ultimately unsuccessful, TNC could record income of $8 million related to the reversal of the previously-recorded fuel over-recovery regulatory liabilities related to the reallocation of off-system sales margins to TNC.

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

Energy Delivery Base Rate Filings

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

4. COMMITMENTS, GUARANTEES AND CONTINGENCIES

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

GUARANTEES

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

Indemnifications and Other Guarantees

Contracts

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, 2007, TNC entered into sale agreements including indemnifications with a maximum exposure that was not significant. There are no material liabilities recorded for any indemnifications.

Master Operating Lease

TNC leases certain equipment under a master operating lease. Under the lease agreement, the lessor is guaranteed to receive up to 87% of the unamortized balance of the equipment at the end of the lease term. If the fair market value of the leased equipment is below the unamortized balance at the end of the lease term, TNC has committed to pay the difference between the fair market value and the unamortized balance, with the total guarantee not to exceed 87% of the unamortized balance. At June 30, 2007, the maximum potential loss for these lease agreements assuming the fair market value of the equipment is zero at the end of the lease term is $3 million.

CONTINGENCIES

Carbon Dioxide (CO_2) Public Nuisance Claims

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

Coal Transportation Dispute

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

FERC Long-term Contracts

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

5. BENEFIT PLANS

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

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

Components of Net Periodic Benefit Cost

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

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

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

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

	Pension Plans		Other Postretirement Benefit Plans	
	2007	**2006**	**2007**	**2006**
	(in thousands)			
Three Months Ended	$ 70	$ 327	$ 630	$ 715
Six Months Ended	140	652	1,261	1,430

6. INCOME TAXES

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

Audit Status

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

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

FIN 48 Adoption

TNC adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, TNC recognized a $557,000 increase in the liabilities for unrecognized tax benefits, as well as related interest expense and penalties, which was accounted for as a reduction to the January 1, 2007 balance of retained earnings.

At January 1, 2007, the total amount of unrecognized tax benefits under FIN 48 was $6.9 million. Management believes it is reasonably possible that there will be a $1.6 million net decrease in unrecognized tax benefits due to the settlement of audits and the expiration of statute of limitations within 12 months of the reporting date. TNC's total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was $2.6 million. There are $2.9 million of tax positions, for which the ultimate deductibility is highly certain but the timing of such deductibility is uncertain. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period.

Prior to the adoption of FIN 48, TNC and other AEP subsidiaries recorded interest and penalty accruals related to income tax positions in tax accrual accounts. With the adoption of FIN 48, TNC and other AEP subsidiaries began recognizing interest accruals related to income tax positions in interest expense and penalties in Other Operations. As of January 1, 2007, TNC accrued $1.0 million for the payment of uncertain interest and penalties.

7. FINANCING ACTIVITIES

Long-term Debt

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

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

	Type of Debt	Principal Amount	Interest Rate	Due Date
		(in thousands)	(%)	
Retirements and Principal Payments:	Defeased First Mortgage Bonds	$ 8,151	7.75	2007

In July 2007, TNC redeemed $44 million of 6.00% Pollution Control Bonds due in 2020.

Lines of Credit

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

Maximum Borrowings from Utility Money Pool	Maximum Loans to Utility Money Pool	Average Borrowings From Utility Money Pool	Average Loans to Utility Money Pool	Borrowings from Utility Money Pool as of June 30, 2007	Authorized Short-Term Borrowing Limit
(in thousands)					
$ 40,182	$ 3,200	$ 27,803	$ 2,365	$ 26,968	$ 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. As of June 30, 2007, TNGC had $15.6 million in outstanding loans to the Nonutility Money Pool.

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

	Maximum Interest Rates for Funds Borrowed from the Utility Money Pool	Minimum Interest Rates for Funds Borrowed from the Utility Money Pool	Maximum Interest Rates for Funds Loaned to the Utility Money Pool	Minimum Interest Rates For Funds Loaned to the Utility Money Pool	Average Interest Rate for Funds Borrowed from the Utility Money Pool	Average Interest Rate for Funds Loaned to the Utility Money Pool
	(in percentage)					
2007 (a)	5.46	5.30	5.35	5.34	5.36	5.35
2006	5.39	4.37	5.17	4.19	4.81	4.62

(a) Does not include short-term lending activity for TNGC, who is a participant in the Nonutility Money Pool. For the six months ended June 30, 2007, the average interest rate for funds loaned to the Nonutility Money Pool by TNGC was 5.33%.

Dividend Restrictions

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