# AEP Generating Company

2008 Second Quarter Report

Financial Statements

**TABLE OF CONTENTS**


| | Page |
|---|---|
| Glossary of Terms | AEGCo-i |
| Condensed Statements of Income and Condensed Statements of Retained Earnings – Unaudited | AEGCo-1 |
| Condensed Balance Sheets – Unaudited | AEGCo-2 |
| Condensed Statements of Cash Flows – Unaudited | AEGCo-4 |
| Condensed Notes to Condensed Financial Statements – Unaudited | AEGCo-5 |

## GLOSSARY OF TERMS

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

| Term | Meaning |
|---|---|
| AEGCo | AEP Generating Company, an AEP electric utility subsidiary. |
| 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. |
| AEPSC | American Electric Power Service Corporation, a service subsidiary providing management and professional services to AEP and its subsidiaries. |
| CAA | Clean Air Act. |
| $CO_2$ | Carbon Dioxide. |
| CSPCo | Columbus Southern Power Company, an AEP electric utility subsidiary. |
| EITF | Financial Accounting Standards Board's Emerging Issues Task Force. |
| FASB | Financial Accounting Standards Board. |
| Federal EPA | United States Environmental Protection Agency. |
| FERC | Federal Energy Regulatory Commission. |
| FIN | FASB Interpretation No. |
| FIN 48 | FIN 48, "Accounting for Uncertainty in Income Taxes" and FASB Staff Position FIN 48-1 "Definition of *Settlement* in FASB Interpretation No. 48." |
| 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. |
| IURC | Indiana Utility Regulatory Commission. |
| MW | Megawatt. |
| $NO_x$ | Nitrogen Oxide. |
| NSR | New Source Review. |
| Rockport Plant | A generating plant, consisting of two 1,300 MW coal-fired generating units near Rockport, Indiana owned by AEGCo and I&M. |
| 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." |
| $SO_2$ | Sulfur Dioxide. |
| Utility Money Pool | AEP System's Utility Money Pool. |

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| **OPERATING REVENUES** | $ 106,944 | $ 83,425 | $ 215,956 | $ 160,576 |
| **EXPENSES** | | | | |
| Fuel Used for Electric Generation | 58,604 | 40,555 | 119,295 | 84,204 |
| Rent – Rockport Plant Unit 2 | 17,071 | 17,071 | 34,142 | 34,142 |
| Other Operation | 5,839 | 4,529 | 12,319 | 7,855 |
| Maintenance | 4,115 | 6,522 | 7,802 | 10,333 |
| Depreciation and Amortization | 8,363 | 6,688 | 16,667 | 12,678 |
| Taxes Other Than Income Taxes | 773 | 1,108 | 1,946 | 2,189 |
| **TOTAL** | 94,765 | 76,473 | 192,171 | 151,401 |
| **OPERATING INCOME** | 12,179 | 6,952 | 23,785 | 9,175 |
| **Other Income (Expense):** | | | | |
| Interest Income | 8 | - | 15 | - |
| Allowance for Equity Funds Used During Construction | 1,445 | - | 2,431 | - |
| Interest Expense | (4,036) | (2,133) | (8,226) | (3,385) |
| **INCOME BEFORE INCOME TAX EXPENSE (CREDIT)** | 9,596 | 4,819 | 18,005 | 5,790 |
| Income Tax Expense (Credit) | 2,033 | 600 | 3,632 | (20) |
| **NET INCOME** | $ 7,563 | $ 4,219 | $ 14,373 | $ 5,810 |

**CONDENSED STATEMENTS OF RETAINED EARNINGS**
**For the Three and Six Months Ended June 30, 2008 and 2007**
**(in thousands)**
**(Unaudited)**

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| **BALANCE AT BEGINNING OF PERIOD** | $ 38,532 | $ 32,560 | $ 34,722 | $ 30,942 |
| FIN 48 Adoption, Net of Tax | - | - | - | 27 |
| Net Income | 7,563 | 4,219 | 14,373 | 5,810 |
| Cash Dividends Declared | (3,000) | (2,500) | (6,000) | (2,500) |
| **BALANCE AT END OF PERIOD** | $ 43,095 | $ 34,279 | $ 43,095 | $ 34,279 |

*The common stock of AEGCo is wholly-owned by AEP.*

*See Condensed Notes to Condensed Financial Statements.*

**AEP GENERATING COMPANY**
**CONDENSED BALANCE SHEETS**
**ASSETS**
**June 30, 2008 and December 31, 2007**
**(in thousands)**
**(Unaudited)**

| | 2008 | 2007 |
|---|---|---|
| **CURRENT ASSETS** | | |
| Accounts Receivable – Affiliated Companies | $ 41,304 | $ 35,611 |
| Fuel | 33,836 | 40,255 |
| Materials and Supplies | 17,170 | 17,592 |
| Accrued Tax Benefits | 101 | 1,026 |
| Prepayments and Other | 394 | 1,005 |
| **TOTAL** | 92,805 | 95,489 |
| **PROPERTY, PLANT AND EQUIPMENT** | | |
| Electric – Production | 1,404,349 | 1,409,822 |
| Other | 5,716 | 5,231 |
| Construction Work in Progress | 144,442 | 111,105 |
| **Total** | 1,554,507 | 1,526,158 |
| Accumulated Depreciation and Amortization | 805,209 | 800,996 |
| **TOTAL – NET** | 749,298 | 725,162 |
| **OTHER NONCURRENT ASSETS** | | |
| Regulatory Assets | 5,231 | 5,300 |
| Deferred Charges and Other | 4,052 | 2,112 |
| **TOTAL** | 9,283 | 7,412 |
| **TOTAL ASSETS** | $ 851,386 | $ 828,063 |

*See Condensed Notes to Condensed Financial Statements.*

**AEP GENERATING COMPANY**
**CONDENSED BALANCE SHEETS**
**LIABILITIES AND SHAREHOLDER'S EQUITY**
**June 30, 2008 and December 31, 2007**
**(Unaudited)**

| | 2008 | 2007 |
|---|---|---|
| | (in thousands) | |
| **CURRENT LIABILITIES** | | |
| Advances from Affiliates | $ 100,409 | $ 93,391 |
| Accounts Payable: | | |
| General | 17,267 | 9,295 |
| Affiliated Companies | 22,078 | 28,466 |
| Long-term Debt Due Within One Year – Nonaffiliated | 7,273 | 7,273 |
| Accrued Taxes | 10,821 | 4,419 |
| Accrued Rent – Rockport Plant Unit 2 | 4,963 | 4,963 |
| Other | 5,155 | 5,167 |
| **TOTAL** | 167,966 | 152,974 |
| **NONCURRENT LIABILITIES** | | |
| Long-term Debt – Nonaffiliated | 252,123 | 255,755 |
| Deferred Income Taxes | 27,676 | 24,736 |
| Regulatory Liabilities and Deferred Investment Tax Credits | 63,828 | 68,836 |
| Deferred Gain on Sale and Leaseback – Rockport Plant Unit 2 | 80,406 | 83,191 |
| Deferred Credits and Other | 18,358 | 16,415 |
| **TOTAL** | 442,391 | 448,933 |
| **TOTAL LIABILITIES** | 610,357 | 601,907 |
| Commitments and Contingencies (Note 3) | | |
| **COMMON SHAREHOLDER'S EQUITY** | | |
| Common Stock – Par Value – $1,000 Per Share: | | |
| Authorized – 1,000 Shares | | |
| Outstanding – 1,000 Shares | 1,000 | 1,000 |
| Paid-in Capital | 196,934 | 190,434 |
| Retained Earnings | 43,095 | 34,722 |
| **TOTAL** | 241,029 | 226,156 |
| **TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY** | $ 851,386 | $ 828,063 |

*See Condensed Notes to Condensed Financial Statements.*

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

| | 2008 | 2007 |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| **Net Income** | $ 14,373 | $ 5,810 |
| **Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:** | | |
| Depreciation and Amortization | 16,667 | 12,678 |
| Deferred Income Taxes | (632) | (2,064) |
| Deferred Investment Tax Credits | (1,636) | (1,640) |
| Amortization of Deferred Gain on Sale and Leaseback – Rockport Plant Unit 2 | (2,785) | (2,785) |
| Allowance for Equity Funds Used During Construction | (2,431) | - |
| Deferred Property Taxes | (1,462) | (2,104) |
| Change in Other Noncurrent Assets | 839 | 3,968 |
| Change in Other Noncurrent Liabilities | 1,656 | 930 |
| **Changes in Certain Components of Working Capital:** | | |
| Accounts Receivable | (5,235) | (9,336) |
| Fuel, Materials and Supplies | 6,841 | (1,444) |
| Accounts Payable | (2,470) | 7,714 |
| Accrued Taxes, Net | 7,327 | 8,298 |
| Other Current Assets | 149 | (37) |
| Other Current Liabilities | (49) | 242 |
| **Net Cash Flows from Operating Activities** | 31,152 | 20,230 |
| **INVESTING ACTIVITIES** | | |
| Construction Expenditures | (34,862) | (11,158) |
| Acquisition of Lawrenceburg Generating Station | - | (324,782) |
| **Net Cash Flows Used for Investing Activities** | (34,862) | (335,940) |
| **FINANCING ACTIVITIES** | | |
| Capital Contributions from Parent | 6,500 | 130,000 |
| Issuance of Long-term Debt – Nonaffiliated | - | 219,034 |
| Change in Advances from Affiliates, Net | 7,018 | (30,662) |
| Retirement of Long-term Debt – Nonaffiliated | (3,636) | - |
| Principal Payments for Capital Lease Obligations | (172) | (162) |
| Dividends Paid on Common Stock | (6,000) | (2,500) |
| **Net Cash Flows from Financing Activities** | 3,710 | 315,710 |
| **Net Change in Cash and Cash Equivalents** | - | - |
| **Cash and Cash Equivalents at Beginning of Period** | - | - |
| **Cash and Cash Equivalents at End of Period** | $ - | $ - |
| **SUPPLEMENTARY INFORMATION** | | |
| Cash Paid for Interest, Net of Capitalized Amounts | $ 7,991 | $ 2,880 |
| Net Cash Paid (Received) for Income Taxes | 3,146 | (2,435) |
| Noncash Acquisitions Under Capital Leases | 13 | 7 |
| Construction Expenditures Included in Accounts Payable at June 30, | 6,323 | 3 |
| Noncash Assumption of Liabilities Related to Acquisition of Lawrenceburg Generating Station | - | 2,857 |

*See Condensed Notes to Condensed Financial Statements.*

## CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

1. Significant Accounting Matters
2. New Accounting Pronouncements
3. Commitments, Guarantees and Contingencies
4. Acquisition
5. Business Segments
6. Income Taxes
7. Financing Activities

## 1. SIGNIFICANT ACCOUNTING MATTERS

***General***

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

In the opinion of management, the unaudited condensed 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 financial statements are unaudited and should be read in conjunction with the audited 2007 financial statements and notes thereto, which are included in AEGCo's 2007 Annual Report.

***Reclassifications***

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

## 2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of final pronouncements, management thoroughly reviews the new accounting literature to determine the relevance, if any, to AEGCo'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 AEGCo'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. AEGCo 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 shareholder's 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).

AEGCo partially adopted SFAS 157 effective January 1, 2008. AEGCo 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 AEGCo'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.

AEGCo adopted SFAS 159 effective January 1, 2008. At adoption, AEGCo 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. AEGCo 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. AEGCo 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. AEGCo will adopt SFAS 162 when it becomes effective.

***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. AEGCo 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.

AEGCo 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 AEGCo.

***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. COMMITMENTS, GUARANTEES AND CONTINGENCIES

AEGCo 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 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*

AEGCo 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. There are no material liabilities recorded for any indemnifications.

### CONTINGENCIES

#### *Carbon Dioxide Public Nuisance Claims*

In 2004, eight states and the City of New York filed an action in federal district court for the Southern District of New York against AEP, AEPSC, Cinergy Corp, Xcel Energy, Southern Company and Tennessee Valley Authority. The Natural Resources Defense Council, on behalf of three special interest groups, filed a similar complaint against the same defendants. The actions allege that $CO_2$ emissions from the defendants' power plants constitute a public nuisance under federal common law due to impacts of global warming, and sought injunctive relief in the form of specific emission reduction commitments from the defendants. The dismissal of this lawsuit was appealed to the Second Circuit Court of Appeals. Briefing and oral argument have concluded. In April 2007, the U.S. Supreme Court issued a decision holding that the Federal EPA has authority to regulate emissions of $CO_2$ 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.

#### *Alaskan Villages' Claims*

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

### *Clean Air Act Interstate Rule*

In 2005, the Federal EPA issued a final rule, the Clean Air Interstate Rule (CAIR), that required further reductions in $SO_2$ and $NO_x$ emissions and assists states developing new state implementation plans to meet 1997 national ambient air quality standards (NAAQS). CAIR reduces regional emissions of $SO_2$ and $NO_x$ (which can be transformed into PM and ozone) from power plants in the Eastern U.S. (29 states and the District of Columbia). Reduction of both $SO_2$ and $NO_x$ would be achieved through a cap-and-trade program. In July 2008, the D.C. Circuit Court of Appeals vacated the CAIR and remanded the rule to the Federal EPA. We are unable to predict how the Federal EPA will respond to the remand which could be stayed or appealed to the U.S. Supreme Court.

AEGCo did not purchase any CAIR allowances. $SO_2$ and seasonal $NO_x$ allowances allocated to the AEP System's facilities under the Acid Rain Program and the $NO_x$ SIP Call will still be required to comply with existing CAA programs that were not affected by the court's decision.

It is too early to determine the full implication of these decisions on environmental compliance strategy. However, independent obligations under the CAA, including obligations under future state implementation plan submittals, and actions taken pursuant to the recent settlement of the NSR enforcement action, are consistent with the actions included in a least-cost CAIR compliance plan. Consequently, management does not anticipate making any immediate changes in near-term compliance plans as a result of these court decisions.

## 4. ACQUISITION

### *Lawrenceburg Generating Station*

In January 2007, AEGCo agreed to purchase Lawrenceburg Generating Station (Lawrenceburg) from an affiliate of Public Service Enterprise Group (PSEG) for $325 million and the assumption of liabilities of $3 million. AEGCo completed the purchase in May 2007. Lawrenceburg is located in Lawrenceburg, Indiana, adjacent to I&M's Tanners Creek Plant, and is a natural gas, combined cycle power plant with a generating capacity of 1,096 MW. AEGCo sells the power to CSPCo through a FERC-approved unit power agreement.

In 2007, AEGCo filed a capital funds agreement which the IURC approved in connection with the acquisition and financing of Lawrenceburg. Under the agreement, AEP has committed to provide all such amounts of capital to enable AEGCo to perform its financial obligations. This agreement will terminate after AEGCo's obligations related to Lawrenceburg are paid in full.

## 5. BUSINESS SEGMENTS

AEGCo has one reportable segment, an electricity generation business. AEGCo's other activities are insignificant.

## 6. INCOME TAXES

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

AEGCo 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.

AEGCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2000. However, AEGCo 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. AEGCo 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, AEGCo 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.

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

***State Tax Legislation***

In March 2008, the Governor of West Virginia signed legislation providing for, among other things, a reduction in the West Virginia corporate income tax rate from 8.75% to 8.5% beginning in 2009. The corporate income tax rate could also be reduced to 7.75% in 2012 and 7% in 2013 contingent upon the state government achieving certain minimum levels of shortfall reserve funds. Management has evaluated the impact of the law change and the application of the law change will not materially impact AEGCo's results of operations, cash flows or financial condition.

## 7. FINANCING ACTIVITIES

***Long-term Debt***

Principal payments made during the first six months of 2008 were:

| | Type of Debt | Principal Amount Paid (in thousands) | Interest Rate | Due Date |
|---|---|---|---|---|
| Principal Payments | Senior Unsecured Notes | $ 3,636 | 6.33% | 2037 (a) |

(a) AEGCo's Senior Unsecured Notes due 2037 are payable over the life of the notes as a $7.3 million annual principal amount plus accrued interest paid semiannually in March and September.

*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. The AEP System corporate borrowing program operates in accordance with the terms and conditions approved in a regulatory order. The amount of outstanding borrowings from the Utility Money Pool as of June 30, 2008 and December 31, 2007 are included in Advances from Affiliates on AEGCo's balance sheets. AEGCo's Utility Money Pool activity and corresponding authorized borrowing limit for the six months ended June 30, 2008 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, 2008 | Authorized Short-Term Borrowing Limit |
|---|---|---|---|---|---|
| (in thousands) | | | | | |
| $ 113,014 | $ - | $ 76,331 | $ - | $ 100,409 | $ 200,000 |

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:

| | 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 |
|---|---|---|---|---|---|---|
| 2008 | 5.37% | 2.91% | -% | -% | 3.67% | -% |
| 2007 | 5.46% | 5.30% | -% | -% | 5.37% | -% |