

AEP Texas Central Company and Subsidiaries

2011 Second Quarter Report

Consolidated Financial Statements



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GLOSSARY OF TERMS

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

| Term | Meaning |
|---------------------------------|---|
| AEP or Parent | American Electric Power Company, Inc., a holding company. |
| AEP 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. |
| AOCI | Accumulated Other Comprehensive Income. |
| ASU | Accounting Standard Update. |
| CAA | Clean Air Act. |
| CO ₂ | Carbon Dioxide and other greenhouse gases. |
| CTC | Competition Transition Charge, a transition charge applied to TCC's transmission and distribution rates for stranded costs and other true-up amounts as required by the Texas Restructuring Legislation. |
| ERCOT | Electric Reliability Council of Texas, an intrastate RTO. |
| ETT | Electric Transmission Texas, LLC, a 50% equity interest joint venture with MidAmerican Energy Holdings Company formed to own and operate electric transmission facilities in ERCOT. |
| Federal EPA | United States Environmental Protection Agency. |
| FERC | Federal Energy Regulatory Commission. |
| FTR | Financial Transmission Right, a financial instrument that entitles the holder to receive compensation for certain congestion-related transmission charges that arise when the power grid is congested resulting in differences in locational prices. |
| GAAP | Accounting Principles Generally Accepted in the United States of America. |
| IRS | Internal Revenue Service. |
| MTM | Mark-to-Market. |
| OPEB | Other Postretirement Benefit Plans. |
| OTC | Over the counter. |
| PUCT | Public Utility Commission of Texas. |
| Risk Management Contracts | Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges. |
| RTO | Regional Transmission Organization, responsible for moving electricity over large interstate areas. |
| 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. |
| Transition Funding | AEP Texas Central Transition Funding I LLC and AEP Texas Central Transition Funding II LLC, wholly-owned subsidiaries of TCC and consolidated variable interest entities formed for the purpose of issuing and servicing securitization bonds related to Texas restructuring law. |
| 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 is the centralized funding mechanism AEP uses to meet the short term cash requirements of pool participants. |
| VIE | Variable Interest Entity. |

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three and Six Months Ended June 30, 2011 and 2010
(in thousands)
(Unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|---------------------------|-----------------|-------------------------|------------------|
| | 2011 | 2010 | 2011 | 2010 |
| REVENUES | | | | |
| Electric Transmission and Distribution | \$ 236,495 | \$ 223,546 | \$ 444,359 | \$ 437,592 |
| Sales to AEP Affiliates | 940 | 1,046 | 1,856 | 2,083 |
| Other Revenues | 700 | 1,958 | 1,020 | 741 |
| TOTAL REVENUES | <u>238,135</u> | <u>226,550</u> | <u>447,235</u> | <u>440,416</u> |
| EXPENSES | | | | |
| Other Operation | 59,015 | 88,353 | 119,241 | 154,315 |
| Maintenance | 9,703 | 9,286 | 18,214 | 17,207 |
| Depreciation and Amortization | 72,615 | 65,444 | 133,101 | 127,299 |
| Taxes Other Than Income Taxes | 19,074 | 18,518 | 35,433 | 36,359 |
| TOTAL EXPENSES | <u>160,407</u> | <u>181,601</u> | <u>305,989</u> | <u>335,180</u> |
| OPERATING INCOME | 77,728 | 44,949 | 141,246 | 105,236 |
| Other Income (Expense): | | | | |
| Interest Income | 56 | 129 | 812 | 186 |
| Allowance for Equity Funds Used During Construction | 286 | 303 | 1,007 | 647 |
| Interest Expense | (36,199) | (38,050) | (72,386) | (76,362) |
| INCOME BEFORE INCOME TAX EXPENSE | 41,871 | 7,331 | 70,679 | 29,707 |
| Income Tax Expense | 16,005 | 2,712 | 26,481 | 10,987 |
| NET INCOME | 25,866 | 4,619 | 44,198 | 18,720 |
| Preferred Stock Dividend Requirements | 54 | 60 | 109 | 120 |
| EARNINGS ATTRIBUTABLE TO COMMON STOCK | <u>\$ 25,812</u> | <u>\$ 4,559</u> | <u>\$ 44,089</u> | <u>\$ 18,600</u> |

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

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S
EQUITY AND COMPREHENSIVE INCOME (LOSS)
For the Six Months Ended June 30, 2011 and 2010
(in thousands)
(Unaudited)

| | Common Stock | Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|--|-------------------------|----------------------------|------------------------------|--|-------------------|
| TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2009 | \$ 55,292 | \$ 171,263 | \$ 368,126 | \$ 163 | \$ 594,844 |
| Common Stock Dividends | | | (18,320) | | (18,320) |
| Preferred Stock Dividends | | | (120) | | (120) |
| SUBTOTAL – COMMON SHAREHOLDER'S EQUITY | | | | | 576,404 |
| COMPREHENSIVE INCOME | | | | | |
| Other Comprehensive Loss, Net of Taxes: | | | | | |
| Cash Flow Hedges, Net of Tax of \$116 | | | | (215) | (215) |
| NET INCOME | | | 18,720 | | 18,720 |
| TOTAL COMPREHENSIVE INCOME | | | | | 18,505 |
| TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2010 | \$ 55,292 | \$ 171,263 | \$ 368,406 | \$ (52) | \$ 594,909 |
| TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2010 | \$ 55,292 | \$ 171,295 | \$ 394,337 | \$ 115 | \$ 621,039 |
| Common Stock Dividends | | | (35,000) | | (35,000) |
| Preferred Stock Dividends | | | (109) | | (109) |
| Gain on Reacquired Preferred Stock | | 51 | | | 51 |
| SUBTOTAL – COMMON SHAREHOLDER'S EQUITY | | | | | 585,981 |
| COMPREHENSIVE INCOME | | | | | |
| Other Comprehensive Income, Net of Taxes: | | | | | |
| Cash Flow Hedges, Net of Tax of \$41 | | | | 76 | 76 |
| NET INCOME | | | 44,198 | | 44,198 |
| TOTAL COMPREHENSIVE INCOME | | | | | 44,274 |
| TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2011 | \$ 55,292 | \$ 171,346 | \$ 403,426 | \$ 191 | \$ 630,255 |

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

June 30, 2011 and December 31, 2010

(in thousands)

(Unaudited)

| | 2011 | 2010 |
|--|---------------------|---------------------|
| CURRENT ASSETS | | |
| Cash and Cash Equivalents | \$ 200 | \$ 274 |
| Restricted Cash for Securitized Transition Funding | 159,772 | 184,040 |
| Advances to Affiliates | 5,708 | 141,584 |
| Accounts Receivable: | | |
| Customers | 87,123 | 63,405 |
| Affiliated Companies | 8,319 | 6,090 |
| Accrued Unbilled Revenues | 49,605 | 41,880 |
| Miscellaneous | 66 | 50 |
| Allowance for Uncollectible Accounts | (312) | (67) |
| Total Accounts Receivable | 144,801 | 111,358 |
| Materials and Supplies | 28,990 | 25,626 |
| Prepayments and Other Current Assets | 9,526 | 1,880 |
| TOTAL CURRENT ASSETS | 348,997 | 464,762 |
| PROPERTY, PLANT AND EQUIPMENT | | |
| Electric: | | |
| Transmission | 1,108,278 | 1,067,604 |
| Distribution | 1,973,781 | 1,924,518 |
| Other Property, Plant and Equipment | 258,756 | 254,354 |
| Construction Work in Progress | 54,376 | 75,440 |
| Total Property, Plant and Equipment | 3,395,191 | 3,321,916 |
| Accumulated Depreciation and Amortization | 731,673 | 706,640 |
| TOTAL PROPERTY, PLANT AND EQUIPMENT – NET | 2,663,518 | 2,615,276 |
| OTHER NONCURRENT ASSETS | | |
| Regulatory Assets | 272,476 | 278,373 |
| Securitized Transition Assets | | |
| (June 30, 2011 and December 31, 2010 amounts include \$1,657,077 and \$1,723,117, respectively, related to Transition Funding) | 1,673,483 | 1,741,655 |
| Deferred Charges and Other Noncurrent Assets | 39,002 | 30,783 |
| TOTAL OTHER NONCURRENT ASSETS | 1,984,961 | 2,050,811 |
| TOTAL ASSETS | \$ 4,997,476 | \$ 5,130,849 |

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
LIABILITIES AND SHAREHOLDERS' EQUITY
June 30, 2011 and December 31, 2010
(dollars in thousands)
(Unaudited)

| | 2011 | 2010 |
|---|---------------------|---------------------|
| CURRENT LIABILITIES | | |
| Accounts Payable: | | |
| General | \$ 29,415 | \$ 27,929 |
| Affiliated Companies | 11,829 | 40,957 |
| Long-term Debt Due Within One Year - Nonaffiliated (June 30, 2011 and December 31, 2010 amounts include \$165,645 and \$159,443, respectively, related to Transition Funding) | 225,645 | 279,708 |
| Customer Deposits | 12,683 | 12,873 |
| Accrued Taxes | 68,309 | 49,861 |
| Accrued Interest (June 30, 2011 and December 31, 2010 amounts include \$46,158 and \$48,609, respectively, related to Transition Funding) | 60,278 | 63,136 |
| Other Current Liabilities | 27,904 | 28,299 |
| TOTAL CURRENT LIABILITIES | 436,063 | 502,763 |
| NONCURRENT LIABILITIES | | |
| Long-term Debt – Nonaffiliated (June 30, 2011 and December 31, 2010 amounts include \$1,588,882 and \$1,687,175, respectively, related to Transition Funding) | 2,232,300 | 2,330,566 |
| Deferred Income Taxes | 1,016,677 | 1,013,232 |
| Regulatory Liabilities and Deferred Investment Tax Credits | 565,522 | 538,964 |
| Deferred Credits and Other Noncurrent Liabilities | 111,313 | 118,581 |
| TOTAL NONCURRENT LIABILITIES | 3,925,812 | 4,001,343 |
| TOTAL LIABILITIES | 4,361,875 | 4,504,106 |
| Cumulative Preferred Stock Not Subject to Mandatory Redemption | 5,346 | 5,704 |
| Rate Matters (Note 3) | | |
| Commitments and Contingencies (Note 4) | | |
| COMMON SHAREHOLDER'S EQUITY | | |
| Common Stock – Par Value – \$25 Per Share: | | |
| Authorized – 12,000,000 Shares | | |
| Outstanding – 2,211,678 Shares | 55,292 | 55,292 |
| Paid-in Capital | 171,346 | 171,295 |
| Retained Earnings | 403,426 | 394,337 |
| Accumulated Other Comprehensive Income (Loss) | 191 | 115 |
| TOTAL COMMON SHAREHOLDER'S EQUITY | 630,255 | 621,039 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 4,997,476 | \$ 5,130,849 |

See Condensed Notes to Condensed Consolidated Financial Statements.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Six Months Ended June 30, 2011 and 2010
(in thousands)
(Unaudited)

| | 2011 | 2010 |
|---|------------------|------------------|
| OPERATING ACTIVITIES | | |
| Net Income | \$ 44,198 | \$ 18,720 |
| Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities: | | |
| Depreciation and Amortization | 133,101 | 127,299 |
| Deferred Income Taxes | 5,687 | (10,557) |
| Allowance for Equity Funds Used During Construction | (1,007) | (647) |
| Property Taxes | (14,552) | (14,412) |
| Change in Other Noncurrent Assets | 320 | 1,877 |
| Change in Other Noncurrent Liabilities | 5,591 | 8,652 |
| Changes in Certain Components of Working Capital: | | |
| Accounts Receivable, Net | (33,443) | (19,212) |
| Materials and Supplies | (3,366) | 848 |
| Accounts Payable | (26,619) | 2,722 |
| Customer Deposits | (191) | 805 |
| Accrued Taxes, Net | 12,976 | (1,814) |
| Accrued Interest | (2,857) | (2,252) |
| Other Current Assets | (5,234) | 1,044 |
| Other Current Liabilities | (1,156) | (306) |
| Net Cash Flows from Operating Activities | 113,448 | 112,767 |
| INVESTING ACTIVITIES | | |
| Construction Expenditures | (97,623) | (76,196) |
| Change in Restricted Cash for Securitized Transition Funding | 24,267 | 19,558 |
| Change in Advances to Affiliates, Net | 135,875 | (15,089) |
| Proceeds from Sales of Assets | 12,692 | 65,075 |
| Other Investing Activities | 82 | (725) |
| Net Cash Flows from (Used for) Investing Activities | 75,293 | (7,377) |
| FINANCING ACTIVITIES | | |
| Issuance of Long-term Debt – Nonaffiliated | 59,802 | - |
| Retirement of Long-term Debt – Nonaffiliated | (212,403) | (86,296) |
| Retirement of Cumulative Preferred Stock | (307) | - |
| Principal Payments for Capital Lease Obligations | (866) | (806) |
| Dividends Paid on Common Stock | (35,000) | (18,320) |
| Dividends Paid on Cumulative Preferred Stock | (109) | (120) |
| Other Financing Activities | 68 | 152 |
| Net Cash Flows Used for Financing Activities | (188,815) | (105,390) |
| Net Decrease in Cash and Cash Equivalents | (74) | - |
| Cash and Cash Equivalents at Beginning of Period | 274 | 200 |
| Cash and Cash Equivalents at End of Period | \$ 200 | \$ 200 |
| SUPPLEMENTARY INFORMATION | | |
| Cash Paid for Interest, Net of Capitalized Amounts | \$ 71,237 | \$ 75,011 |
| Net Cash Paid for Income Taxes | 14,039 | 33,600 |
| Noncash Acquisitions Under Capital Leases | 417 | 291 |
| Construction Expenditures Included in Current Liabilities at June 30, | 17,046 | 7,908 |

See Condensed Notes to Condensed Consolidated Financial Statements.

INDEX OF CONDENSED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Significant Accounting Matters
2. New Accounting Pronouncements
3. Rate Matters
4. Commitments, Guarantees and Contingencies
5. Dispositions
6. Benefit Plans
7. Business Segments
8. Derivatives and Hedging
9. Fair Value Measurements
10. Income Taxes
11. Financing Activities
12. Cost Reduction Initiatives

1. SIGNIFICANT ACCOUNTING MATTERS

General

The 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. Net income for the three and six months ended June 30, 2011 is not necessarily indicative of results that may be expected for the year ending December 31, 2011. The condensed consolidated financial statements are unaudited and should be read in conjunction with the audited 2010 financial statements and notes thereto, which are included in TCC's 2010 Annual Report.

Management reviewed subsequent events through July 29, 2011, the date that the second quarter 2011 report was issued.

Variable Interest Entities

The accounting guidance for "Variable Interest Entities" is a consolidation model that considers if a company has a controlling financial interest in a VIE. A controlling financial interest will have both (a) the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Entities are required to consolidate a VIE when it is determined that they have a controlling financial interest in a VIE and therefore, are the primary beneficiary of that VIE, as defined by the accounting guidance for "Variable Interest Entities." In determining whether TCC is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE's variability TCC absorbs, guarantees of indebtedness, voting rights including kick-out rights, the power to direct the VIE and other factors. Management believes that significant assumptions and judgments were applied consistently. There have been no changes to the reporting of VIEs in the financial statements where it is concluded that TCC is the primary beneficiary. In addition, TCC has not provided financial or other support to any VIE that was not previously contractually required.

AEP Texas Central Transition Funding I LLC and AEP Texas Central Transition Funding II LLC, wholly-owned subsidiaries of TCC, (collectively Transition Funding) were formed for the sole purpose of issuing and servicing securitization bonds related to Texas Restructuring Legislation. Management has concluded that TCC is the primary beneficiary of Transition Funding because TCC has the power to direct the most significant activities of the VIE and TCC's equity interest could potentially be significant. Therefore, TCC is required to consolidate Transition Funding. The securitized bonds totaled \$1.8 billion and \$1.8 billion at June 30, 2011 and December 31, 2010, respectively, and are included in current and long-term debt on the Condensed Consolidated Balance Sheets. Transition Funding has securitized transition assets of \$1.7 billion and \$1.7 billion at June 30, 2011 and December 31, 2010, respectively, which are presented separately on the face of the Condensed Consolidated Balance Sheets. The securitized transition assets represent the right to impose and collect Texas true-up costs from customers receiving electric transmission or distribution service from TCC under recovery mechanisms approved by the PUCT. The securitization bonds are payable only from and secured by the securitized transition assets. The bondholders have no recourse to TCC or any other AEP entity. TCC acts as the servicer for Transition Funding's securitized transition asset and remits all related amounts collected from customers to Transition Funding for interest and principal payments on the securitization bonds and related costs.

The balances below represent the assets and liabilities of Transition Funding that are consolidated. These balances include intercompany transactions that are eliminated upon consolidation.

AEP TEXAS CENTRAL COMPANY AND SUBSIDIARIES
VARIABLE INTEREST ENTITIES
June 30, 2011 and December 31, 2010
(in millions)

| ASSETS | Transition Funding | |
|-------------------------------------|--------------------|-----------------|
| | 2011 | 2010 |
| Current Assets | \$ 197 | \$ 214 |
| Other Noncurrent Assets | 1,678 | 1,746 |
| Total Assets | \$ 1,875 | \$ 1,960 |
| LIABILITIES AND EQUITY | | |
| Current Liabilities | \$ 224 | \$ 221 |
| Noncurrent Liabilities | 1,637 | 1,725 |
| Equity | 14 | 14 |
| Total Liabilities and Equity | \$ 1,875 | \$ 1,960 |

AEPSC provides certain managerial and professional services to AEP’s subsidiaries. AEP is the sole equity owner of AEPSC. AEP management controls the activities of AEPSC. The costs of the services are based on a direct charge or on a prorated basis and billed to the AEP subsidiary companies at AEPSC’s cost. AEP subsidiaries have not provided financial or other support outside the reimbursement of costs for services rendered. AEPSC finances its operations through cost reimbursement from other AEP subsidiaries. There are no other terms or arrangements between AEPSC and any of the AEP subsidiaries that could require additional financial support from an AEP subsidiary or expose them to losses outside of the normal course of business. AEPSC and its billings are subject to regulation by the FERC. AEP subsidiaries are exposed to losses to the extent they cannot recover the costs of AEPSC through their normal business operations. AEP subsidiaries are considered to have a significant interest in AEPSC due to their activity in AEPSC’s cost reimbursement structure. However, AEP subsidiaries do not have control over AEPSC. 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. TCC’s total billings from AEPSC for the three months ended June 30, 2011 and 2010 were \$16 million and \$25 million, respectively, and for the six months ended June 30, 2011 and 2010 were \$31 million and \$45 million, respectively. The carrying amount of liabilities associated with AEPSC as of June 30, 2011 and December 31, 2010 were \$6 million and \$6 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

2. NEW ACCOUNTING PRONOUNCEMENTS

Upon issuance of final pronouncements, management reviews the new accounting literature to determine its relevance, if any, to TCC’s business. The following represents a summary of final pronouncements that impact the financial statements.

Pronouncements Issued During 2011

The following standard was issued during the first six months of 2011. The following paragraphs discuss its impact on future financial statements.

ASU 2011-05 “Presentation of Comprehensive Income” (ASU 2011-05)

In June 2011, the FASB issued ASU 2011-05 eliminating the option to present the components of other comprehensive income as a part of the statement of shareholders’ equity. The standard requires other comprehensive income be presented as part of a single continuous statement of comprehensive income or in a statement of other comprehensive income immediately following the statement of net income. Reclassification adjustments from other comprehensive income to net income must be presented on the face of the financial statements. This standard must be retrospectively applied to all reporting periods presented in financial reports issued after the effective date.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2011. This standard will change the presentation of the financial statements but will not affect the calculation of net income or comprehensive income. TCC will adopt ASU 2011-05 effective January 1, 2012.

3. RATE MATTERS

As discussed in TCC's 2010 Annual Report, TCC is involved in rate and regulatory proceedings at the FERC and the PUCT. The Rate Matters note within TCC's 2010 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 2011 and updates TCC's 2010 Annual Report.

Regulatory Assets Not Yet Being Recovered

| <u>Noncurrent Regulatory Assets (excluding fuel)</u> | <u>June 30, 2011</u> | <u>December 31, 2010</u> |
|--|--------------------------|------------------------------|
| | (in thousands) | |
| Regulatory assets not yet being recovered pending future proceedings to determine the recovery method and timing: | | |
| <u>Regulatory Assets Currently Earning a Return</u> | | |
| Storm Related Costs | \$ 24,989 | \$ 24,372 |
| <u>Regulatory Assets Currently Not Earning a Return</u> | | |
| Rate Case Expenses | <u>145</u> | <u>139</u> |
| Total Regulatory Assets Not Yet Being Recovered | <u>\$ 25,134</u> | <u>\$ 24,511</u> |

TEXAS RESTRUCTURING

Texas Restructuring Appeals

Pursuant to PUCT restructuring orders, TCC securitized net recoverable stranded generation costs of \$2.5 billion and is recovering the principal and interest on the securitization bonds through the end of 2020. TCC also refunded other net true-up regulatory liabilities of \$375 million during the period October 2006 through June 2008 via a CTC credit rate rider under PUCT restructuring orders. TCC and intervenors appealed the PUCT's true-up related orders. After rulings from the Texas District Court and the Texas Court of Appeals, TCC, the PUCT and intervenors filed petitions for review with the Supreme Court of Texas. In July 2011, the Supreme Court of Texas granted review and issued its opinion. The following issues were decided by the Supreme Court:

- The PUCT's order denying recovery of capacity auction true-up amounts was reversed. Management estimates that, in the remand to the PUCT, TCC will be entitled to recover approximately \$420 million, plus interest from January 1, 2002.
- The Supreme Court of Texas reversed the Texas Court of Appeals decision and found that the PUCT could adjust the net book value for what it determined to be commercially unreasonable conduct. This portion of the decision is unfavorable, but was already reflected in TCC's financial statements.
- The Supreme Court of Texas affirmed the PUCT's finding that the sales price should be used to value TCC's nuclear generation. This portion of the decision is favorable, but this issue will have no impact on TCC's rate recovery as this was already reflected in TCC's financial statements.
- The Supreme Court of Texas reversed the Court of Appeal's decision and found it was appropriate for the PUCT to take into account previously refunded excess mitigation credits to affiliate retail electricity providers. This portion of the decision upheld the PUCT's decision. However, resolution of related issues will be addressed on remand.

- The PUCT decisions allowing recovery of construction work in progress balances and specifying the interest rate on stranded costs were upheld. These decisions are already reflected in TCC's financial statements and will not be addressed in the remand proceeding.

No parties have filed for rehearing with the Supreme Court of Texas, and the case will be remanded to the PUCT.

TCC Deferred Investment Tax Credits and Excess Deferred Federal Income Taxes

In 2006, the PUCT reduced recovery of the amount securitized by \$103 million of tax benefits and associated carrying costs related to TCC's generation assets. In 2006, TCC obtained a private letter ruling from the IRS which confirmed that such a reduction was an IRS normalization violation. In order to avoid a normalization violation, the PUCT agreed to allow TCC to defer refunding the tax benefits of \$103 million plus interest through the CTC refund period pending resolution of the normalization issue. In 2008, the IRS issued final regulations, which supported the IRS's private letter ruling which would make the refunding of or the reduction of the amount securitized by such tax benefits a normalization violation. After the IRS issued its final regulations the Texas Court of Appeals, at the request of the PUCT, remanded the tax normalization issue to the PUCT for the consideration of additional evidence including the IRS regulations. The issue will be considered by the PUCT when the true-up proceeding is remanded following the July 2011 Supreme Court of Texas decision. See the "Texas Restructuring Appeals" section above. TCC is not accruing interest on the \$103 million because management believes it is not probable that the PUCT will order TCC to violate the normalization provision of the Internal Revenue Code. If interest were accrued, management estimates interest expense would have been approximately \$27 million higher for the period July 2008 through June 2011.

Management believes that the PUCT will ultimately allow TCC to retain the deferred amounts, which would have a favorable effect on future net income and cash flows. Although unexpected, if the PUCT fails to issue a favorable order and orders TCC to return the tax benefits to customers, the resulting normalization violation could result in TCC's repayment to the IRS of Accumulated Deferred Investment Tax Credits (ADITC) on all property, including transmission and distribution property. This amount approximates \$101 million as of June 30, 2011. It could also lead to a loss of TCC's right to claim accelerated tax depreciation in future tax returns. If TCC is required to repay its ADITC to the IRS and is also required to refund ADITC plus unaccrued interest to customers, it would reduce future net income and cash flows and impact financial condition.

TCC Excess Earnings

In 2005, a Texas appellate court issued a decision finding that a PUCT order requiring TCC to refund to the REPs excess earnings prior to and outside of the true-up process was unlawful under the Texas Restructuring Legislation. From 2002 to 2005, TCC refunded \$55 million of excess earnings, including interest, under the overturned PUCT order. The PUCT must determine if adjustments are required on remand based on the July 2011 decision of the Supreme Court of Texas on the impact of excess earnings in the true-up proceeding. See the "Texas Restructuring Appeals" section above.

4. COMMITMENTS, GUARANTEES AND CONTINGENCIES

TCC is subject to certain claims and legal actions arising in its ordinary course of business. In addition, TCC's business activities are subject to extensive governmental regulation related to public health and the environment. The ultimate outcome of such pending or potential litigation cannot be predicted. For current proceedings not specifically discussed below, management does not anticipate that the liabilities, if any, arising from such proceedings would have a material adverse effect on the financial statements. The Commitments, Guarantees and Contingencies note within TCC's 2010 Annual Report should be read in conjunction with this report.

GUARANTEES

Liabilities for guarantees are recorded in accordance with the accounting guidance for "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

TCC enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of June 30, 2011, there were no material liabilities recorded for any indemnifications.

Master Lease Agreements

TCC leases certain equipment under master lease agreements. In December 2010, management signed a new master lease agreement with GE Capital Commercial Inc. (GE) to replace existing operating and capital leases with GE. These assets were included in existing master lease agreements that were to be terminated in 2011 since GE exercised the termination provision related to these leases in 2008. Certain previously leased assets were not included in the 2010 refinancing, but were purchased in January 2011.

For equipment under the GE master lease agreements, the lessor is guaranteed receipt of up to 78% of the unamortized balance of the equipment at the end of the lease term. If the fair value of the leased equipment is below the unamortized balance at the end of the lease term, TCC is committed to pay the difference between the fair value and the unamortized balance, with the total guarantee not to exceed 78% of the unamortized balance. For equipment under other master lease agreements, the lessor is guaranteed a residual value up to a stated percentage of either the unamortized balance or the equipment cost at the end of the lease term. If the actual fair value of the leased equipment is below the guaranteed residual value at the end of the lease term, TCC is committed to pay the difference between the actual fair value and the residual value guarantee. At June 30, 2011, the maximum potential loss for these lease agreements was approximately \$3 million assuming the fair value of the equipment is zero at the end of the lease term. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance.

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 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 trial court dismissed the lawsuits.

In September 2009, the Second Circuit Court of Appeals issued a ruling on appeal remanding the cases to the Federal District Court for the Southern District of New York. The Second Circuit held that the issues of climate change and global warming do not raise political questions and that Congress' refusal to regulate CO₂ emissions does not mean that plaintiffs must wait for an initial policy determination by Congress or the President's administration to secure the relief sought in their complaints. The court stated that Congress could enact comprehensive legislation to regulate CO₂ emissions or that the Federal EPA could regulate CO₂ emissions under existing CAA authorities and that either of these actions could override any decision made by the district court under federal common law. The Second Circuit did not rule on whether the plaintiffs could proceed with their state common law nuisance claims. In 2010, the U.S. Supreme Court granted the defendants' petition for review. In June 2011, the U.S. Supreme Court reversed and remanded the case to the Court of Appeals, finding that plaintiffs' federal common law claims are displaced by the regulatory authority granted to the Federal EPA under the CAA.

In October 2009, the Fifth Circuit Court of Appeals reversed a decision by the Federal District Court for the District of Mississippi dismissing state common law nuisance claims in a putative class action by Mississippi residents asserting that CO₂ emissions exacerbated the effects of Hurricane Katrina. The Fifth Circuit held that there was no exclusive commitment of the common law issues raised in plaintiffs' complaint to a coordinate branch of

government and that no initial policy determination was required to adjudicate these claims. The court granted petitions for rehearing. An additional recusal left the Fifth Circuit without a quorum to reconsider the decision and the appeal was dismissed, leaving the district court's decision in place. Plaintiffs filed a petition with the U.S. Supreme Court asking the court to remand the case to the Fifth Circuit and reinstate the panel decision. The petition was denied in January 2011. Plaintiffs refiled their complaint in federal district court. Management believes the claims are without merit, and in addition to other defenses, are barred by the doctrine of collateral estoppel and the applicable statute of limitations. Management intends to vigorously defend against the claims. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

Alaskan Villages' Claims

In 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 and 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. In October 2009, the judge dismissed plaintiffs' federal common law claim for nuisance, finding the claim barred by the political question doctrine and by plaintiffs' lack of standing to bring the claim. The judge also dismissed plaintiffs' state law claims without prejudice to refile in state court. The plaintiffs appealed the decision. Briefing is complete and no date has been set for oral argument. The defendants requested that the court defer setting this case for oral argument until after the Supreme Court issues its decision in the CO₂ public nuisance case discussed above. The court entered an order deferring argument until after June 2011 and the parties requested supplemental briefing on the impact of the Supreme Court's decision. Management believes the action is without merit and intends to defend against the claims. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

Claims by the City of Brownsville, Texas Against TCC

In 2007, the City of Brownsville, Texas filed an original petition in litigation pending in the District Court of Dallas County, Texas. The petition seeks recovery against TCC based on allegations of breach of contract, breach of fiduciary duty, unjust enrichment, constructive trust, conversion, breach of the Texas theft liability act and fraud allegedly occurring in connection with a transaction in which Brownsville purchased TCC's interest in the Oklaunion electric generating station. The court signed the Final Summary Judgment in favor of TCC on Brownsville's claims against TCC and severed TCC's claims against Brownsville for further proceedings. Brownsville filed an appeal to the Dallas Court of Appeals. The Court of Appeals ordered the parties to mediate this dispute. Mediation was unsuccessful. Oral argument was heard by the Court of Appeals in December 2010. In July 2011, the Court of Appeals partially reversed the District Court and remanded certain issues to the District Court. Management expects to file a motion for rehearing with the Court of Appeals. Management believes that the claims are without merit and intends to defend against them vigorously. Management is unable to determine a range of potential losses that are reasonably possible of occurring.

5. DISPOSITIONS

2011

During the six months ended June 30, 2011, TCC sold, at cost, \$10 million of transmission facilities to ETT.

2010

During the six months ended June 30, 2010, TCC sold, at cost, \$64 million of transmission facilities to ETT.

6. BENEFIT PLANS

TCC participates in an AEP sponsored qualified pension plan and one unfunded nonqualified pension plan. Substantially all of TCC's employees are covered by the qualified plan or both the qualified and nonqualified pension plans. TCC also participates in OPEB plans sponsored by AEP to provide medical and life insurance benefits for retired employees.

Components of Net Periodic Benefit Cost

The following tables provide the components of TCC's net periodic benefit cost for the plans for the three and six months ended June 30, 2011 and 2010:

| | <u>Pension Plans</u> | | <u>Other Postretirement Benefit Plans</u> | |
|---------------------------------------|---|---------------|---|-----------------|
| | <u>Three Months Ended June 30, 2011</u> | <u>2010</u> | <u>Three Months Ended June 30, 2011</u> | <u>2010</u> |
| | (in thousands) | | | |
| Service Cost | \$ 1,251 | \$ 1,388 | \$ 554 | \$ 615 |
| Interest Cost | 4,171 | 4,648 | 1,699 | 1,783 |
| Expected Return on Plan Assets | (5,452) | (6,432) | (1,775) | (1,727) |
| Amortization of Transition Obligation | - | - | - | 867 |
| Amortization of Prior Service Credit | (321) | (318) | (15) | - |
| Amortization of Net Actuarial Loss | 2,146 | 1,631 | 440 | 445 |
| Net Periodic Benefit Cost | <u>\$ 1,795</u> | <u>\$ 917</u> | <u>\$ 903</u> | <u>\$ 1,983</u> |

| | <u>Pension Plans</u> | | <u>Other Postretirement Benefit Plans</u> | |
|---------------------------------------|---------------------------------------|-----------------|---|-----------------|
| | <u>Six Months Ended June 30, 2011</u> | <u>2010</u> | <u>Six Months Ended June 30, 2011</u> | <u>2010</u> |
| | (in thousands) | | | |
| Service Cost | \$ 2,500 | \$ 2,778 | \$ 1,109 | \$ 1,231 |
| Interest Cost | 8,260 | 9,296 | 3,398 | 3,566 |
| Expected Return on Plan Assets | (10,905) | (12,864) | (3,550) | (3,455) |
| Amortization of Transition Obligation | - | - | - | 1,735 |
| Amortization of Prior Service Credit | (635) | (636) | (31) | - |
| Amortization of Net Actuarial Loss | 4,236 | 3,261 | 880 | 889 |
| Net Periodic Benefit Cost | <u>\$ 3,456</u> | <u>\$ 1,835</u> | <u>\$ 1,806</u> | <u>\$ 3,966</u> |

7. BUSINESS SEGMENTS

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

8. DERIVATIVES AND HEDGING

Cash Flow Hedging Strategies

TCC's vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEPSC, on behalf of TCC, enters into financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. Not all fuel price risk exposure is hedged.

The gross notional volumes of TCC's outstanding derivative contracts for heating oil and gasoline as of June 30, 2011 and December 31, 2010 were 960 thousand gallons and 808 thousand gallons, respectively.

The following tables represent the gross fair value impact of TCC's derivative activity on the Condensed Consolidated Balance Sheets as of June 30, 2011 and December 31, 2010:

Fair Value of Derivative Instruments
June 30, 2011

| <u>Balance Sheet Location</u> | <u>Hedging Contracts (a)</u> | <u>Other (a) (b)</u> | <u>Total</u> |
|---|------------------------------|----------------------|---------------|
| | (in thousands) | | |
| Prepayments and Other Current Assets | \$ 258 | \$ (4) | \$ 254 |
| Deferred Charges and Other Noncurrent Assets | 13 | (3) | 10 |
| Total Assets | <u>271</u> | <u>(7)</u> | <u>264</u> |
| Other Current Liabilities | 11 | (4) | 7 |
| Deferred Credits and Other Noncurrent Liabilities | 7 | (6) | 1 |
| Total Liabilities | <u>18</u> | <u>(10)</u> | <u>8</u> |
| Total MTM Derivative Contract Net Assets | <u>\$ 253</u> | <u>\$ 3</u> | <u>\$ 256</u> |

Fair Value of Derivative Instruments
December 31, 2010

| <u>Balance Sheet Location</u> | <u>Hedging Contracts (a)</u> | <u>Other (a) (b)</u> | <u>Total</u> |
|---|------------------------------|----------------------|---------------|
| | (in thousands) | | |
| Prepayments and Other Current Assets | \$ 175 | \$ - | \$ 175 |
| Deferred Charges and Other Noncurrent Assets | - | - | - |
| Total Assets | <u>175</u> | <u>-</u> | <u>175</u> |
| Other Current Liabilities | - | - | - |
| Deferred Charges and Other Noncurrent Liabilities | - | - | - |
| Total Liabilities | <u>-</u> | <u>-</u> | <u>-</u> |
| Total MTM Derivative Contract Net Assets | <u>\$ 175</u> | <u>\$ -</u> | <u>\$ 175</u> |

- (a) Derivative instruments within these categories are reported gross. These instruments are subject to master netting agreements and are presented on the Condensed Consolidated Balance Sheets on a net basis in accordance with the accounting guidance for "Derivatives and Hedging."
- (b) Amounts include counterparty netting of risk management and hedging contracts and associated cash collateral in accordance with the accounting guidance for "Derivatives and Hedging." Amounts also include dedesignated risk management contracts.

Accounting for Cash Flow Hedging Strategies

For cash flow hedges (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), TCC initially reports the effective portion of the gain or loss on the derivative instrument as a component of Accumulated Other Comprehensive Income (Loss) on its Condensed Consolidated Balance Sheets until the period the hedged item affects Net Income. TCC records hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains).

TCC reclassifies gains and losses on financial fuel derivative contracts designated as cash flow hedges from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Other Operation expense, Maintenance expense or Depreciation and Amortization expense, as it relates to capital projects, on its Condensed Consolidated Statements of Income. During the three and six months ended June 30, 2011 and 2010, TCC designated cash flow hedging strategies of forecasted fuel purchases. Hedge ineffectiveness was immaterial for this hedge strategy.

The following tables provide details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TCC's Condensed Consolidated Balance Sheets and the reasons for changes in cash flow hedges for the three and six months ended June 30, 2011 and 2010. All amounts in the following tables are presented net of related income taxes.

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
For the Three Months Ended June 30, 2011 and 2010**

| | <u>2011</u> | <u>2010</u> |
|--|----------------|----------------|
| | (in thousands) | |
| Balance in AOCI as of April 1, | \$ 348 | \$ 146 |
| Changes in Fair Value Recognized in AOCI | (15) | (144) |
| Amount of (Gain) or Loss Reclassified from AOCI to Income Statement/within Balance Sheet: | | |
| Other Operation Expense | (52) | (24) |
| Maintenance Expense | (38) | (12) |
| Property, Plant and Equipment | (52) | (18) |
| Balance in AOCI as of June 30, | <u>\$ 191</u> | <u>\$ (52)</u> |

**Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
For the Six Months Ended June 30, 2011 and 2010**

| | <u>2011</u> | <u>2010</u> |
|--|----------------|----------------|
| | (in thousands) | |
| Balance in AOCI as of January 1, | \$ 115 | \$ 163 |
| Changes in Fair Value Recognized in AOCI | 269 | (135) |
| Amount of (Gain) or Loss Reclassified from AOCI to Income Statement/within Balance Sheet: | | |
| Other Operation Expense | (70) | (35) |
| Maintenance Expense | (51) | (19) |
| Property, Plant and Equipment | (72) | (26) |
| Balance in AOCI as of June 30, | <u>\$ 191</u> | <u>\$ (52)</u> |

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on TCC's Condensed Consolidated Balance Sheets at June 30, 2011 and December 31, 2010 were:

**Impact of Cash Flow Hedges on the Condensed Consolidated Balance Sheet
June 30, 2011 and December 31, 2010**

| | <u>June 30, 2011</u> | <u>December 31, 2010</u> |
|--|----------------------|--------------------------|
| | (in thousands) | |
| Hedging Assets | \$ 265 | \$ 175 |
| Hedging Liabilities | 12 | - |
| AOCI Gain Net of Tax | 191 | 115 |
| Portion Expected to be Reclassified to Net Income During the Next Twelve Months | 188 | 115 |

The actual amounts that TCC reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ from the estimate above due to market price changes. As of June 30, 2011, the maximum length of time that TCC is hedging (with contracts subject to the accounting guidance for “Derivatives and Hedging”) exposure to variability in future cash flows related to forecasted transactions is 18 months.

9. FAIR VALUE MEASUREMENTS

Fair Value Hierarchy and Valuation Techniques

The accounting guidance for “Fair Value Measurements and Disclosures” establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). Where observable inputs are available for substantially the full term of the asset or liability, the instrument is categorized in Level 2. When quoted market prices are not available, pricing may be completed using comparable securities, dealer values, operating data and general market conditions to determine fair value. Valuation models utilize various inputs such as commodity, interest rate and, to a lesser degree, volatility and credit that include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets, market corroborated inputs (i.e. inputs derived principally from, or correlated to, observable market data) and other observable inputs for the asset or liability.

For commercial activities, exchange traded derivatives, namely futures contracts, are generally fair valued based on unadjusted quoted prices in active markets and are classified as Level 1. Level 2 inputs primarily consist of OTC broker quotes in moderately active or less active markets, as well as exchange traded contracts where there is insufficient market liquidity to warrant inclusion in Level 1. Management verifies price curves using these broker quotes and classifies these fair values within Level 2 when substantially all of the fair value can be corroborated. Management typically obtains multiple broker quotes, which are non-binding in nature but are based on recent trades in the marketplace. When multiple broker quotes are obtained, the quoted bid and ask prices are averaged. In certain circumstances, a broker quote may be discarded if it is a clear outlier. Management uses a historical correlation analysis between the broker quoted location and the illiquid locations. If the points are highly correlated, these locations are included within Level 2 as well. Certain OTC and bilaterally executed derivative instruments are executed in less active markets with a lower availability of pricing information. Long-dated and illiquid complex or structured transactions and FTRs can introduce the need for internally developed modeling inputs based upon extrapolations and assumptions of observable market data to estimate fair value. When such inputs have a significant impact on the measurement of fair value, the instrument is categorized as Level 3.

For Restricted Cash for Securitized Transition Funding, items classified as Level 1 are investments in money market funds. They are valued based on observable inputs primarily unadjusted quoted prices in active markets for identical assets.

Fair Value Measurements of Long-term Debt

The fair values of Long-term Debt are based on quoted market prices, without credit enhancements, for the same or similar issues and the current interest rates offered for instruments with similar maturities. These instruments are not marked-to-market. The estimates presented are not necessarily indicative of the amounts that could be realized in a current market exchange.

The book values and fair values of TCC’s Long-term Debt as of June 30, 2011 and December 31, 2010 are summarized in the following table:

| | <u>June 30, 2011</u> | | <u>December 31, 2010</u> | |
|----------------|----------------------|-------------------|--------------------------|-------------------|
| | <u>Book Value</u> | <u>Fair Value</u> | <u>Book Value</u> | <u>Fair Value</u> |
| | (in thousands) | | | |
| Long-term Debt | \$ 2,457,945 | \$ 2,692,514 | \$ 2,610,274 | \$ 2,827,552 |

Fair Value Measurements of Financial Assets and Liabilities

The following tables set forth, by level within the fair value hierarchy, TCC's financial assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2011 and December 31, 2010. As required by the accounting guidance for "Fair Value Measurements and Disclosures," financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Management's assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. There have not been any significant changes in management's valuation techniques.

Assets and Liabilities Measured at Fair Value on a Recurring Basis June 30, 2011

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Other</u> | <u>Total</u> |
|--|-------------------|----------------|----------------|--------------|-------------------|
| | (in thousands) | | | | |
| Assets: | | | | | |
| Restricted Cash for Securitized Transition Funding (a) | \$ 159,772 | \$ - | \$ - | \$ 14 | \$ 159,786 |
| Risk Management Assets | | | | | |
| Cash Flow Hedges: | | | | | |
| Commodity Hedges (b) | - | 271 | - | (7) | 264 |
| Total Assets | <u>\$ 159,772</u> | <u>\$ 271</u> | <u>\$ -</u> | <u>\$ 7</u> | <u>\$ 160,050</u> |
| Liabilities: | | | | | |
| Risk Management Liabilities | | | | | |
| Cash Flow Hedges: | | | | | |
| Commodity Hedges (b) | \$ - | \$ 18 | \$ - | \$ (10) | \$ 8 |

Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2010

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Other</u> | <u>Total</u> |
|--|-------------------|----------------|----------------|--------------|-------------------|
| | (in thousands) | | | | |
| Assets: | | | | | |
| Restricted Cash for Securitized Transition Funding (a) | \$ 184,040 | \$ - | \$ - | \$ 14 | \$ 184,054 |
| Risk Management Assets | | | | | |
| Cash Flow Hedges: | | | | | |
| Commodity Hedges | - | 175 | - | - | 175 |
| Total Assets | <u>\$ 184,040</u> | <u>\$ 175</u> | <u>\$ -</u> | <u>\$ 14</u> | <u>\$ 184,229</u> |

- (a) Amounts in "Other" column primarily represent cash deposits with third parties. Level 1 amounts primarily represent investments in money market funds.
- (b) Amounts in "Other" column primarily represent counterparty netting of risk management and hedging contracts and associated cash collateral under the accounting guidance for "Derivatives and Hedging."

At December 31, 2010, TCC had no liabilities measured at fair value on a recurring basis.

There were no transfers between Level 1 and Level 2 during the six months ended June 30, 2011 and 2010.

10. INCOME TAXES

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

TCC and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2001. TCC 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. In April 2011, the IRS's examination of the years 2007 and 2008 was concluded with a settlement of all outstanding issues. The settlement will not have a material impact on net income, cash flows or financial condition. Although the outcome of tax audits is uncertain, in management's opinion, adequate provisions for federal income taxes have been made for potential liabilities resulting from such matters. In addition, TCC accrues interest on these uncertain tax positions. Management is not aware of any issues for open tax years that upon final resolution are expected to have a material adverse effect on net income.

TCC and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns and TCC and other AEP subsidiaries are currently under examination in several state and local jurisdictions. Management believes that previously filed tax returns have positions that may be challenged by these tax authorities. However, management believes that adequate provisions for income taxes have been made for potential liabilities resulting from such challenges and that the ultimate resolution of these audits will not materially impact net income. With few exceptions, TCC is no longer subject to state or local income tax examinations by tax authorities for years before 2000.

Federal Legislation

The Patient Protection and Affordable Care Act and the related Health Care and Education Reconciliation Act (Health Care Acts) were enacted in March 2010. The Health Care Acts amend tax rules so that the portion of employer health care costs that are reimbursed by the Medicare Part D prescription drug subsidy will no longer be deductible by the employer for federal income tax purposes effective for years beginning after December 31, 2012. Because of the loss of the future tax deduction, a reduction in the deferred tax asset related to the nondeductible OPEB liabilities accrued to date was recorded by TCC in March 2010. This reduction, which was offset by recording net tax regulatory assets, did not materially affect TCC's net income, cash flows or financial condition.

The Small Business Jobs Act (the Act) was enacted in September 2010. Included in the Act was a one-year extension of the 50% bonus depreciation provision. The Tax Relief, Unemployment Insurance Reauthorization and the Job Creation Act of 2010 extended the life of research and development, employment and several energy tax credits originally scheduled to expire at the end of 2010. In addition, the Act extended the time for claiming bonus depreciation and increased the deduction to 100% for part of 2010 and 2011. The enacted provisions will not have a material impact on TCC's net income or financial condition.

11. FINANCING ACTIVITIES

Long-term Debt

Long-term debt issued, retired and principal payments made during the first six months of 2011 are shown in the table below:

| Issuances: | <u>Type of Debt</u> | <u>Principal Amount</u> (in thousands) | <u>Interest Rate</u> (%) | <u>Due Date</u> |
|-------------------|-------------------------|---|-----------------------------|-----------------|
| | Pollution Control Bonds | \$ 60,000 (a) | 1.125 | 2012 |

| Retirements and Principal Payments: | <u>Type of Debt</u> | <u>Principal Amount Paid</u> (in thousands) | <u>Interest Rate</u> (%) | <u>Due Date</u> |
|--|-------------------------|--|-----------------------------|-----------------|
| | Securitization Bonds | \$ 33,872 | 5.96 | 2013 |
| | Securitization Bonds | 58,266 | 4.98 | 2013 |
| | Pollution Control Bonds | 120,265 | 5.125 | 2011 |

(a) These pollution control bonds are subject to redemption earlier than the maturity date. Consequently, these bonds have been classified for maturity purposes as Long-term Debt Due Within One Year – Nonaffiliated on TCC’s Condensed Consolidated Balance Sheets.

As of June 30, 2011, trustees held, on TCC’s behalf, \$60 million of its reacquired Pollution Control Bonds.

Dividend Restrictions

Federal Power Act

The Federal Power Act prohibits TCC from participating “in the making or paying of any dividends of such public utility from any funds properly included in capital account.” The term “capital account” is not defined in the Federal Power Act or its regulations. Management understands “capital account” to mean the par value of the common stock multiplied by the number of shares outstanding. This restriction does not limit the ability of TCC to pay dividends out of retained earnings.

Charter and Leverage Restrictions

Provisions within the articles or certificates of incorporation of TCC relating to preferred stock or shares restrict the payment of cash dividends on common and preferred stock or shares.

Utility Money Pool – AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of its subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds the utility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions approved in a regulatory order. The amount of outstanding loans to the Utility Money Pool as of June 30, 2011 and December 31, 2010 is included in Advances to Affiliates on TCC’s balance sheets. TCC’s Utility Money Pool activity and corresponding authorized borrowing limit for the six months ended June 30, 2011 are described in 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>Loans to Utility Money Pool as of June 30, 2011</u> | <u>Authorized Short-Term Borrowing Limit</u> |
|---|--|---|--|--|--|
| (in thousands) | | | | | |
| \$ 7,419 | \$ 141,586 | \$ 4,922 | \$ 78,566 | \$ 5,708 | \$ 250,000 |

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, 2011 and 2010 are summarized in the following table:

| Year | Maximum Interest Rates for Funds Borrowed from Utility Money Pool | Minimum Interest Rates for Funds Borrowed from Utility Money Pool | Maximum Interest Rates for Funds Loaned to Utility Money Pool | Minimum Interest Rates for Funds Loaned to Utility Money Pool | Average Interest Rates for Funds Borrowed from Utility Money Pool | Average Interest Rates for Funds Loaned to Utility Money Pool |
|-------------|--|--|--|--|--|--|
| 2011 | 0.42 % | 0.41 % | 0.56 % | 0.06 % | 0.41 % | 0.28 % |
| 2010 | - % | - % | 0.51 % | 0.09 % | - % | 0.23 % |

12. COST REDUCTION INITIATIVES

In April 2010, management began initiatives to decrease both labor and non-labor expenses with a goal of achieving significant reductions in operation and maintenance expenses. A total of 2,461 positions was eliminated across the AEP System as a result of process improvements, streamlined organizational designs and other efficiencies. Most of the affected employees terminated employment May 31, 2010. The severance program provided two weeks of base pay for every year of service along with other severance benefits.

TCC recorded a charge of \$24.9 million to Other Operation expense during the second quarter of 2010 primarily related to severance benefits as the result of headcount reduction initiatives.

The following table shows the cost reduction activity for the six months ended June 30, 2011:

| Balance at December 31, 2010 | Incurred | Settled | Adjustments | Balance at June 30, 2011 |
|-------------------------------------|-----------------|----------------|--------------------|---------------------------------|
| (in thousands) | | | | |
| \$ 1,516 | \$ - | \$ (1,078) | \$ (76) | \$ 362 |

The remaining accrual is included in Other Current Liabilities on the Condensed Consolidated Balance Sheets.