Kentucky Power Company

2013 Second Quarter Report

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
AEGCo	AEP Generating Company, an AEP electric utility subsidiary.
AEP or Parent	American Electric Power Company, Inc., an electric utility holding company.
AEP Credit	AEP Credit, Inc., a consolidated variable interest entity of AEP which securitizes accounts receivable and accrued utility revenues for affiliated electric utility companies.
AEP East Companies	APCo, I&M, KPCo and OPCo.
AEP System	American Electric Power System, an integrated electric utility system, owned and operated by AEP's electric utility subsidiaries.
AEPSC	American Electric Power Service Corporation, an AEP service subsidiary providing management and professional services to AEP and its subsidiaries.
AOCI	Accumulated Other Comprehensive Income.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
CAA	Clean Air Act.
CO_2	Carbon dioxide and other greenhouse gases.
FERC	Federal Energy Regulatory Commission.
FGD	Flue Gas Desulfurization or Scrubbers.
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.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
IRS	Internal Revenue Service.
Interconnection Agreement	An agreement by and among APCo, I&M, KPCo and OPCo, defining the sharing of costs and benefits associated with their respective generating plants.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
KPSC	Kentucky Public Service Commission.
MMBtu	Million British Thermal Units.
MTM	Mark-to-Market.
MW	Megawatt.
MWh	Megawatthour.
OPCo	Ohio Power Company, an AEP electric utility subsidiary.
OPEB	Other Postretirement Benefit Plans.
OTC	Over the counter.
PJM	Pennsylvania – New Jersey – Maryland regional transmission organization.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
Rockport Plant	A generating plant, consisting of two 1,300 MW coal-fired generating units near Rockport, Indiana, owned by AEGCo and I&M.
RTO	Regional Transmission Organization, responsible for moving electricity over large interstate areas.
SIA	System Integration Agreement, effective June 15, 2000, provides contractual basis for coordinated planning, operation and maintenance of the power supply sources of the combined AEP.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
VIE	Variable Interest Entity.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF INCOME
For the Three and Six Months Ended June 30, 2013 and 2012
(in thousands)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2012**	**2013**	**2012**
REVENUES				
Electric Generation, Transmission and Distribution	$ 140,087	$ 130,385	$ 306,505	$ 289,188
Sales to AEP Affiliates	9,176	9,629	23,730	14,654
Other Revenues	150	103	282	305
TOTAL REVENUES	149,413	140,117	330,517	304,147
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	25,034	26,610	68,755	56,595
Purchased Electricity for Resale	2,940	3,107	6,310	7,101
Purchased Electricity from AEP Affiliates	60,411	43,498	118,075	99,526
Other Operation	13,590	14,158	26,857	28,501
Maintenance	11,959	6,985	23,655	25,779
Depreciation and Amortization	14,205	13,628	28,871	27,169
Taxes Other Than Income Taxes	3,239	3,054	6,374	6,247
TOTAL EXPENSES	131,378	111,040	278,897	250,918
OPERATING INCOME	18,035	29,077	51,620	53,229
Other Income (Expense):				
Interest Income	217	93	244	215
Allowance for Equity Funds Used During Construction	404	803	665	1,502
Interest Expense	(8,799)	(8,899)	(17,684)	(17,664)
INCOME BEFORE INCOME TAX EXPENSE	9,857	21,074	34,845	37,282
Income Tax Expense	3,245	6,339	11,471	11,529
NET INCOME	$ 6,612	$ 14,735	$ 23,374	$ 25,753

The common stock of KPCo is wholly-owned by AEP.

See Condensed Notes to Condensed Financial Statements beginning on page 8.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Three and Six Months Ended June 30, 2013 and 2012
(in thousands)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2012**	**2013**	**2012**
Net Income	$ 6,612	$ 14,735	$ 23,374	$ 25,753
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAXES				
Cash Flow Hedges, Net of Tax of $12 and $32 for the Three Months Ended June 30, 2013 and 2012, Respectively, and $106 and $33 for the Six Months Ended June 30, 2013 and 2012, Respectively	(22)	60	196	(61)
TOTAL COMPREHENSIVE INCOME	$ 6,590	$ 14,795	$ 23,570	$ 25,692

See Condensed Notes to Condensed Financial Statements beginning on page 8.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CHANGES IN COMMON SHAREHOLDER'S EQUITY
For the Six Months Ended June 30, 2013 and 2012
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2011	$ 50,450	$ 238,750	$ 171,841	$ (625)	$ 460,416
Common Stock Dividends			(16,000)		(16,000)
Net Income			25,753		25,753
Other Comprehensive Loss				(61)	(61)
TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2012	$ 50,450	$ 238,750	$ 181,594	$ (686)	$ 470,108
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2012	$ 50,450	$ 238,750	$ 190,819	$ (409)	$ 479,610
Common Stock Dividends			(12,500)		(12,500)
Net Income			23,374		23,374
Other Comprehensive Income				196	196
TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2013	$ 50,450	$ 238,750	$ 201,693	$ (213)	$ 490,680

See Condensed Notes to Condensed Financial Statements beginning on page 8.

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
ASSETS
June 30, 2013 and December 31, 2012
(in thousands)
(Unaudited)

	June 30, 2013	December 31, 2012
CURRENT ASSETS		
Cash and Cash Equivalents	$ 1,046	$ 1,482
Advances to Affiliates	4,600	-
Accounts Receivable:		
Customers	16,766	15,666
Affiliated Companies	7,168	10,152
Accrued Unbilled Revenues	320	817
Miscellaneous	259	151
Allowance for Uncollectible Accounts	(19)	(142)
Total Accounts Receivable	24,494	26,644
Fuel	47,193	69,147
Materials and Supplies	21,406	25,061
Risk Management Assets	5,937	6,175
Accrued Tax Benefits	7,270	5,186
Prepayments and Other Current Assets	3,852	6,626
TOTAL CURRENT ASSETS	115,798	140,321
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	560,292	558,935
Transmission	491,243	490,152
Distribution	670,752	652,615
Other Property, Plant and Equipment	62,914	63,151
Construction Work in Progress	49,072	44,281
Total Property, Plant and Equipment	1,834,273	1,809,134
Accumulated Depreciation and Amortization	622,022	603,373
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,212,251	1,205,761
OTHER NONCURRENT ASSETS		
Regulatory Assets	212,542	213,734
Long-term Risk Management Assets	4,864	6,882
Deferred Charges and Other Noncurrent Assets	43,788	48,880
TOTAL OTHER NONCURRENT ASSETS	261,194	269,496
TOTAL ASSETS	$ 1,589,243	$ 1,615,578

See Condensed Notes to Condensed Financial Statements beginning on page 8.

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
June 30, 2013 and December 31, 2012
(Unaudited)

	June 30, 2013	December 31, 2012
	(in thousands)	
CURRENT LIABILITIES		
Advances from Affiliates	$ -	$ 13,359
Accounts Payable:		
General	19,464	30,337
Affiliated Companies	30,369	40,965
Risk Management Liabilities	2,822	3,320
Customer Deposits	24,616	23,485
Accrued Taxes	11,239	11,818
Accrued Interest	6,598	7,210
Regulatory Liability for Over-Recovered Fuel Costs	1,573	7,928
Other Current Liabilities	21,587	25,685
TOTAL CURRENT LIABILITIES	118,268	164,107
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	529,305	529,222
Long-term Debt – Affiliated	20,000	20,000
Long-term Risk Management Liabilities	2,886	3,700
Deferred Income Taxes	361,552	353,578
Regulatory Liabilities and Deferred Investment Tax Credits	25,433	26,159
Employee Benefits and Pension Obligations	32,546	30,981
Deferred Credits and Other Noncurrent Liabilities	8,573	8,221
TOTAL NONCURRENT LIABILITIES	980,295	971,861
TOTAL LIABILITIES	1,098,563	1,135,968
Rate Matters (Note 3)		
Commitments and Contingencies (Note 4)		
COMMON SHAREHOLDER’S EQUITY		
Common Stock – Par Value – $50 Per Share:		
Authorized – 2,000,000 Shares		
Outstanding – 1,009,000 Shares	50,450	50,450
Paid-in Capital	238,750	238,750
Retained Earnings	201,693	190,819
Accumulated Other Comprehensive Income (Loss)	(213)	(409)
TOTAL COMMON SHAREHOLDER’S EQUITY	490,680	479,610
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	$ 1,589,243	$ 1,615,578

See Condensed Notes to Condensed Financial Statements beginning on page 8.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CASH FLOWS
For the Six Months Ended June 30, 2013 and 2012
(in thousands)
(Unaudited)

	Six Months Ended June 30, 2013	2012
OPERATING ACTIVITIES		
Net Income	$ 23,374	$ 25,753
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	28,871	27,169
Deferred Income Taxes	7,705	3,610
Net Recovery of (Deferral of) Storm Costs	2,349	(2,998)
Allowance for Equity Funds Used During Construction	(665)	(1,502)
Mark-to-Market of Risk Management Contracts	1,208	9
Property Taxes	5,418	5,193
Fuel Over/Under-Recovery, Net	(6,355)	(120)
Change in Other Noncurrent Assets	(3,736)	(6,723)
Change in Other Noncurrent Liabilities	1,545	1,940
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	2,330	11,275
Fuel, Materials and Supplies	25,609	(14,064)
Accounts Payable	(17,866)	(15,214)
Accrued Taxes, Net	(2,663)	(518)
Other Current Assets	2,596	1,148
Other Current Liabilities	(5,804)	(4,323)
Net Cash Flows from Operating Activities	63,916	30,635
INVESTING ACTIVITIES		
Construction Expenditures	(38,211)	(46,714)
Change in Advances to Affiliates, Net	(4,600)	32,337
Acquisitions of Assets	(55)	(7)
Proceeds from Sales of Assets	4,663	206
Net Cash Flows Used for Investing Activities	(38,203)	(14,178)
FINANCING ACTIVITIES		
Change in Advances from Affiliates, Net	(13,359)	-
Principal Payments for Capital Lease Obligations	(524)	(612)
Dividends Paid on Common Stock	(12,500)	(16,000)
Other Financing Activities	234	13
Net Cash Flows Used for Financing Activities	(26,149)	(16,599)
Net Decrease in Cash and Cash Equivalents	(436)	(142)
Cash and Cash Equivalents at Beginning of Period	1,482	778
Cash and Cash Equivalents at End of Period	$ 1,046	$ 636
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 17,888	$ 17,827
Net Cash Paid for Income Taxes	5,969	6,401
Noncash Acquisitions Under Capital Leases	682	252
Construction Expenditures Included in Current Liabilities as of June 30,	5,975	7,457

See Condensed Notes to Condensed Financial Statements beginning on page 8.

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1. SIGNIFICANT ACCOUNTING MATTERS

General

The unaudited condensed 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 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, 2013 is not necessarily indicative of results that may be expected for the year ending December 31, 2013. The condensed financial statements are unaudited and should be read in conjunction with the audited 2012 financial statements and notes thereto, which are included in KPCo's 2012 Annual Report.

Management reviewed subsequent events through July 26, 2013, the date that the second quarter 2013 report was issued.

2. COMPREHENSIVE INCOME

Presentation of Comprehensive Income

The following tables provide the components of changes in AOCI for the three and six months ended June 30, 2013. All amounts in the following tables are presented net of related income taxes.

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Three Months Ended June 30, 2013

	Cash Flow Hedges		
	Commodity	Interest Rate and Foreign Currency	Total
		(in thousands)	
Balance in AOCI as of March 31, 2013	$ 76	$ (267)	$ (191)
Change in Fair Value Recognized in AOCI	(22)	-	(22)
Amounts Reclassified from AOCI	(15)	15	-
Net Current Period Other Comprehensive Income	(37)	15	(22)
Balance in AOCI as of June 30, 2013	$ 39	$ (252)	$ (213)

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Six Months Ended June 30, 2013

	Cash Flow Hedges		
	Commodity	Interest Rate and Foreign Currency	Total
		(in thousands)	
Balance in AOCI as of December 31, 2012	$ (127)	$ (282)	$ (409)
Change in Fair Value Recognized in AOCI	139	-	139
Amounts Reclassified from AOCI	27	30	57
Net Current Period Other Comprehensive Income	166	30	196
Balance in AOCI as of June 30, 2013	$ 39	$ (252)	$ (213)

Reclassifications Out of Accumulated Other Comprehensive Income

The following tables provide details of reclassifications from AOCI for the three and six months ended June 30, 2013.

Reclassifications from Accumulated Other Comprehensive Income (Loss)
For the Three Months Ended June 30, 2013

Gains and Losses on Cash Flow Hedges	Amount of (Gain) Loss Reclassified from AOCI (in thousands)
Commodity:	
Electric Generation, Transmission and Distribution Revenues	$ 12
Purchased Electricity for Resale	(30)
Other Operation Expense	(2)
Maintenance Expense	-
Property, Plant and Equipment	(2)
Subtotal - Commodity	(22)
Interest Rate and Foreign Currency:	
Interest Expense	23
Subtotal - Interest Rate and Foreign Currency	23
Reclassifications from AOCI, before Income Tax (Expense) Credit	1
Income Tax (Expense) Credit	1
Total Reclassifications from AOCI, Net of Income Tax (Expense) Credit	$ -

Reclassifications from Accumulated Other Comprehensive Income (Loss)
For the Six Months Ended June 30, 2013

Gains and Losses on Cash Flow Hedges	Amount of (Gain) Loss Reclassified from AOCI (in thousands)
Commodity:	
Electric Generation, Transmission and Distribution Revenues	$ 31
Purchased Electricity for Resale	24
Other Operation Expense	(5)
Maintenance Expense	(2)
Property, Plant and Equipment	(6)
Subtotal - Commodity	42
Interest Rate and Foreign Currency:	
Interest Expense	46
Subtotal - Interest Rate and Foreign Currency	46
Reclassifications from AOCI, before Income Tax (Expense) Credit	88
Income Tax (Expense) Credit	31
Total Reclassifications from AOCI, Net of Income Tax (Expense) Credit	$ 57

The following tables provide details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on the condensed balance sheets and the reasons for changes in cash flow hedges for the three and six months ended June 30, 2012. 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, 2012

	Commodity	Interest Rate	Total
		(in thousands)	
Balance in AOCI as of March 31, 2012	$ (419)	$ (327)	$ (746)
Changes in Fair Value Recognized in AOCI	(94)	-	(94)
Amount of (Gain) or Loss Reclassified from AOCI			
to Statement of Income/within Balance Sheet:			
Electric Generation, Transmission and Distribution Revenues	(3)	-	(3)
Purchased Electricity for Resale	149	-	149
Other Operation Expense	(3)	-	(3)
Maintenance Expense	(1)	-	(1)
Interest Expense	-	15	15
Property, Plant and Equipment	(3)	-	(3)
Balance in AOCI as of June 30, 2012	$ (374)	$ (312)	$ (686)

Total Accumulated Other Comprehensive Income (Loss) Activity for Cash Flow Hedges
For the Six Months Ended June 30, 2012

	Commodity	Interest Rate	Total
		(in thousands)	
Balance in AOCI as of December 31, 2011	$ (283)	$ (342)	$ (625)
Changes in Fair Value Recognized in AOCI	(444)	-	(444)
Amount of (Gain) or Loss Reclassified from AOCI			
to Statement of Income/within Balance Sheet:			
Electric Generation, Transmission and Distribution Revenues	(3)	-	(3)
Purchased Electricity for Resale	365	-	365
Other Operation Expense	(3)	-	(3)
Maintenance Expense	(2)	-	(2)
Interest Expense	-	30	30
Property, Plant and Equipment	(4)	-	(4)
Balance in AOCI as of June 30, 2012	$ (374)	$ (312)	$ (686)

3. RATE MATTERS

As discussed in KPCo's 2012 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within KPCo's 2012 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 2013 and updates KPCo's 2012 Annual Report.

Regulatory Assets Not Yet Being Recovered

Noncurrent Regulatory Assets	June 30, 2013	December 31, 2012
	(in thousands)	
Regulatory assets not yet being recovered pending future proceedings:		
Regulatory Assets Currently Not Earning a Return		
Storm Related Costs	$ 12,146	$ 12,146
Mountaineer Carbon Capture and Storage Commercial Scale Facility	873	873
Total Regulatory Assets Not Yet Being Recovered	$ 13,019	$ 13,019

If these costs are ultimately determined not to be recoverable, it could reduce future net income and cash flows and impact financial condition.

Plant Transfer

In October 2012, the AEP East Companies submitted several filings with the FERC. See the "Corporate Separation and Termination of Interconnection Agreement" section of FERC Rate Matters. In December 2012, KPCo filed a request with the KPSC for approval to transfer at net book value to KPCo a one-half interest in the Mitchell Plant, comprising 780 MW of average annual generating capacity presently owned by OPCo. KPCo also requested costs related to the Big Sandy Plant, Unit 2 FGD project be established as a regulatory asset. KPCo is currently seeking recovery of these costs with the KPSC. In March 2013, KPCo issued a Request for Proposal (RFP) to purchase up to 250 MW of long-term capacity and energy to replace the capacity from the retirement of Big Sandy Plant, Unit 1. In June 2013, KPCo filed the results of its RFP with the KPSC. As of June 30, 2013, KPCo has incurred $28 million related to the FGD project, which is recorded in Deferred Charges and Other Noncurrent Assets on the balance sheet.

In May 2013, a memorandum of understanding (MOU) between KPCo, KIUC and the Sierra Club was filed with the KPSC. The MOU includes (a) the transfer of a one-half interest in the Mitchell Plant to KPCo at net book value on December 31, 2013 (b) the implementation of an Asset Transfer Rider to collect $44 million annually effective January 2014, subject to true-up, (c) the authorization to record FGD project costs as a regulatory asset, (d) the conversion of Big Sandy Plant, Unit 1 to natural gas and (e) any off-system sales margins above the $15.3 million annual level in base rates be retained by KPCo. In July 2013, KPCo, KIUC and the Sierra Club filed a settlement agreement with the KPSC pursuant to the MOU as modified. The settlement agreement also addressed potential greenhouse gas initiatives on the Mitchell Plant. The Attorney General was not a party to the settlement agreement. If approved, KPCo will withdraw the current base rate case request and current rates will remain in effect until at least May 2015. Hearings were held at the KPSC in July 2013. If KPCo is not ultimately permitted to recover its incurred costs, it could reduce future net income and cash flows and impact financial condition.

2013 Kentucky Base Rate Case

In June 2013, KPCo filed a request with the KPSC for an annual increase in base rates of $114 million based upon a return on common equity of 10.65% to be effective January 2014. The proposed revenue increase includes cost recovery of the pending transfer of the one-half interest in the Mitchell Plant (780 MW) and cost recovery of Big Sandy Plant, Units 1 and 2. The filing also includes requests for recovery of deferrals totaling $48 million including $28 million related to the Big Sandy Plant FGD project and $12 million related to 2012 storm costs which are recorded in Deferred Charges and Other Noncurrent Assets and Regulatory Assets, respectively, on the balance sheet. Additionally, KPCo proposed that Big Sandy Plant, Unit 2 expenses incurred over the period January 2014

through May 2015 be deferred and recovered over five years beginning January 2014. Also in June 2013, a settlement agreement between KPCo, Kentucky Industrial Utility Customers, Inc. and the Sierra Club was filed with the KPSC which supported the Mitchell plant transfer discussed above. If the settlement agreement is approved, KPCo will withdraw this base rate case request and current rates will remain in effect until at least May 2015. If KPCo is not ultimately permitted to recover its incurred costs, it could reduce future net income and cash flows and impact financial condition.

FERC Rate Matters

Corporate Separation and Termination of Interconnection Agreement

In October 2012, the AEP East Companies submitted several filings with the FERC seeking approval to fully separate OPCo's generation assets from its distribution and transmission operations and to transfer at net book value OPCo's Mitchell Plant to APCo and KPCo in equal one-half interests (780 MW each). This transfer is proposed to be effective December 31, 2013. In April 2013, the FERC issued orders approving the transfer of OPCo's generation assets to AEPGenCo and the Mitchell Plant assets to APCo and KPCo. In May 2013, the IEU petitioned the FERC for rehearing of its order granting OPCo authority to implement corporate separation by transferring its generation assets to AEPGenCo. This issue remains pending before the FERC.

Additionally, the AEP East Companies requested FERC approval, effective January 1, 2014, to terminate the existing Interconnection Agreement and approve a Power Coordination Agreement (PCA) among APCo, I&M and KPCo with AEPSC as the agent to coordinate their respective power supply resources. Under the PCA, KPCo would be individually responsible for planning its respective capacity obligations and there would be no capacity equalization charges/credits on deficit/surplus companies. Further, the PCA allows, but does not obligate, KPCo to participate collectively under a common fixed resource requirement capacity plan in PJM and to participate in specified collective off-system sales and purchase activities. Intervenors have opposed several of these filings. The AEP East Companies responded to intervenor comments and filed a revised PCA at the FERC in March 2013. The revised PCA included certain clarifying wording changes that have been agreed upon by intervenors. A decision is pending at the FERC. Similar filings have been made at the KPSC. See the "Plant Transfer" section of Rate Matters.

If KPCo experiences decreases in revenues or increases in expenses as a result of changes to its relationship with affiliates and is unable to recover the change in revenues and costs through rates, prices or additional sales, it could reduce future net income and cash flows.

4. COMMITMENTS, GUARANTEES AND CONTINGENCIES

KPCo is subject to certain claims and legal actions arising in its ordinary course of business. In addition, KPCo'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 effect on the financial statements. The Commitments, Guarantees and Contingencies note within KPCo's 2012 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 unless specified below.

Indemnifications and Other Guarantees

Contracts

KPCo 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, 2013, there were no material liabilities recorded for any indemnifications.

KPCo is jointly and severally liable for activity conducted by AEPSC on behalf of the AEP East Companies related to power purchase and sale activity conducted pursuant to the SIA.

Master Lease Agreements

KPCo leases certain equipment under master lease agreements. Under the 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, KPCo is committed to pay the difference between the actual fair value and the residual value guarantee. Historically, at the end of the lease term the fair value has been in excess of the unamortized balance. As of June 30, 2013, the maximum potential loss for these lease agreements was approximately $1.1 million assuming the fair value of the equipment is zero at the end of the lease term.

CONTINGENCIES

Carbon Dioxide Public Nuisance Claims

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 CO_2 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. The court ordered all defendants to respond to the refiled complaints in October 2011. In March 2012, the court granted the defendants' motion for dismissal on several grounds, including the doctrine of collateral estoppel and the applicable statute of limitations. In May 2013, the U.S. Court of Appeals for the Fifth Circuit affirmed the district court's dismissal of the complaint. The plaintiffs may seek further review in the U.S. Supreme Court. Management will continue to 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 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. 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 refiling in state court. In September 2012, the Ninth Circuit Court of Appeals affirmed the trial court's decision, holding that the CAA displaced Kivalina's claims for damages. Plaintiffs filed seeking further review in the U.S. Supreme Court. In May 2013, the U.S. Supreme Court denied the plaintiffs' request for review.

5. BENEFIT PLANS

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

Components of Net Periodic Benefit Cost

The following tables provide the components of KPCo's net periodic benefit cost (credit) for the plans for the three and six months ended June 30, 2013 and 2012:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended June 30,		Three Months Ended June 30,	
	2013	2012	2013	2012
	(in thousands)			
Service Cost	$ 258	$ 353	$ 112	$ 251
Interest Cost	1,235	1,366	458	709
Expected Return on Plan Assets	(1,605)	(1,848)	(738)	(728)
Amortization of Prior Service Cost (Credit)	11	21	(505)	(126)
Amortization of Net Actuarial Loss	1,117	920	421	392
Net Periodic Benefit Cost (Credit)	$ 1,016	$ 812	$ (252)	$ 498

	Pension Plans		Other Postretirement Benefit Plans	
	Six Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(in thousands)			
Service Cost	$ 515	$ 706	$ 223	$ 503
Interest Cost	2,470	2,732	916	1,418
Expected Return on Plan Assets	(3,210)	(3,696)	(1,475)	(1,456)
Amortization of Prior Service Cost (Credit)	21	42	(1,010)	(252)
Amortization of Net Actuarial Loss	2,235	1,839	842	784
Net Periodic Benefit Cost (Credit)	$ 2,031	$ 1,623	$ (504)	$ 997

6. BUSINESS SEGMENTS

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

7. DERIVATIVES AND HEDGING

OBJECTIVES FOR UTILIZATION OF DERIVATIVE INSTRUMENTS

KPCo is exposed to certain market risks as a major power producer and marketer of wholesale electricity, coal and emission allowances. These risks include commodity price risk, interest rate risk, credit risk and, to a lesser extent, foreign currency exchange risk. These risks represent the risk of loss that may impact KPCo due to changes in the underlying market prices or rates. AEPSC, on behalf of KPCo, manages these risks using derivative instruments.

STRATEGIES FOR UTILIZATION OF DERIVATIVE INSTRUMENTS TO ACHIEVE OBJECTIVES

Risk Management Strategies

The strategy surrounding the use of derivative instruments primarily focuses on managing risk exposures, future cash flows and creating value utilizing both economic and formal hedging strategies. The risk management strategies also include the use of derivative instruments for trading purposes, focusing on seizing market opportunities to create value driven by expected changes in the market prices of the commodities in which AEPSC

transacts on behalf of KPCo. To accomplish these objectives, AEPSC, on behalf of KPCo, primarily employs risk management contracts including physical and financial forward purchase-and-sale contracts and, to a lesser extent, OTC swaps and options. Not all risk management contracts meet the definition of a derivative under the accounting guidance for "Derivatives and Hedging." Derivative risk management contracts elected normal under the normal purchases and normal sales scope exception are not subject to the requirements of this accounting guidance.

AEPSC, on behalf of KPCo, enters into power, coal, natural gas, interest rate and, to a lesser degree, heating oil and gasoline, emission allowance and other commodity contracts to manage the risk associated with the energy business. AEPSC, on behalf of KPCo, enters into interest rate derivative contracts in order to manage the interest rate exposure associated with KPCo's commodity portfolio. For disclosure purposes, such risks are grouped as "Commodity," as these risks are related to energy risk management activities. AEPSC, on behalf of KPCo, also engages in risk management of interest rate risk associated with debt financing and foreign currency risk associated with future purchase obligations denominated in foreign currencies. The amount of risk taken is determined by the Commercial Operations and Finance groups in accordance with the established risk management policies as approved by the Finance Committee of AEP's Board of Directors.

The following table represents the gross notional volume of the KPCo's outstanding derivative contracts as of June 30, 2013 and December 31, 2012:

Notional Volume of Derivative Instruments

	Volume		
	June 30, 2013	**December 31, 2012**	**Unit of Measure**
	(in thousands)		
Commodity:			
Power	20,536	18,838	MWhs
Coal	148	247	Tons
Natural Gas	1,261	2,018	MMBtus
Heating Oil and Gasoline	216	269	Gallons
Interest Rate	$ 3,734	$ 4,836	USD

Fair Value Hedging Strategies

AEPSC, on behalf of KPCo, enters into interest rate derivative transactions as part of an overall strategy to manage the mix of fixed-rate and floating-rate debt. Certain interest rate derivative transactions effectively modify KPCo's exposure to interest rate risk by converting a portion of KPCo's fixed-rate debt to a floating rate. Provided specific criteria are met, these interest rate derivatives are designated as fair value hedges.

Cash Flow Hedging Strategies

AEPSC, on behalf of KPCo, enters into and designates as cash flow hedges certain derivative transactions for the purchase and sale of power, coal, natural gas and heating oil and gasoline ("Commodity") in order to manage the variable price risk related to the forecasted purchase and sale of these commodities. Management monitors the potential impacts of commodity price changes and, where appropriate, enters into derivative transactions to protect profit margins for a portion of future electricity sales and fuel or energy purchases. KPCo does not hedge all commodity price risk.

KPCo's vehicle fleet is exposed to gasoline and diesel fuel price volatility. AEPSC, on behalf of KPCo, enters into financial heating oil and gasoline derivative contracts in order to mitigate price risk of future fuel purchases. For disclosure purposes, these contracts are included with other hedging activities as "Commodity." KPCo does not hedge all fuel price risk.

AEPSC, on behalf of KPCo, enters into a variety of interest rate derivative transactions in order to manage interest rate risk exposure. Some interest rate derivative transactions effectively modify exposure to interest rate risk by converting a portion of floating-rate debt to a fixed rate. AEPSC, on behalf of KPCo, also enters into interest rate derivative contracts to manage interest rate exposure related to future borrowings of fixed-rate debt. The forecasted

fixed-rate debt offerings have a high probability of occurrence as the proceeds will be used to fund existing debt maturities and projected capital expenditures. KPCo does not hedge all interest rate exposure.

At times, KPCo is exposed to foreign currency exchange rate risks primarily when KPCo purchases certain fixed assets from foreign suppliers. In accordance with AEP's risk management policy, AEPSC, on behalf of KPCo, may enter into foreign currency derivative transactions to protect against the risk of increased cash outflows resulting from a foreign currency's appreciation against the dollar. KPCo does not hedge all foreign currency exposure.

ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND THE IMPACT ON KPCo's FINANCIAL STATEMENTS

The accounting guidance for "Derivatives and Hedging" requires recognition of all qualifying derivative instruments as either assets or liabilities on the condensed balance sheets at fair value. The fair values of derivative instruments accounted for using MTM accounting or hedge accounting are based on exchange prices and broker quotes. If a quoted market price is not available, the estimate of fair value is based on the best information available including valuation models that estimate future energy prices based on existing market and broker quotes, supply and demand market data and assumptions. In order to determine the relevant fair values of the derivative instruments, KPCo applies valuation adjustments for discounting, liquidity and credit quality.

Credit risk is the risk that a counterparty will fail to perform on the contract or fail to pay amounts due. Liquidity risk represents the risk that imperfections in the market will cause the price to vary from estimated fair value based upon prevailing market supply and demand conditions. Since energy markets are imperfect and volatile, there are inherent risks related to the underlying assumptions in models used to fair value risk management contracts. Unforeseen events may cause reasonable price curves to differ from actual price curves throughout a contract's term and at the time a contract settles. Consequently, there could be significant adverse or favorable effects on future net income and cash flows if market prices are not consistent with management's estimates of current market consensus for forward prices in the current period. This is particularly true for longer term contracts. Cash flows may vary based on market conditions, margin requirements and the timing of settlement of KPCo's risk management contracts.

According to the accounting guidance for "Derivatives and Hedging," KPCo reflects the fair values of derivative instruments subject to netting agreements with the same counterparty net of related cash collateral. For certain risk management contracts, KPCo is required to post or receive cash collateral based on third party contractual agreements and risk profiles. For the June 30, 2013 and December 31, 2012 condensed balance sheets, KPCo netted $114 thousand and $253 thousand, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and $1.0 million and $2.2 million, respectively, of cash collateral paid to third parties against short-term and long-term risk management liabilities.

The following tables represent the gross fair value impact of KPCo's derivative activity on the condensed balance sheets as of June 30, 2013 and December 31, 2012:

Fair Value of Derivative Instruments
June 30, 2013

	Risk Management Contracts	Hedging Contracts		Gross Amounts of Risk Management Assets/	Gross Amounts Offset in the Statement of	Net Amounts of Assets/Liabilities Presented in the Statement of
Balance Sheet Location	**Commodity (a)**	**Commodity (a)**	**Interest Rate (a)**	**Liabilities Recognized**	**Financial Position (b)**	**Financial Position (c)**
			(in thousands)			
Current Risk Management Assets	$ 18,158	$ 205	$ -	$ 18,363	$ (12,426)	$ 5,937
Long-term Risk Management Assets	7,946	-	-	7,946	(3,082)	4,864
Total Assets	26,104	205	-	26,309	(15,508)	10,801
Current Risk Management Liabilities	15,811	143	-	15,954	(13,132)	2,822
Long-term Risk Management Liabilities	6,179	6	-	6,185	(3,299)	2,886
Total Liabilities	21,990	149	-	22,139	(16,431)	5,708
Total MTM Derivative Contract Net Assets (Liabilities)	$ 4,114	$ 56	$ -	$ 4,170	$ 923	$ 5,093

Fair Value of Derivative Instruments
December 31, 2012

	Risk Management Contracts	Hedging Contracts		Gross Amounts of Risk Management Assets/	Gross Amounts Offset in the Statement of	Net Amounts of Assets/Liabilities Presented in the Statement of
Balance Sheet Location	**Commodity (a)**	**Commodity (a)**	**Interest Rate (a)**	**Liabilities Recognized**	**Financial Position (b)**	**Financial Position (c)**
			(in thousands)			
Current Risk Management Assets	$ 25,448	$ 72	$ -	$ 25,520	$ (19,345)	$ 6,175
Long-term Risk Management Assets	12,117	43	-	12,160	(5,278)	6,882
Total Assets	37,565	115	-	37,680	(24,623)	13,057
Current Risk Management Liabilities	23,806	239	-	24,045	(20,725)	3,320
Long-term Risk Management Liabilities	9,469	85	-	9,554	(5,854)	3,700
Total Liabilities	33,275	324	-	33,599	(26,579)	7,020
Total MTM Derivative Contract Net Assets (Liabilities)	$ 4,290	$ (209)	$ -	$ 4,081	$ 1,956	$ 6,037

(a) Derivative instruments within these categories are reported gross. These instruments are subject to master netting agreements and are presented on the condensed 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."

(c) There are no derivative contracts subject to a master netting arrangement or similar agreement which are not offset in the statement of financial position.

The table below presents KPCo's activity of derivative risk management contracts for the three and six months ended June 30, 2013 and 2012:

Amount of Gain (Loss) Recognized on
Risk Management Contracts
For the Three and Six Months Ended June 30, 2013 and 2012

	Three Months Ended June 30,		Six Months Ended June 30,	
Location of Gain (Loss)	**2013**	**2012**	**2013**	**2012**
	(in thousands)			
Electric Generation, Transmission and Distribution Revenues	$ (150)	$ (877)	$ 446	$ (1,571)
Regulatory Assets (a)	-	(3)	-	9
Regulatory Liabilities (a)	298	858	(169)	1,917
Total Gain (Loss) on Risk Management Contracts	$ 148	$ (22)	$ 277	$ 355

(a) Represents realized and unrealized gains and losses subject to regulatory accounting treatment recorded as either current or noncurrent on the condensed balance sheets.

Certain qualifying derivative instruments have been designated as normal purchase or normal sale contracts, as provided in the accounting guidance for "Derivatives and Hedging." Derivative contracts that have been designated as normal purchases or normal sales under that accounting guidance are not subject to MTM accounting treatment and are recognized on the condensed statements of income on an accrual basis.

KPCo's accounting for the changes in the fair value of a derivative instrument depends on whether it qualifies for and has been designated as part of a hedging relationship and further, on the type of hedging relationship. Depending on the exposure, management designates a hedging instrument as a fair value hedge or a cash flow hedge.

For contracts that have not been designated as part of a hedging relationship, the accounting for changes in fair value depends on whether the derivative instrument is held for trading purposes. Unrealized and realized gains and losses on derivative instruments held for trading purposes are included in revenues on a net basis on KPCo's condensed statements of income. Unrealized and realized gains and losses on derivative instruments not held for trading purposes are included in revenues or expenses on KPCo's condensed statements of income depending on the relevant facts and circumstances. However, unrealized and some realized gains and losses for both trading and non-trading derivative instruments are recorded as regulatory assets (for losses) or regulatory liabilities (for gains), in accordance with the accounting guidance for "Regulated Operations."

Accounting for Fair Value Hedging Strategies

For fair value hedges (i.e. hedging the exposure to changes in the fair value of an asset, liability or an identified portion thereof attributable to a particular risk), the gain or loss on the derivative instrument as well as the offsetting gain or loss on the hedged item associated with the hedged risk affects Net Income during the period of change.

KPCo records realized and unrealized gains or losses on interest rate swaps that qualify for fair value hedge accounting treatment and any offsetting changes in the fair value of the debt being hedged in Interest Expense on KPCo's condensed statements of income. During the three and six months ended June 30, 2013 and 2012, KPCo did not designate any fair value hedging strategies.

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), KPCo initially reports the effective portion of the gain or loss on the derivative instrument as a component of Accumulated Other Comprehensive Income (Loss) on the condensed balance sheets until the period the hedged item affects Net Income. KPCo recognizes any hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains).

Realized gains and losses on derivative contracts for the purchase and sale of power, coal and natural gas designated as cash flow hedges are included in Revenues, Fuel and Other Consumables Used for Electric Generation or Purchased Electricity for Resale on KPCo's condensed statements of income, or in Regulatory Assets or Regulatory Liabilities on KPCo's condensed balance sheets, depending on the specific nature of the risk being hedged. During the three and six months ended June 30, 2013 and 2012, KPCo designated power, coal and natural gas derivatives as cash flow hedges.

KPCo reclassifies gains and losses on heating oil and gasoline derivative contracts designated as cash flow hedges from Accumulated Other Comprehensive Income (Loss) on its condensed balance sheets into Other Operation expense, Maintenance expense or Depreciation and Amortization expense, as it relates to capital projects, on the condensed statements of income. During the three and six months ended June 30, 2013 and 2012, KPCo designated heating oil and gasoline derivatives as cash flow hedges.

KPCo reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its condensed balance sheets into Interest Expense on its condensed statements of income in those periods in which hedged interest payments occur. During the three and six months ended June 30, 2013 and 2012, KPCo did not designate any interest rate derivatives as cash flow hedges.

The accumulated gains or losses related to foreign currency hedges are reclassified from Accumulated Other Comprehensive Income (Loss) on KPCo's condensed balance sheets into Depreciation and Amortization expense on the condensed statements of income over the depreciable lives of the fixed assets designated as the hedged items in qualifying foreign currency hedging relationships. During the three and six months ended June 30, 2013 and 2012, KPCo did not designate any foreign currency derivatives as cash flow hedges.

During the three and six months ended June 30, 2013 and 2012, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies disclosed above.

For details on designated, effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's condensed balance sheets and the reasons for changes in cash flow hedges for the three and six months ended June 30, 2013 and 2012, see Note 2.

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's condensed balance sheets as of June 30, 2013 and December 31, 2012 were:

Impact of Cash Flow Hedges on the Condensed Balance Sheet
June 30, 2013

	Commodity	Interest Rate	Total
		(in thousands)	
Hedging Assets (a)	$ 117	$ -	$ 117
Hedging Liabilities (a)	61	-	61
AOCI Gain (Loss) Net of Tax	39	(252)	(213)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	43	(60)	(17)

Impact of Cash Flow Hedges on the Condensed Balance Sheet
December 31, 2012

	Commodity	Interest Rate	Total
		(in thousands)	
Hedging Assets (a)	$ 63	$ -	$ 63
Hedging Liabilities (a)	272	-	272
AOCI Loss Net of Tax	(127)	(282)	(409)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(100)	(60)	(160)

(a) Hedging Assets and Hedging Liabilities are included in Risk Management Assets and Liabilities on KPCo's condensed balance sheets.

The actual amounts that KPCo 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, 2013, the maximum length of time that KPCo is hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions is 18 months.

Credit Risk

AEPSC, on behalf of KPCo, limits credit risk in KPCo's wholesale marketing and trading activities by assessing the creditworthiness of potential counterparties before entering into transactions with them and continuing to evaluate their creditworthiness on an ongoing basis. AEPSC, on behalf of KPCo, uses Moody's, Standard and Poor's and current market-based qualitative and quantitative data as well as financial statements to assess the financial health of counterparties on an ongoing basis.

When AEPSC, on behalf of KPCo, uses standardized master agreements, these agreements may include collateral requirements. These master agreements facilitate the netting of cash flows associated with a single counterparty. Cash, letters of credit and parental/affiliate guarantees may be obtained as security from counterparties in order to mitigate credit risk. The collateral agreements require a counterparty to post cash or letters of credit in the event an exposure exceeds the established threshold. The threshold represents an unsecured credit limit which may be supported by a parental/affiliate guaranty, as determined in accordance with AEP's credit policy. In addition, collateral agreements allow for termination and liquidation of all positions in the event of a failure or inability to post collateral.

Collateral Triggering Events

Under the tariffs of the RTOs and Independent System Operators (ISOs) and a limited number of derivative and non-derivative contracts primarily related to competitive retail auction loads, KPCo is obligated to post an additional amount of collateral if certain credit ratings decline below investment grade. The amount of collateral required fluctuates based on market prices and total exposure. On an ongoing basis, AEP's risk management organization assesses the appropriateness of these collateral triggering items in contracts. KPCo has not experienced a downgrade below investment grade. The following table represents: (a) KPCo's fair value of such derivative contracts, (b) the amount of collateral KPCo would have been required to post for all derivative and non-derivative contracts if the credit ratings had declined below investment grade and (c) how much was attributable to RTO and ISO activities as of June 30, 2013 and December 31, 2012:

	June 30, 2013	December 31, 2012
	(in thousands)	
Liabilities for Derivative Contracts with Credit Downgrade Triggers	$ 193	$ 432
Amount of Collateral KPCo Would Have Been Required to Post	1,267	741
Amount Attributable to RTO and ISO Activities	1,252	703

In addition, a majority of KPCo's non-exchange traded commodity contracts contain cross-default provisions that, if triggered, would permit the counterparty to declare a default and require settlement of the outstanding payable. These cross-default provisions could be triggered if there was a non-performance event by Parent or the obligor under outstanding debt or a third party obligation in excess of $50 million. On an ongoing basis, AEP's risk management organization assesses the appropriateness of these cross-default provisions in the contracts. The following table represents: (a) the fair value of these derivative liabilities subject to cross-default provisions prior to consideration of contractual netting arrangements, (b) the amount this exposure has been reduced by cash collateral posted by KPCo and (c) if a cross-default provision would have been triggered, the settlement amount that would be required after considering KPCo's contractual netting arrangements as of June 30, 2013 and December 31, 2012:

	June 30, 2013	December 31, 2012
	(in thousands)	
Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements	$ 6,583	$ 9,907
Amount of Cash Collateral Posted	-	365
Additional Settlement Liability if Cross Default Provision is Triggered	5,099	6,041

8. 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. The AEP System's market risk oversight staff independently monitors its valuation policies and procedures and provides members of the Commercial Operations Risk Committee (CORC) various daily, weekly and monthly reports, regarding compliance with policies and procedures. The CORC consists of AEPSC's Chief Operating Officer, Chief Financial Officer, Executive Vice President of Energy Supply, Senior Vice President of Commercial Operations and Chief Risk Officer.

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 nonbinding 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. Illiquid transactions, complex structured transactions, FTRs and counterparty credit risk may require nonmarket based inputs. Some of these inputs may be internally developed or extrapolated and utilized to estimate fair value. When such inputs have a significant impact on the measurement of fair value, the instrument is categorized as Level 3. The main driver of the contracts being classified as Level 3 is the inability to substantiate energy price curves in the market. A significant portion of the Level 3 instruments have been economically hedged which greatly limits potential earnings volatility.

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 classified as Level 2 measurement inputs. 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 KPCo's Long-term Debt as of June 30, 2013 and December 31, 2012 are summarized in the following table:

	June 30, 2013		December 31, 2012	
	Book Value	Fair Value	Book Value	Fair Value
	(in thousands)			
Long-term Debt	$ 549,305	$ 658,719	$ 549,222	$ 708,566

Fair Value Measurements of Financial Assets and Liabilities

The following tables set forth, by level within the fair value hierarchy, KPCo's financial assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2013 and December 31, 2012. 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, 2013

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in thousands)		
Risk Management Assets					
Risk Management Commodity Contracts (a) (b)	$ 526	$ 22,346	$ 3,199	$ (15,387)	$ 10,684
Cash Flow Hedges:					
Commodity Hedges (a)	-	205	-	(88)	117
Total Risk Management Assets	$ 526	$ 22,551	$ 3,199	$ (15,475)	$ 10,801
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a) (b)	$ 304	$ 21,128	$ 525	$ (16,310)	$ 5,647
Cash Flow Hedges:					
Commodity Hedges (a)	-	149	-	(88)	61
Total Risk Management Liabilities	$ 304	$ 21,277	$ 525	$ (16,398)	$ 5,708

Assets and Liabilities Measured at Fair Value on a Recurring Basis
December 31, 2012

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in thousands)		
Risk Management Assets					
Risk Management Commodity Contracts (a) (b)	$ 833	$ 33,315	$ 3,417	$ (24,571)	$ 12,994
Cash Flow Hedges:					
Commodity Hedges (a)	-	103	-	(40)	63
Total Risk Management Assets	$ 833	$ 33,418	$ 3,417	$ (24,611)	$ 13,057
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a) (b)	$ 392	$ 31,665	$ 1,218	$ (26,527)	$ 6,748
Cash Flow Hedges:					
Commodity Hedges (a)	-	312	-	(40)	272
Total Risk Management Liabilities	$ 392	$ 31,977	$ 1,218	$ (26,567)	$ 7,020

(a) 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."
(b) Substantially comprised of power contracts.

There were no transfers between Level 1 and Level 2 during the three and six months ended June 30, 2013 and 2012.

The following tables set forth a reconciliation of changes in the fair value of net trading derivatives and other investments classified as Level 3 in the fair value hierarchy:

Three Months Ended June 30, 2013	Net Risk Management Assets (Liabilities)	
	(in thousands)	
Balance as of March 31, 2013	$	1,804
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)		(76)
Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets) Relating to Assets Still Held at the Reporting Date (a)		-
Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income		-
Purchases, Issuances and Settlements (c)		132
Transfers into Level 3 (d) (e)		50
Transfers out of Level 3 (e) (f)		(75)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)		839
Balance as of June 30, 2013	$	2,674

Three Months Ended June 30, 2012	Net Risk Management Assets (Liabilities)	
	(in thousands)	
Balance as of March 31, 2012	$	1,599
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)		(643)
Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets) Relating to Assets Still Held at the Reporting Date (a)		-
Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income		(2)
Purchases, Issuances and Settlements (c)		999
Transfers into Level 3 (d) (e)		261
Transfers out of Level 3 (e) (f)		(112)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)		475
Balance as of June 30, 2012	$	2,577

Six Months Ended June 30, 2013		Net Risk Management Assets (Liabilities)
		(in thousands)
Balance as of December 31, 2012	$	2,199
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)		(725)
Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets) Relating to Assets Still Held at the Reporting Date (a)		-
Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income		-
Purchases, Issuances and Settlements (c)		591
Transfers into Level 3 (d) (e)		177
Transfers out of Level 3 (e) (f)		(191)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)		623
Balance as of June 30, 2013	$	2,674

Six Months Ended June 30, 2012		Net Risk Management Assets (Liabilities)
		(in thousands)
Balance as of December 31, 2011	$	416
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)		(1,100)
Unrealized Gain (Loss) Included in Net Income (or Changes in Net Assets) Relating to Assets Still Held at the Reporting Date (a)		-
Realized and Unrealized Gains (Losses) Included in Other Comprehensive Income		11
Purchases, Issuances and Settlements (c)		2,367
Transfers into Level 3 (d) (e)		743
Transfers out of Level 3 (e) (f)		(984)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)		1,124
Balance as of June 30, 2012	$	2,577

(a) Included in revenues on KPCo's condensed statements of income.
(b) Represents the change in fair value between the beginning of the reporting period and the settlement of the risk management commodity contract.
(c) Represents the settlement of risk management commodity contracts for the reporting period.
(d) Represents existing assets or liabilities that were previously categorized as Level 2.
(e) Transfers are recognized based on their value at the beginning of the reporting period that the transfer occurred.
(f) Represents existing assets or liabilities that were previously categorized as Level 3.
(g) Relates to the net gains (losses) of those contracts that are not reflected on KPCo's condensed statements of income. These net gains (losses) are recorded as regulatory liabilities/assets.

The following table quantifies the significant unobservable inputs used in developing the fair value of Level 3 positions as of June 30, 2013:

	Fair Value		Valuation	Significant	Forward Price Range	
	Assets	Liabilities	Technique	Unobservable Input (a)	Low	High
	(in thousands)					
Energy Contracts	$ 2,436	$ 332	Discounted Cash Flow	Forward Market Price	$ 11.48	$ 70.90
FTRs	763	193	Discounted Cash Flow	Forward Market Price	(12.31)	11.19
Total	$ 3,199	$ 525				

(a) Represents market prices in dollars per MWh.

9. INCOME TAXES

AEP System Tax Allocation Agreement

KPCo 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.

Federal and State Income Tax Audit Status

The IRS examination of years 2009 and 2010 started in October 2011 and was completed in the second quarter of 2013. The completion of the federal audit did not result in 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, KPCo 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 materially impact net income.

KPCo and other AEP subsidiaries file income tax returns in various state and local jurisdictions. These taxing authorities routinely examine the tax returns and KPCo 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. KPCo is no longer subject to state or local income tax examinations by tax authorities for years before 2008.

10. FINANCING ACTIVITIES

Long-term Debt

KPCo did not have any long-term debt issuances or retirements during the first six months of 2013.

In July 2013, AEPGenCo, APCo, KPCo and OPCo entered into a $1 billion term credit facility due in May 2015 to provide liquidity during the corporate separation process. Under the credit facility, OPCo may assign borrowings to AEPGenCo upon the transfer of OPCo's generation assets to AEPGenCo. Subject to regulatory approval, AEPGenCo may further assign a portion of the borrowings to APCo and KPCo, not to exceed $500 million and $250 million, respectively, upon AEPGenCo's subsequent transfer of certain of those generation assets to APCo and KPCo.

Dividend Restrictions

KPCo pays dividends to Parent provided funds are legally available. Various financing arrangements and regulatory requirements may impose certain restrictions on the ability of KPCo to transfer funds to Parent in the form of dividends.

Federal Power Act

The Federal Power Act prohibits KPCo 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 book value of the common stock. This restriction does not limit the ability of KPCo to pay dividends out of retained earnings.

Leverage Restrictions

Pursuant to the credit agreement leverage restrictions, KPCo must maintain a percentage of debt to total capitalization at a level that does not exceed 67.5%.

Utility Money Pool – AEP System

The AEP System uses a corporate borrowing program to meet the short-term borrowing needs of AEP's subsidiaries. The corporate borrowing program includes a Utility Money Pool, which funds AEP's utility subsidiaries. The AEP System Utility Money Pool operates in accordance with the terms and conditions of the AEP System Utility Money Pool agreement filed with the FERC. The amounts of outstanding loans to (borrowings from) the Utility Money Pool as of June 30, 2013 and December 31, 2012 are included in Advances to Affiliates and Advances from Affiliates, respectively, on KPCo's condensed balance sheets. KPCo's Utility Money Pool activity and corresponding authorized borrowing limits for the six months ended June 30, 2013 are described in the following table:

Maximum Borrowings from the Utility Money Pool	Maximum Loans to the Utility Money Pool	Average Borrowings from the Utility Money Pool	Average Loans to the Utility Money Pool	Loans to the Utility Money Pool as of June 30, 2013	Authorized Short-Term Borrowing Limit
		(in thousands)			
$ 32,649	$ 27,164	$ 11,271	$ 14,234	$ 4,600	$ 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, 2013 and 2012 are summarized in the following table:

Six Months Ended June 30,	Maximum Interest Rate for Funds Borrowed from the Utility Money Pool	Minimum Interest Rate for Funds Borrowed from the Utility Money Pool	Maximum Interest Rate for Funds Loaned to the Utility Money Pool	Minimum Interest Rate 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
2013	0.43 %	0.35 %	0.36 %	0.32 %	0.38 %	0.34 %
2012	- %	- %	0.56 %	0.45 %	- %	0.49 %

Sale of Receivables – AEP Credit

Under a sale of receivables arrangement, KPCo sells, without recourse, certain of its customer accounts receivable and accrued unbilled revenue balances to AEP Credit and is charged a fee based on AEP Credit's financing costs, administrative costs and uncollectible accounts experience for KPCo's receivables. The costs of customer accounts receivable sold are reported in Other Operation expense on KPCo's condensed statements of income. KPCo manages and services its accounts receivable sold.

In June 2013, AEP Credit amended its receivables securitization agreement. The agreement provides a commitment of $700 million from bank conduits to purchase receivables. AEP Credit amended a commitment of $385 million to now expire in June 2014. The remaining commitment of $315 million expires in June 2015.

KPCo's amount of accounts receivable and accrued unbilled revenues sold under the sale of receivables agreement was $41 million and $46 million as of June 30, 2013 and December 31, 2012, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold for the three months ended June 30, 2013 and 2012 were $481 thousand and $597 thousand, respectively, and for the six months ended June 30, 2013 and 2012 were $1 million and $1.3 million, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit for the three months ended June 30, 2013 and 2012 were $128 million and $114 million, respectively, and for the six months ended June 30, 2013 and 2012 were $268 million and $265 million, respectively.

11. 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 KPCo is the primary beneficiary of a VIE, management considers factors such as equity at risk, the amount of the VIE's variability KPCo absorbs, guarantees of indebtedness, voting rights including kick-out rights, the power to direct the VIE, variable interests held by related parties and other factors. Management believes that significant assumptions and judgments were applied consistently. KPCo is not the primary beneficiary of any VIE and has not provided financial or other support to any VIE that was not previously contractually required.

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. KPCo's total billings from AEPSC for the three months ended June 30, 2013 and 2012 were both $8 million and for the six months ended June 30, 2013 and 2012 were both $15 million. The carrying amount of liabilities associated with AEPSC as of June 30, 2013 and December 31, 2012 was $2 million and $6 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

AEGCo, a wholly-owned subsidiary of AEP, is consolidated by AEP. AEGCo owns a 50% ownership interest in Rockport Plant, Unit 1 and leases a 50% interest in Rockport Plant, Unit 2. AEGCo sells all the output from the Rockport Plant to I&M and KPCo. AEP guarantees all the debt obligations of AEGCo. KPCo is considered to have a significant interest in AEGCo due to its transactions. KPCo is exposed to losses to the extent it cannot recover the costs of AEGCo through its normal business operations. Due to AEP management's control over AEGCo, KPCo is not considered the primary beneficiary of AEGCo. In the event AEGCo would require financing or other support outside the billings to KPCo, this financing would be provided by AEP. Total billings from AEGCo for the three months ended June 30, 2013 and 2012 were both $23 million and for the six months ended June 30, 2013 and 2012 were both $48 million. The carrying amount of liabilities associated with AEGCo as of June 30, 2013 and December 31, 2012 was $8 million and $10 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

12. SUSTAINABLE COST REDUCTIONS

In April 2012, management initiated a process to identify strategic repositioning opportunities and efficiencies that will result in sustainable cost savings. Management selected a consulting firm to facilitate an organizational and process evaluation and a second firm to evaluate current employee benefit programs. The process resulted in involuntary severances and was completed by the end of the first quarter of 2013. The severance program provides two weeks of base pay for every year of service along with other severance benefits.

KPCo recorded a charge of $1.7 million to Other Operation expense in 2012 primarily related to severance benefits as a result of the sustainable cost reductions initiative. In addition, the sustainable cost reduction activity for the six months ended June 30, 2013 is described in the following table:

Balance as of December 31, 2012	Expense Allocation from AEPSC	Incurred	Settled	Adjustments	Remaining Balance as of June 30, 2013
		(in thousands)			
$ 497	$ 230	$ -	$ (327)	$ (400)	$ -

These expenses, net of adjustments, relate primarily to severance benefits and are included primarily in Other Operation expense on the condensed statements of income. Management does not expect additional costs to be incurred related to this initiative.