

# Kentucky Power Company

2016 Second Quarter Report

Financial Statements





## TABLE OF CONTENTS

---

## Page Number

---

Glossary of Terms	1
Condensed Statements of Income – Unaudited	2
Condensed Statements of Comprehensive Income (Loss) – Unaudited	3
Condensed Statements of Changes in Common Shareholder’s Equity – Unaudited	4
Condensed Balance Sheets – Unaudited	5
Condensed Statements of Cash Flows – Unaudited	7
Index of Condensed Notes to Condensed Financial Statements – Unaudited	8

## 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	American Electric Power Company, Inc., an investor-owned electric public utility holding company which includes American Electric Power Company, Inc. (Parent) and majority owned consolidated subsidiaries and consolidated affiliates.
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 System	American Electric Power System, an electric system, owned and operated by AEP 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.
ASU	Accounting Standards Update.
ESP	Electric Security Plans, a PUCO requirement for electric utilities to adjust their rates by filing with the PUCO.
FASB	Financial Accounting Standards Board.
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.
I&M	Indiana Michigan Power Company, an AEP electric utility subsidiary.
IRS	Internal Revenue Service.
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.
Parent	American Electric Power Company, Inc., the equity owner of AEP subsidiaries within the AEP consolidation.
PUCO	Public Utilities Commission of Ohio.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
Rockport Plant	A generation plant, consisting of two 1,310 MW coal-fired generating units near Rockport, Indiana. AEGCo and I&M jointly-own Unit 1. In 1989, AEGCo and I&M entered into a sale-and-leaseback transaction with Wilmington Trust Company, an unrelated, unconsolidated trustee for Rockport Plant, Unit 2.
RTO	Regional Transmission Organization, responsible for moving electricity over large interstate areas.
SSO	Standard service offer.
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, 2016 and 2015**  
**(in thousands)**  
**(Unaudited)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
<b>REVENUES</b>				
Electric Generation, Transmission and Distribution	\$ 144,318	\$ 148,503	\$ 308,613	\$ 348,403
Sales to AEP Affiliates	1,658	2,577	4,821	3,934
Other Revenues	224	196	437	388
<b>TOTAL REVENUES</b>	<b>146,200</b>	<b>151,276</b>	<b>313,871</b>	<b>352,725</b>
<b>EXPENSES</b>				
Fuel and Other Consumables Used for Electric Generation	23,805	37,586	52,645	106,785
Purchased Electricity for Resale	11,146	6,165	24,961	17,961
Purchased Electricity from AEP Affiliates	24,001	25,711	43,463	49,268
Other Operation	22,873	19,749	42,843	40,080
Maintenance	16,767	18,896	34,444	37,185
Depreciation and Amortization	20,275	23,508	41,341	48,249
Taxes Other Than Income Taxes	5,215	5,395	11,025	10,999
<b>TOTAL EXPENSES</b>	<b>124,082</b>	<b>137,010</b>	<b>250,722</b>	<b>310,527</b>
<b>OPERATING INCOME</b>	<b>22,118</b>	<b>14,266</b>	<b>63,149</b>	<b>42,198</b>
<b>Other Income (Expense):</b>				
Interest Income	443	93	367	112
Allowance for Equity Funds Used During Construction	282	388	687	454
Interest Expense	(11,056)	(11,183)	(22,300)	(22,220)
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	<b>11,787</b>	<b>3,564</b>	<b>41,903</b>	<b>20,544</b>
Income Tax Expense	2,900	1,256	13,213	7,238
<b>NET INCOME</b>	<b>\$ 8,887</b>	<b>\$ 2,308</b>	<b>\$ 28,690</b>	<b>\$ 13,306</b>

*The common stock of KPCo is wholly-owned by Parent.*

*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, 2016 and 2015**  
**(in thousands)**  
**(Unaudited)**

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
Net Income	<u>\$ 8,887</u>	<u>\$ 2,308</u>	<u>\$ 28,690</u>	<u>\$ 13,306</u>
<b>OTHER COMPREHENSIVE INCOME, NET OF TAXES</b>				
Cash Flow Hedges, Net of Tax of \$8 and \$8 for the Three Months Ended June 30, 2016 and 2015, Respectively, and \$16 and \$16 for the Six Months Ended June 30, 2016 and 2015, Respectively	15	15	30	30
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$3 and \$9 for the Three Months Ended June 30, 2016 and 2015, Respectively, and \$5 and \$18 for the Six Months Ended June 30, 2016 and 2015, Respectively	<u>5</u>	<u>17</u>	<u>9</u>	<u>33</u>
<b>TOTAL OTHER COMPREHENSIVE INCOME</b>	<u>20</u>	<u>32</u>	<u>39</u>	<u>63</u>
<b>TOTAL COMPREHENSIVE INCOME</b>	<u>\$ 8,907</u>	<u>\$ 2,340</u>	<u>\$ 28,729</u>	<u>\$ 13,369</u>

*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, 2016 and 2015**  
**(in thousands)**  
**(Unaudited)**

	<b>Common Stock</b>	<b>Paid-in Capital</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Total</b>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2014</b>	\$ 50,450	\$ 517,460	\$ 103,069	\$ (7,336)	\$ 663,643
Common Stock Dividends			(22,000)		(22,000)
Net Income			13,306		13,306
Other Comprehensive Income				63	63
Pension and OPEB Adjustment Related to Mitchell Plant				5,174	5,174
<b>TOTAL COMMON SHAREHOLDER'S EQUITY - JUNE 30, 2015</b>	<u>\$ 50,450</u>	<u>\$ 517,460</u>	<u>\$ 94,375</u>	<u>\$ (2,099)</u>	<u>\$ 660,186</u>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2015</b>	\$ 50,450	\$ 527,309	\$ 86,960	\$ (1,645)	\$ 663,074
Common Stock Dividends			(22,000)		(22,000)
Net Income			28,690		28,690
Other Comprehensive Income				39	39
<b>TOTAL COMMON SHAREHOLDER'S EQUITY - JUNE 30, 2016</b>	<u>\$ 50,450</u>	<u>\$ 527,309</u>	<u>\$ 93,650</u>	<u>\$ (1,606)</u>	<u>\$ 669,803</u>

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

**KENTUCKY POWER COMPANY**  
**CONDENSED BALANCE SHEETS**  
**ASSETS**  
**June 30, 2016 and December 31, 2015**  
**(in thousands)**  
**(Unaudited)**

	<b>June 30,</b>	<b>December 31,</b>
	<b>2016</b>	<b>2015</b>
<b>CURRENT ASSETS</b>		
Cash and Cash Equivalents	\$ 1,053	\$ 867
Accounts Receivable:		
Customers	14,656	13,747
Affiliated Companies	19,867	20,373
Accrued Unbilled Revenues	2,078	53
Miscellaneous	2,324	110
Allowance for Uncollectible Accounts	(69)	(243)
Total Accounts Receivable	<u>38,856</u>	<u>34,040</u>
Fuel	21,317	22,085
Materials and Supplies	16,359	26,705
Risk Management Assets – Nonaffiliated	1,016	2,869
Risk Management Assets – Affiliated	15	173
Accrued Tax Benefits	10,953	47,812
Prepayments and Other Current Assets	4,366	4,623
<b>TOTAL CURRENT ASSETS</b>	<u>93,935</u>	<u>139,174</u>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Electric:		
Generation	1,185,691	1,118,837
Transmission	571,523	568,963
Distribution	769,764	756,631
Other Property, Plant and Equipment	63,081	58,294
Construction Work in Progress	19,252	59,351
<b>Total Property, Plant and Equipment</b>	<u>2,609,311</u>	<u>2,562,076</u>
Accumulated Depreciation and Amortization	865,326	847,675
<b>TOTAL PROPERTY, PLANT AND EQUIPMENT – NET</b>	<u>1,743,985</u>	<u>1,714,401</u>
<b>OTHER NONCURRENT ASSETS</b>		
Regulatory Assets	563,047	557,956
Long-term Risk Management Assets – Nonaffiliated	61	12
Employee Benefits and Pension Assets	7,680	6,939
Deferred Charges and Other Noncurrent Assets	19,503	17,774
<b>TOTAL OTHER NONCURRENT ASSETS</b>	<u>590,291</u>	<u>582,681</u>
<b>TOTAL ASSETS</b>	<u>\$ 2,428,211</u>	<u>\$ 2,436,256</u>

*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, 2016 and December 31, 2015**  
**(Unaudited)**

	<b>June 30, 2016</b>	<b>December 31, 2015</b>
<b>(in thousands)</b>		
<b>CURRENT LIABILITIES</b>		
Advances from Affiliates	\$ 16,274	\$ 18,692
Accounts Payable:		
General	31,361	36,882
Affiliated Companies	25,694	25,139
Long-term Debt Due Within One Year – Nonaffiliated	65,000	65,000
Risk Management Liabilities – Nonaffiliated	896	1,002
Customer Deposits	26,732	26,916
Accrued Taxes	18,033	26,867
Accrued Interest	8,050	7,928
Regulatory Liability for Over-Recovered Fuel Costs	—	1,553
Other Current Liabilities	39,619	49,557
<b>TOTAL CURRENT LIABILITIES</b>	<b>231,659</b>	<b>259,536</b>
<b>NONCURRENT LIABILITIES</b>		
Long-term Debt – Nonaffiliated	801,809	801,451
Long-term Risk Management Liabilities – Nonaffiliated	47	11
Deferred Income Taxes	653,525	636,158
Regulatory Liabilities and Deferred Investment Tax Credits	147	1,608
Asset Retirement Obligations	54,862	55,151
Employee Benefits and Pension Obligations	10,726	13,536
Deferred Credits and Other Noncurrent Liabilities	5,633	5,731
<b>TOTAL NONCURRENT LIABILITIES</b>	<b>1,526,749</b>	<b>1,513,646</b>
<b>TOTAL LIABILITIES</b>	<b>1,758,408</b>	<b>1,773,182</b>
Rate Matters (Note 4)		
Commitments and Contingencies (Note 5)		
<b>COMMON SHAREHOLDER'S EQUITY</b>		
Common Stock – Par Value – \$50 Per Share:		
Authorized – 2,000,000 Shares		
Outstanding – 1,009,000 Shares	50,450	50,450
Paid-in Capital	527,309	527,309
Retained Earnings	93,650	86,960
Accumulated Other Comprehensive Income (Loss)	(1,606)	(1,645)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY</b>	<b>669,803</b>	<b>663,074</b>
<b>TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY</b>	<b>\$ 2,428,211</b>	<b>\$ 2,436,256</b>

*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, 2016 and 2015**  
(in thousands)  
(Unaudited)

	<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>
<b>OPERATING ACTIVITIES</b>		
<b>Net Income</b>	\$ 28,690	\$ 13,306
<b>Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:</b>		
Depreciation and Amortization	41,341	48,249
Deferred Income Taxes	14,711	43,286
Allowance for Equity Funds Used During Construction	(687)	(454)
Mark-to-Market of Risk Management Contracts	1,894	(1,059)
Pension Contributions to Qualified Plan Trust	(1,509)	(1,900)
Property Taxes	7,681	7,164
Fuel Over/Under-Recovery, Net	(1,951)	(3,977)
Provision for Refund	—	(13,155)
Change in Other Noncurrent Assets	(17,535)	(6,868)
Change in Other Noncurrent Liabilities	(1,620)	2,551
<b>Changes in Certain Components of Working Capital:</b>		
Accounts Receivable, Net	(4,816)	16,543
Fuel, Materials and Supplies	2,310	26,667
Accounts Payable	486	(7,872)
Accrued Taxes, Net	27,997	(38,699)
Other Current Assets	(177)	638
Other Current Liabilities	(8,746)	(9,815)
<b>Net Cash Flows from Operating Activities</b>	<b>88,069</b>	<b>74,605</b>
<b>INVESTING ACTIVITIES</b>		
Construction Expenditures	(63,964)	(59,866)
Other Investing Activities	810	861
<b>Net Cash Flows Used for Investing Activities</b>	<b>(63,154)</b>	<b>(59,005)</b>
<b>FINANCING ACTIVITIES</b>		
Issuance of Long-term Debt – Nonaffiliated	—	24,546
Change in Advances from Affiliates, Net	(2,418)	(17,952)
Principal Payments for Capital Lease Obligations	(476)	(550)
Dividends Paid on Common Stock	(22,000)	(22,000)
Other Financing Activities	165	76
<b>Net Cash Flows Used for Financing Activities</b>	<b>(24,729)</b>	<b>(15,880)</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>186</b>	<b>(280)</b>
<b>Cash and Cash Equivalents at Beginning of Period</b>	<b>867</b>	<b>795</b>
<b>Cash and Cash Equivalents at End of Period</b>	<b>\$ 1,053</b>	<b>\$ 515</b>
<b>SUPPLEMENTARY INFORMATION</b>		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 21,733	\$ 21,718
Net Cash Paid (Received) for Income Taxes	(36,639)	106
Noncash Acquisitions Under Capital Leases	470	132
Construction Expenditures Included in Current Liabilities as of June 30,	7,723	11,081

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

## INDEX OF CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

	<b>Page Number</b>
Significant Accounting Matters	9
New Accounting Pronouncements	10
Comprehensive Income	12
Rate Matters	14
Commitments, Guarantees and Contingencies	15
Benefit Plans	16
Business Segments	17
Derivatives and Hedging	18
Fair Value Measurements	24
Income Taxes	28
Financing Activities	29
Variable Interest Entities	31

## **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, 2016 is not necessarily indicative of results that may be expected for the year ending December 31, 2016. The condensed financial statements are unaudited and should be read in conjunction with the audited 2015 financial statements and notes thereto, which are included in KPCo's 2015 Annual Report.

Management reviewed subsequent events through July 28, 2016, the date that the second quarter 2016 report was issued.

## **2. NEW ACCOUNTING PRONOUNCEMENTS**

Upon issuance of final pronouncements, management reviews the new accounting literature to determine its relevance, if any, to KPCo's business. The following final pronouncements will impact the financial statements.

### ***ASU 2014-09 "Revenue from Contracts with Customers" (ASU 2014-09)***

In May 2014, the FASB issued ASU 2014-09 clarifying the method used to determine the timing and requirements for revenue recognition on the statements of income. Under the new standard, an entity must identify the performance obligations in a contract, determine the transaction price and allocate the price to specific performance obligations to recognize the revenue when the obligation is completed. The amendments in this update also require disclosure of sufficient information to allow users to understand the nature, amount, timing and uncertainty of revenue and cash flow arising from contracts.

The FASB deferred implementation of ASU 2014-09 under the terms in ASU 2015-14, "Revenue from Contracts with Customers (Topic: 606): Deferral of the Effective Date." The new accounting guidance is effective for interim and annual periods beginning after December 15, 2017. Early adoption is permitted for annual periods beginning after December 15, 2016. As applicable, this standard may change the amount of revenue recognized on the statements of income in each reporting period. Management is analyzing the impact of this new standard and the related ASUs that clarify guidance in the standard. At this time, management cannot estimate the impact of adoption on revenue or net income. Management plans to adopt ASU 2014-09 effective January 1, 2018.

### ***ASU 2015-11 "Simplifying the Measurement of Inventory" (ASU 2015-11)***

In July 2015, the FASB issued ASU 2015-11 simplifying the guidance on the subsequent measurement of inventory, excluding inventory measured using last-in, first-out or the retail inventory method. Under the new standard, inventory should be at the lower of cost and net realizable value. The new accounting guidance is effective for interim and annual periods beginning after December 15, 2016 with early adoption permitted. Management does not expect the new standard to impact KPCo's results of operations, financial position or cash flows. Management plans to adopt ASU 2015-11 prospectively, effective January 1, 2017.

### ***ASU 2016-01 "Recognition and Measurement of Financial Assets and Financial Liabilities" (ASU 2016-01)***

In January 2016, the FASB issued ASU 2016-01 enhancing the reporting model for financial instruments. Under the new standard, equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) are required to be measured at fair value with changes in fair value recognized in net income. The new standard also amends disclosure requirements and requires separate presentation of financial assets and liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. The amendments also clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for sale securities in combination with the entity's other deferred tax assets.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2017 with early adoption permitted. The amendments will be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption on net income. Management plans to adopt ASU 2016-01 effective January 1, 2018.

### ***ASU 2016-02 “Accounting for Leases” (ASU 2016-02)***

In February 2016, the FASB issued ASU 2016-02 increasing the transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Under the new standard, an entity must recognize an asset and liability for operating leases on the balance sheets. Additionally, a capital lease will be known as a finance lease going forward. Leases with lease terms of 12 months or longer will be subject to the new requirements. Fundamentally, the criteria used to determine lease classification will remain the same, but will be more subjective under the new standard.

The new accounting guidance is effective for annual periods beginning after December 15, 2018 with early adoption permitted. The guidance will be applied by means of a modified retrospective approach. The modified retrospective approach will require lessees and lessors to recognize and measure leases at the beginning of the earliest period presented as well as a number of optional practical expedients that entities may elect to apply. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption. Management expects the new standard to impact KPCo’s financial position, but not KPCo’s results of operations or cash flows. Management plans to adopt ASU 2016-02 effective January 1, 2019.

### ***ASU 2016-09 “Compensation – Stock Compensation” (ASU 2016-09)***

In March 2016, the FASB issued ASU 2016-09 simplifying the accounting for share-based payment transactions including the income tax consequences, classification of awards as either equity or liabilities and classification on the statements of cash flows. Under the new standard, all excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) should be recognized as income tax expense or benefit on the statements of income. Under current GAAP, excess tax benefits are recognized in additional paid-in capital while tax deficiencies are recognized either as an offset to accumulated excess tax benefits, if any, or on the statements of income.

The new accounting guidance is effective for annual periods beginning after December 15, 2016. Early adoption is permitted in any interim or annual period. Certain provisions require retrospective/modified retrospective transition while others are to be applied prospectively. Management plans to adopt ASU 2016-09 effective January 1, 2017.

### ***ASU 2016-13 “Measurement of Credit Losses on Financial Instruments” (ASU 2016-13)***

In June 2016, the FASB issued ASU 2016-13 requiring an allowance to be recorded for all expected credit losses for financial assets. The allowance for credit losses is based on historical information, current conditions and reasonable and supportable forecasts. The new standard also makes revisions to the other than temporary impairment model for available-for-sale debt securities. Disclosures of credit quality indicators in relation to the amortized cost of financing receivables are further disaggregated by year of origination.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2019 with early adoption permitted for interim and annual periods beginning after December 15, 2018. The amendments will be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. Management is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption on net income. Management plans to adopt ASU 2016-13 effective January 1, 2020.

### 3. COMPREHENSIVE INCOME

#### *Presentation of Comprehensive Income*

The following tables provide the components of changes in AOCI and details of reclassifications from AOCI for the three and six months ended June 30, 2016 and 2015. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 6 for additional details.

#### **Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended June 30, 2016**

	<u>Cash Flow Hedges</u>		<u>Pension and OPEB</u>	<u>Total</u>
	<u>Interest Rate and Foreign Currency</u>			
	(in thousands)			
<b>Balance in AOCI as of March 31, 2016</b>	\$ (86)	\$ (1,540)		\$ (1,626)
Change in Fair Value Recognized in AOCI	—	—		—
Amount of (Gain) Loss Reclassified from AOCI				
Interest Expense	23	—		23
Amortization of Prior Service Cost (Credit)	—	(56)		(56)
Amortization of Actuarial (Gains)/Losses	—	62		62
Reclassifications from AOCI, before Income Tax (Expense) Credit	23	6		29
Income Tax (Expense) Credit	8	1		9
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	15	5		20
Net Current Period Other Comprehensive Income (Loss)	15	5		20
<b>Balance in AOCI as of June 30, 2016</b>	<u>\$ (71)</u>	<u>\$ (1,535)</u>		<u>\$ (1,606)</u>

#### **Changes in Accumulated Other Comprehensive Income (Loss) by Component For the Three Months Ended June 30, 2015**

	<u>Cash Flow Hedges</u>		<u>Pension and OPEB</u>	<u>Total</u>
	<u>Interest Rate and Foreign Currency</u>			
	(in thousands)			
<b>Balance in AOCI as of March 31, 2015</b>	\$ (146)	\$ (1,985)		\$ (2,131)
Change in Fair Value Recognized in AOCI	—	—		—
Amount of (Gain) Loss Reclassified from AOCI				
Interest Expense	23	—		23
Amortization of Prior Service Cost (Credit)	—	(10)		(10)
Amortization of Actuarial (Gains)/Losses	—	36		36
Reclassifications from AOCI, before Income Tax (Expense) Credit	23	26		49
Income Tax (Expense) Credit	8	9		17
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	15	17		32
Net Current Period Other Comprehensive Income (Loss)	15	17		32
<b>Balance in AOCI as of June 30, 2015</b>	<u>\$ (131)</u>	<u>\$ (1,968)</u>		<u>\$ (2,099)</u>

**Changes in Accumulated Other Comprehensive Income (Loss) by Component  
For the Six Months Ended June 30, 2016**

	<u>Cash Flow Hedges</u>		<u>Total</u>
	<u>Interest Rate and Foreign Currency</u>	<u>Pension and OPEB</u>	
	<u>(in thousands)</u>		
<b>Balance in AOCI as of December 31, 2015</b>	\$ (101)	\$ (1,544)	\$ (1,645)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	46	—	46
Amortization of Prior Service Cost (Credit)	—	(111)	(111)
Amortization of Actuarial (Gains)/Losses	—	124	124
Reclassifications from AOCI, before Income Tax (Expense) Credit	46	13	59
Income Tax (Expense) Credit	16	4	20
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	30	9	39
Net Current Period Other Comprehensive Income (Loss)	30	9	39
<b>Balance in AOCI as of June 30, 2016</b>	<u>\$ (71)</u>	<u>\$ (1,535)</u>	<u>\$ (1,606)</u>

**Changes in Accumulated Other Comprehensive Income (Loss) by Component  
For the Six Months Ended June 30, 2015**

	<u>Cash Flow Hedges</u>		<u>Total</u>
	<u>Interest Rate and Foreign Currency</u>	<u>Pension and OPEB</u>	
	<u>(in thousands)</u>		
<b>Balance in AOCI as of December 31, 2014</b>	\$ (161)	\$ (7,175)	\$ (7,336)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	46	—	46
Amortization of Prior Service Cost (Credit)	—	(20)	(20)
Amortization of Actuarial (Gains)/Losses	—	71	71
Reclassifications from AOCI, before Income Tax (Expense) Credit	46	51	97
Income Tax (Expense) Credit	16	18	34
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	30	33	63
Net Current Period Other Comprehensive Income (Loss)	30	33	63
Pension and OPEB Adjustment Related to Mitchell Plant	—	5,174	5,174
<b>Balance in AOCI as of June 30, 2015</b>	<u>\$ (131)</u>	<u>\$ (1,968)</u>	<u>\$ (2,099)</u>



#### 4. RATE MATTERS

As discussed in KPCo's 2015 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within KPCo's 2015 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 2016 and updates KPCo's 2015 Annual Report.

##### *Regulatory Assets Pending Final Regulatory Approval*

<u>Noncurrent Regulatory Assets</u>	<u>June 30, 2016</u>	<u>December 31, 2015</u>
	(in thousands)	
<u>Regulatory Assets Currently Not Earning a Return</u>		
Storm Related Costs	\$ 4,759	\$ 4,377
Other Regulatory Assets Pending Final Regulatory Approval	621	—
<b>Total Regulatory Assets Pending Final Regulatory Approval</b>	<u>\$ 5,380</u>	<u>\$ 4,377</u>

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

## **5. 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 against KPCo cannot be predicted. Management accrues contingent liabilities only when management concludes that it is both probable that a liability has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. When management determines that it is not probable, but rather reasonably possible that a liability has been incurred at the date of the financial statements, management discloses such contingencies and the possible loss or range of loss if such estimate can be made. Any estimated range is based on currently available information and involves elements of judgment and significant uncertainties. Any estimated range of possible loss may not represent the maximum possible loss exposure. Circumstances change over time and actual results may vary significantly from estimates.

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 2015 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.

#### ***Letter of Credit***

KPCo has \$65 million of variable rate Pollution Control Bonds supported by a bilateral letter of credit for \$66 million. The letter of credit matures in June 2017.

#### ***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, 2016, there were no material liabilities recorded for any indemnifications.

KPCo is jointly and severally liable for activity conducted by AEPSC on behalf of AEP companies related to power purchase and sale activity.

##### ***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, 2016, the maximum potential loss for these lease agreements was \$1.6 million assuming the fair value of the equipment is zero at the end of the lease term.

## 6. 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, 2016 and 2015:

	<b>Pension Plans</b>		<b>Other Postretirement Benefit Plans</b>	
	<b>Three Months Ended June 30,</b>		<b>Three Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>			
Service Cost	\$ 615	\$ 670	\$ 70	\$ 86
Interest Cost	1,873	1,831	537	488
Expected Return on Plan Assets	(2,533)	(2,495)	(988)	(1,015)
Amortization of Prior Service Cost (Credit)	13	13	(606)	(606)
Amortization of Net Actuarial Loss	735	947	288	156
<b>Net Periodic Benefit Cost (Credit)</b>	<b>\$ 703</b>	<b>\$ 966</b>	<b>\$ (699)</b>	<b>\$ (891)</b>

	<b>Pension Plans</b>		<b>Other Postretirement Benefit Plans</b>	
	<b>Six Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>			
Service Cost	\$ 1,230	\$ 1,340	\$ 141	\$ 172
Interest Cost	3,745	3,663	1,075	976
Expected Return on Plan Assets	(5,066)	(4,991)	(1,977)	(2,030)
Amortization of Prior Service Cost (Credit)	26	26	(1,212)	(1,212)
Amortization of Net Actuarial Loss	1,471	1,893	575	311
<b>Net Periodic Benefit Cost (Credit)</b>	<b>\$ 1,406</b>	<b>\$ 1,931</b>	<b>\$ (1,398)</b>	<b>\$ (1,783)</b>

## **7. BUSINESS SEGMENTS**

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

## 8. DERIVATIVES AND HEDGING

### OBJECTIVES FOR UTILIZATION OF DERIVATIVE INSTRUMENTS

AEPSC is agent for and transacts on behalf of KPCo.

KPCo is exposed to certain market risks as a major power producer and participant in the electricity, natural gas, coal and emission allowance markets. These risks include commodity price risk, interest rate risk and credit risk. These risks represent the risk of loss that may impact KPCo due to changes in the underlying market prices or rates. Management utilizes derivative instruments to manage these risks.

### 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 which focus on seizing market opportunities to create value driven by expected changes in the market prices of the commodities. To accomplish these objectives, 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.

KPCo utilizes power, capacity, natural gas, interest rate and, to a lesser extent, heating oil, gasoline and other commodity contracts to manage the risk associated with the energy business. KPCo utilizes interest rate derivative contracts in order to manage the interest rate exposure associated with its commodity portfolio. For disclosure purposes, such risks are grouped as “Commodity,” as these risks are related to energy risk management activities. KPCo also utilizes derivative contracts to manage interest rate risk associated with debt financing. 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 the Board of Directors.

The following table represents the gross notional volume of KPCo’s outstanding derivative contracts as of June 30, 2016 and December 31, 2015:

#### Notional Volume of Derivative Instruments

Primary Risk Exposure	Volume		Unit of Measure
	June 30, 2016	December 31, 2015	
	(in thousands)		
Commodity:			
Power	17,649	7,864	MWhs
Natural Gas	40	64	MMBtus
Heating Oil and Gasoline	410	341	Gallons
Interest Rate	\$ 243	\$ 500	USD

## *Cash Flow Hedging Strategies*

KPCo utilizes cash flow hedges on certain derivative transactions for the purchase and sale of power (“Commodity”) in order to manage the variable price risk related to forecasted purchases and sales. 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 purchases. KPCo does not hedge all commodity price risk.

KPCo utilizes a variety of interest rate derivative transactions in order to manage interest rate risk exposure. KPCo also utilizes interest rate derivative contracts to manage interest rate exposure related to future borrowings of fixed-rate debt. KPCo does not hedge all interest rate 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 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 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, 2016 and December 31, 2015 balance sheets, KPCo netted \$76 thousand and \$0, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and \$209 thousand and \$656 thousand, 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 of KPCo's derivative activity on the balance sheets as of June 30, 2016 and December 31, 2015:

**Fair Value of Derivative Instruments  
June 30, 2016**

<b>Balance Sheet Location</b>	<b>Risk Management Contracts - Commodity (a)</b>	<b>Gross Amounts Offset in the Statement of Financial Position (b)</b>	<b>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</b>
		(in thousands)	
Current Risk Management Assets - Nonaffiliated and Affiliated	\$ 4,300	\$ (3,269)	\$ 1,031
Long-term Risk Management Assets - Nonaffiliated	142	(81)	61
<b>Total Assets</b>	<b>4,442</b>	<b>(3,350)</b>	<b>1,092</b>
Current Risk Management Liabilities - Nonaffiliated	4,298	(3,402)	896
Long-term Risk Management Liabilities - Nonaffiliated	128	(81)	47
<b>Total Liabilities</b>	<b>4,426</b>	<b>(3,483)</b>	<b>943</b>
<b>Total MTM Derivative Contract Net Assets</b>	<b>\$ 16</b>	<b>\$ 133</b>	<b>\$ 149</b>

**Fair Value of Derivative Instruments  
December 31, 2015**

<b>Balance Sheet Location</b>	<b>Risk Management Contracts - Commodity (a)</b>	<b>Gross Amounts Offset in the Statement of Financial Position (b)</b>	<b>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</b>
		(in thousands)	
Current Risk Management Assets - Nonaffiliated and Affiliated	\$ 5,017	\$ (1,975)	\$ 3,042
Long-term Risk Management Assets - Nonaffiliated	59	(47)	12
<b>Total Assets</b>	<b>5,076</b>	<b>(2,022)</b>	<b>3,054</b>
Current Risk Management Liabilities - Nonaffiliated	3,621	(2,619)	1,002
Long-term Risk Management Liabilities - Nonaffiliated	69	(58)	11
<b>Total Liabilities</b>	<b>3,690</b>	<b>(2,677)</b>	<b>1,013</b>
<b>Total MTM Derivative Contract Net Assets</b>	<b>\$ 1,386</b>	<b>\$ 655</b>	<b>\$ 2,041</b>

- (a) Derivative instruments within this category are reported gross. These instruments are subject to master netting agreements and are presented on the 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, 2016 and 2015:

**Amount of Gain (Loss) Recognized on  
Risk Management Contracts  
For the Three and Six Months Ended June 30, 2016 and 2015**

<u>Location of Gain (Loss)</u>	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
	(in thousands)			
Electric Generation, Transmission and Distribution Revenues	\$ 111	\$ 310	\$ (52)	\$ 2,157
Sales to AEP Affiliates	139	249	429	249
Other Operation Expense	(8)	(21)	(33)	(52)
Maintenance Expense	(20)	(29)	(57)	(71)
Purchased Electricity for Resale	710	319	1,439	2,573
Fuel and Other Consumables Used for Electric Generation	—	(4)	—	(13)
Regulatory Assets (a)	103	(301)	145	(267)
Regulatory Liabilities (a)	(633)	4,176	(444)	545
<b>Total Gain on Risk Management Contracts</b>	<u>\$ 402</u>	<u>\$ 4,699</u>	<u>\$ 1,427</u>	<u>\$ 5,121</u>

(a) Represents realized and unrealized gains and losses subject to regulatory accounting treatment recorded as either current or noncurrent on the 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 statements of income on an accrual basis.

The 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 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 statements of income depending on the relevant facts and circumstances. Certain derivatives that economically hedge future commodity risk are recorded in the same expense line item on the statements of income as that of the associated risk. 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."

In connection with OPCo's June 2012 - May 2015 ESP, the PUCO ordered OPCo to conduct energy and capacity auctions for its entire SSO load for delivery beginning in June 2015. These auctions resulted in a range of products, including 12-month, 24-month, and 36-month periods. The delivery period for each contract is scheduled to start on the first day of June of each year, immediately following the auction. Certain affiliated entities, including KPCo, participated in the auction process and were awarded tranches of OPCo's SSO load. The underlying contracts are derivatives subject to the accounting guidance for "Derivatives and Hedging" and are accounted for using MTM accounting, unless the contract has been designated as a normal purchase or normal sale.



## ***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 balance sheets until the period the hedged item affects Net Income. KPCo would recognize any hedge ineffectiveness as a regulatory asset (for losses) or a regulatory liability (for gains) if applicable.

Realized gains and losses on derivative contracts for the purchase and sale of power designated as cash flow hedges are included in Total Revenues or Purchased Electricity for Resale on KPCo's statements of income, or in Regulatory Assets or Regulatory Liabilities on KPCo's balance sheets, depending on the specific nature of the risk being hedged. During the three and six months ended June 30, 2016 and 2015, KPCo did not designate power 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 balance sheets into Interest Expense on its statements of income in those periods in which hedged interest payments occur. During the three and six months ended June 30, 2016 and 2015, KPCo did not apply cash flow hedging to outstanding interest rate derivatives.

During the three and six months ended June 30, 2016 and 2015, hedge ineffectiveness was immaterial or nonexistent for all cash flow hedge strategies disclosed above.

For details on effective cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's balance sheets and the reasons for changes in cash flow hedges, see Note 3.

Cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's balance sheets as of June 30, 2016 and December 31, 2015 were:

### **Impact of Cash Flow Hedges on the Condensed Balance Sheet**

	<b>Interest Rate</b>	
	<b>June 30, 2016</b>	<b>December 31, 2015</b>
	<b>(in thousands)</b>	
AOCI Loss Net of Tax	\$ (71)	\$ (101)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(60)	(60)

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, 2016, KPCo is not hedging (with contracts subject to the accounting guidance for "Derivatives and Hedging") its exposure to variability in future cash flows related to forecasted transactions.

## ***Credit Risk***

Management 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. Management 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.

Master agreements are typically used to facilitate the netting of cash flows associated with a single counterparty and may include collateral requirements. Collateral requirements in the form of cash, letters of credit and parental/affiliate guarantees may be obtained as security from counterparties in order to mitigate credit risk. A counterparty is required 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, master 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 a specified rating threshold. 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 a specified rating threshold that would require the posting of additional collateral. There is no exposure relating to derivative contracts, however, there is exposure relating to RTOs, ISOs and non-derivative contracts. The following table represents KPCo's exposure if credit ratings were to decline below a specified rating threshold as of June 30, 2016 and December 31, 2015:

	<b>June 30, 2016</b>	<b>December 31, 2015</b>
	<b>(in thousands)</b>	
Amount of Collateral KPCo Would Have Been Required to Post Attributable to RTOs and ISOs	\$ 234	\$ 1,003
Amount of Collateral Attributable to Other Contracts	203	23

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 that is \$50 million or greater. 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 and (c) if a cross-default provision would have been triggered, the settlement amount that would be required after considering contractual netting arrangements as of June 30, 2016 and December 31, 2015:

	<b>June 30, 2016</b>	<b>December 31, 2015</b>
	<b>(in thousands)</b>	
Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements	\$ 403	\$ 750
Amount of Cash Collateral Posted	—	—
Additional Settlement Liability if Cross Default Provision is Triggered	396	750

## 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. The amount of risk taken is determined by the Commercial Operations and Finance groups in accordance with established risk management policies as approved by the Finance Committee of AEP’s Board of Directors. AEPSC’s market risk oversight staff independently monitors risk policies, procedures and risk levels and provides members of the Commercial Operations Risk Committee (Regulated Risk Committee) various reports regarding compliance with policies, limits and procedures. The Regulated Risk Committee consists of AEPSC’s Chief Operating Officer, Chief Financial Officer, Executive Vice President of Generation, 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 contracts being classified as Level 3 is the inability to substantiate energy price curves in the market. A portion of the Level 3 instruments have been economically hedged which 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, 2016 and December 31, 2015 are summarized in the following table:

	<u>June 30, 2016</u>		<u>December 31, 2015</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 866,809	\$ 1,006,537	\$ 866,451	\$ 963,639

## ***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, 2016 and December 31, 2015. 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, 2016**

<b>Assets:</b>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
<b><u>Risk Management Assets – Nonaffiliated and Affiliated</u></b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ 11</u>	<u>\$ 3,381</u>	<u>\$ 969</u>	<u>\$ (3,269)</u>	<u>\$ 1,092</u>
<b>Liabilities:</b>					
<b><u>Risk Management Liabilities – Nonaffiliated</u></b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ 25</u>	<u>\$ 3,635</u>	<u>\$ 685</u>	<u>\$ (3,402)</u>	<u>\$ 943</u>

### **Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2015**

<b>Assets:</b>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
<b><u>Risk Management Assets – Nonaffiliated and Affiliated</u></b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ 36</u>	<u>\$ 2,692</u>	<u>\$ 2,338</u>	<u>\$ (2,012)</u>	<u>\$ 3,054</u>
<b>Liabilities:</b>					
<b><u>Risk Management Liabilities – Nonaffiliated</u></b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ 43</u>	<u>\$ 3,545</u>	<u>\$ 92</u>	<u>\$ (2,667)</u>	<u>\$ 1,013</u>

(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, 2016 and 2015.

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

<b>Three Months Ended June 30, 2016</b>	<b>Net Risk Management Assets (Liabilities) (a) (in thousands)</b>
<b>Balance as of March 31, 2016</b>	\$ 1,370
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	843
Purchases, Issuances and Settlements (d)	(1,315)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	(614)
<b>Balance as of June 30, 2016</b>	<u>\$ 284</u>
<b>Three Months Ended June 30, 2015</b>	<b>Net Risk Management Assets (Liabilities) (in thousands)</b>
<b>Balance as of March 31, 2015</b>	\$ 1,670
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	(221)
Purchases, Issuances and Settlements (d)	(697)
Transfers out of Level 3 (e) (f)	240
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	4,782
<b>Balance as of June 30, 2015</b>	<u>\$ 5,774</u>
<b>Six Months Ended June 30, 2016</b>	<b>Net Risk Management Assets (Liabilities) (a) (in thousands)</b>
<b>Balance as of December 31, 2015</b>	\$ 2,246
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	1,278
Purchases, Issuances and Settlements (d)	(3,056)
Transfers out of Level 3 (e) (f)	22
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	(206)
<b>Balance as of June 30, 2016</b>	<u>\$ 284</u>
<b>Six Months Ended June 30, 2015</b>	<b>Net Risk Management Assets (Liabilities) (in thousands)</b>
<b>Balance as of December 31, 2014</b>	\$ 3,927
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	365
Purchases, Issuances and Settlements (d)	(3,489)
Transfers out of Level 3 (e) (f)	240
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	4,731
<b>Balance as of June 30, 2015</b>	<u>\$ 5,774</u>

- (a) Includes both affiliated and nonaffiliated transactions.
- (b) Included in revenues on KPCo's statements of income.
- (c) Represents the change in fair value between the beginning of the reporting period and the settlement of the risk management commodity contract.
- (d) Represents the settlement of risk management commodity contracts for the reporting period.
- (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 statements of income. These net gains (losses) are recorded as regulatory liabilities/assets.

The following tables quantify the significant unobservable inputs used in developing the fair value of Level 3 positions as of June 30, 2016 and December 31, 2015:

**Significant Unobservable Inputs  
June 30, 2016**

	<u>Fair Value</u>		<u>Valuation Technique</u>	<u>Significant Unobservable Input (a)</u>	<u>Forward Price Range</u>		
	<u>Assets</u>	<u>Liabilities</u>			<u>Low</u>	<u>High</u>	<u>Weighted Average</u>
	(in thousands)						
Energy Contracts	\$ 615	\$ 73	Discounted Cash Flow	Forward Market Price	\$ 10.20	\$ 50.27	\$ 35.25
FTRs	354	612	Discounted Cash Flow	Forward Market Price	0.11	7.63	0.86
<b>Total</b>	<u>\$ 969</u>	<u>\$ 685</u>					

**Significant Unobservable Inputs  
December 31, 2015**

	<u>Fair Value</u>		<u>Valuation Technique</u>	<u>Significant Unobservable Input (a)</u>	<u>Forward Price Range</u>		
	<u>Assets</u>	<u>Liabilities</u>			<u>Low</u>	<u>High</u>	<u>Weighted Average</u>
	(in thousands)						
Energy Contracts	\$ 1,580	\$ 37	Discounted Cash Flow	Forward Market Price	\$ 12.61	\$ 47.24	\$ 32.38
FTRs	758	55	Discounted Cash Flow	Forward Market Price	(6.96)	8.43	1.34
<b>Total</b>	<u>\$ 2,338</u>	<u>\$ 92</u>					

(a) Represents market prices in dollars per MWh.

The following table provides sensitivity of fair value measurements to increases (decreases) in significant unobservable inputs related to Energy Contracts and FTRs as of June 30, 2016 and December 31, 2015:

**Sensitivity of Fair Value Measurements**

<u>Significant Unobservable Input</u>	<u>Position</u>	<u>Change in Input</u>	<u>Impact on Fair Value Measurement</u>
Forward Market Price	Buy	Increase (Decrease)	Higher (Lower)
Forward Market Price	Sell	Increase (Decrease)	Lower (Higher)

## **10. 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***

KPCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011, 2012 and 2013 started in April 2014. KPCo and other AEP subsidiaries received a Revenue Agents Report in April 2016, completing the 2011 through 2013 audit cycle indicating an agreed upon audit. However, the audit is awaiting final approval by the Congressional Joint Committee on Taxation. 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. KPCo and other AEP subsidiaries are currently under examination in several state and local jurisdictions. However, it is possible that previously filed tax returns have positions that may be challenged by these tax authorities. 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 2009.

## 11. FINANCING ACTIVITIES

### *Long-term Debt*

KPCo did not have any long-term debt issuances or retirements during the first six months of 2016.

### *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.” 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%.

### *Corporate Borrowing Program – 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 borrowings from the Utility Money Pool as of June 30, 2016 and December 31, 2015 are included in Advances from Affiliates on KPCo’s balance sheets. KPCo’s Utility Money Pool activity and corresponding authorized borrowing limits for the six months ended June 30, 2016 are described in the following table:

<b>Maximum Borrowings from the Utility Money Pool</b>	<b>Maximum Loans to the Utility Money Pool</b>	<b>Average Borrowings from the Utility Money Pool</b>	<b>Average Loans to the Utility Money Pool</b>	<b>Borrowings from the Utility Money Pool as of June 30, 2016</b>	<b>Authorized Short-Term Borrowing Limit</b>
(in thousands)					
\$ 39,102	\$ 10,102	\$ 15,839	\$ 6,391	\$ 16,274	\$ 225,000

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, 2016 and 2015 are summarized in the following table:

<b>Six Months Ended June 30,</b>	<b>Maximum Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Minimum Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Maximum Interest Rate for Funds Loaned to the Utility Money Pool</b>	<b>Minimum Interest Rate for Funds Loaned to the Utility Money Pool</b>	<b>Average Interest Rate for Funds Borrowed from the Utility Money Pool</b>	<b>Average Interest Rate for Funds Loaned to the Utility Money Pool</b>
<b>2016</b>	0.84%	0.69%	0.76%	0.75%	0.75%	0.76%
<b>2015</b>	0.59%	0.39%	0.54%	0.42%	0.47%	0.51%



### ***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 statements of income. KPCo manages and services its accounts receivable sold.

AEP Credit's receivables securitization agreement provides a commitment of \$750 million from bank conduits to purchase receivables and expires in June 2018.

KPCo's amounts of accounts receivable and accrued unbilled revenues sold under the sale of receivables agreement were \$43 million and \$38 million as of June 30, 2016 and December 31, 2015, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold for the three months ended June 30, 2016 and 2015 were \$666 thousand and \$713 thousand, respectively, and for the six months ended June 30, 2016 and 2015 were \$1.4 million and \$1.6 million, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit for the three months ended June 30, 2016 and 2015 were \$134.6 million and \$118 million, respectively, and for the six months ended June 30, 2016 and 2015 were \$289.9 million and \$273 million, respectively.

## **12. 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. Parent 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, 2016 and 2015 were \$13.8 million and \$15.6 million, respectively, and for the six months ended June 30, 2016 and 2015 were \$29.8 million and \$28.8 million, respectively. The carrying amount of liabilities associated with AEPSC as of June 30, 2016 and December 31, 2015 was \$4.8 million and \$7.7 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.

AEGCo, a wholly-owned subsidiary of Parent, 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 has agreed to provide AEGCo with the funds necessary to satisfy all of the debt obligations of AEGCo. KPCo is considered to have a significant interest in AEGCo due to these 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, 2016 and 2015 were \$24 million and \$25.7 million, respectively, and for the six months ended June 30, 2016 and 2015 were \$43.5 million and \$49.3 million, respectively. The carrying amount of liabilities associated with AEGCo as of June 30, 2016 and December 31, 2015 was \$8.6 million and \$7.7 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.