Kentucky Power Company

2016 Third Quarter Report

Financial Statements

AEP AMERICAN® ELECTRIC POWER

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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	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 Nine Months Ended September 30, 2016 and 2015
(in thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
REVENUES				
Electric Generation, Transmission and Distribution	$ 166,654	$ 154,019	$ 475,267	$ 502,422
Sales to AEP Affiliates	1,636	4,962	6,457	8,896
Other Revenues	249	212	686	600
TOTAL REVENUES	168,539	159,193	482,410	511,918
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	32,722	41,055	85,367	147,840
Purchased Electricity for Resale	8,224	4,167	33,185	22,128
Purchased Electricity from AEP Affiliates	27,653	28,835	71,116	78,103
Other Operation	23,838	21,587	66,681	61,667
Maintenance	18,259	17,788	52,703	54,973
Depreciation and Amortization	21,689	18,915	63,030	67,164
Taxes Other Than Income Taxes	4,741	5,933	15,766	16,932
TOTAL EXPENSES	137,126	138,280	387,848	448,807
OPERATING INCOME	31,413	20,913	94,562	63,111
Other Income (Expense):				
Other Income (Expense)	(578)	1,864	476	2,430
Interest Expense	(11,808)	(11,050)	(34,108)	(33,270)
INCOME BEFORE INCOME TAX EXPENSE	19,027	11,727	60,930	32,271
Income Tax Expense	7,542	4,731	20,755	11,969
NET INCOME	$ 11,485	$ 6,996	$ 40,175	$ 20,302

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 Nine Months Ended September 30, 2016 and 2015
(in thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net Income	$ 11,485	$ 6,996	$ 40,175	$ 20,302
OTHER COMPREHENSIVE INCOME, NET OF TAXES				
Cash Flow Hedges, Net of Tax of $8 and $8 for the Three Months Ended September 30, 2016 and 2015, Respectively, and $24 and $24 for the Nine Months Ended September 30, 2016 and 2015, Respectively	15	15	45	45
Amortization of Pension and OPEB Deferred Costs, Net of Tax of $2 and $9 for the Three Months Ended September 30, 2016 and 2015, Respectively, and $7 and $27 for the Nine Months Ended September 30, 2016 and 2015, Respectively	4	17	13	50
TOTAL OTHER COMPREHENSIVE INCOME	19	32	58	95
TOTAL COMPREHENSIVE INCOME	$ 11,504	$ 7,028	$ 40,233	$ 20,397

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 Nine Months Ended September 30, 2016 and 2015
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2014	$ 50,450	$ 517,460	$ 103,069	$ (7,336)	$ 663,643
Common Stock Dividends			(33,000)		(33,000)
Net Income			20,302		20,302
Other Comprehensive Income				95	95
Pension and OPEB Adjustment Related to Mitchell Plant				5,174	5,174
TOTAL COMMON SHAREHOLDER'S EQUITY - SEPTEMBER 30, 2015	$ 50,450	$ 517,460	$ 90,371	$ (2,067)	$ 656,214
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2015	$ 50,450	$ 527,309	$ 86,960	$ (1,645)	$ 663,074
Common Stock Dividends			(33,000)		(33,000)
Net Income			40,175		40,175
Other Comprehensive Income				58	58
TOTAL COMMON SHAREHOLDER'S EQUITY - SEPTEMBER 30, 2016	$ 50,450	$ 527,309	$ 94,135	$ (1,587)	$ 670,307

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

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

	September 30, 2016	December 31, 2015
CURRENT ASSETS		
Cash and Cash Equivalents	$ 913	$ 867
Accounts Receivable:		
Customers	7,927	13,747
Affiliated Companies	23,418	20,373
Accrued Unbilled Revenues	647	53
Miscellaneous	2,038	110
Allowance for Uncollectible Accounts	(71)	(243)
Total Accounts Receivable	33,959	34,040
Fuel	22,887	22,085
Materials and Supplies	16,649	26,705
Risk Management Assets – Nonaffiliated	640	2,869
Risk Management Assets – Affiliated	—	173
Accrued Tax Benefits	12,239	47,812
Prepayments and Other Current Assets	8,423	4,623
TOTAL CURRENT ASSETS	95,710	139,174
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	1,180,451	1,118,837
Transmission	574,926	568,963
Distribution	776,462	756,631
Other Property, Plant and Equipment	64,008	58,294
Construction Work in Progress	19,168	59,351
Total Property, Plant and Equipment	2,615,015	2,562,076
Accumulated Depreciation and Amortization	871,460	847,675
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,743,555	1,714,401
OTHER NONCURRENT ASSETS		
Regulatory Assets	564,433	557,956
Long-term Risk Management Assets – Nonaffiliated	35	12
Employee Benefits and Pension Assets	8,061	6,939
Deferred Charges and Other Noncurrent Assets	15,231	17,774
TOTAL OTHER NONCURRENT ASSETS	587,760	582,681
TOTAL ASSETS	$ 2,427,025	$ 2,436,256

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

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
September 30, 2016 and December 31, 2015
(Unaudited)

	September 30, 2016	December 31, 2015
	(in thousands)	
CURRENT LIABILITIES		
Advances from Affiliates	$ 11,384	$ 18,692
Accounts Payable:		
General	36,678	36,882
Affiliated Companies	24,179	25,139
Long-term Debt Due Within One Year – Nonaffiliated	390,000	65,000
Risk Management Liabilities – Nonaffiliated	1,160	1,002
Customer Deposits	26,778	26,916
Accrued Taxes	14,414	26,867
Accrued Interest	6,444	7,928
Other Current Liabilities	38,321	51,110
TOTAL CURRENT LIABILITIES	549,358	259,536
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	476,982	801,451
Long-term Risk Management Liabilities – Nonaffiliated	61	11
Deferred Income Taxes	662,557	636,158
Asset Retirement Obligations	51,890	55,151
Employee Benefits and Pension Obligations	10,746	13,536
Deferred Credits and Other Noncurrent Liabilities	5,124	7,339
TOTAL NONCURRENT LIABILITIES	1,207,360	1,513,646
TOTAL LIABILITIES	1,756,718	1,773,182
Rate Matters (Note 4)		
Commitments and Contingencies (Note 5)		
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	527,309	527,309
Retained Earnings	94,135	86,960
Accumulated Other Comprehensive Income (Loss)	(1,587)	(1,645)
TOTAL COMMON SHAREHOLDER'S EQUITY	670,307	663,074
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	$ 2,427,025	$ 2,436,256

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

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2016 and 2015
(in thousands)
(Unaudited)

	Nine Months Ended September 30, 2016	2015
OPERATING ACTIVITIES		
Net Income	$ 40,175	$ 20,302
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	63,030	67,164
Deferred Income Taxes	22,592	44,673
Allowance for Equity Funds Used During Construction	(743)	(739)
Mark-to-Market of Risk Management Contracts	2,588	846
Pension Contributions to Qualified Plan Trust	(1,509)	(1,900)
Property Taxes	11,863	10,663
Deferred Fuel Over/Under-Recovery, Net	(5,825)	(1,076)
Provision for Refund	—	(22,094)
Change in Other Noncurrent Assets	(25,438)	(18,009)
Change in Other Noncurrent Liabilities	(3,966)	2,100
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	81	12,325
Fuel, Materials and Supplies	680	31,959
Accounts Payable	5,513	5,357
Accrued Taxes, Net	23,118	(11,368)
Other Current Assets	(356)	331
Other Current Liabilities	(11,269)	(10,109)
Net Cash Flows from Operating Activities	120,534	130,425
INVESTING ACTIVITIES		
Construction Expenditures	(80,687)	(84,943)
Other Investing Activities	1,078	1,496
Net Cash Flows Used for Investing Activities	(79,609)	(83,447)
FINANCING ACTIVITIES		
Issuance of Long-term Debt – Nonaffiliated	—	24,546
Change in Advances from Affiliates, Net	(7,308)	(38,043)
Principal Payments for Capital Lease Obligations	(736)	(813)
Dividends Paid on Common Stock	(33,000)	(33,000)
Other Financing Activities	165	78
Net Cash Flows Used for Financing Activities	(40,879)	(47,232)
Net Increase (Decrease) in Cash and Cash Equivalents	46	(254)
Cash and Cash Equivalents at Beginning of Period	867	795
Cash and Cash Equivalents at End of Period	$ 913	$ 541
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 34,905	$ 34,168
Net Cash Paid (Received) for Income Taxes	(35,715)	(24,547)
Noncash Acquisitions Under Capital Leases	571	171
Construction Expenditures Included in Current Liabilities as of September 30,	5,963	9,210

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

INDEX OF CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

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 nine months ended September 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.

Investment Tax Credits

Investment tax credits (ITC) were historically accounted for under the flow-through method, except where regulatory commissions reflected ITC in the rate-making process. In the third quarter of 2016, KPCo and other AEP subsidiaries changed accounting for the recognition of ITC and elected to apply the preferred deferral methodology. Retrospective application is not necessary for reporting periods prior to 2016 as the financial impact to KPCo was immaterial.

Deferred ITC is amortized to income tax expense over the life of the asset. Amortization of deferred ITC begins when the asset is placed into service, except where regulatory commissions reflect ITC in the rate-making process, then amortization begins when the cash tax benefit is recognized.

Subsequent Events

Management reviewed subsequent events through November 1, 2016, the date that the third 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 is analyzing the impact of this new standard and, at this time, cannot estimate the impact of adoption. 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 nine months ended September 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 September 30, 2016

	Cash Flow Hedges		
	Interest Rate and Foreign Currency	Pension and OPEB	Total
	(in thousands)		
Balance in AOCI as of June 30, 2016	$ (71)	$ (1,535)	$ (1,606)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	24	—	24
Amortization of Prior Service Cost (Credit)	—	(55)	(55)
Amortization of Actuarial (Gains)/Losses	—	62	62
Reclassifications from AOCI, before Income Tax (Expense) Credit	24	7	31
Income Tax (Expense) Credit	9	3	12
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	15	4	19
Net Current Period Other Comprehensive Income	15	4	19
Balance in AOCI as of September 30, 2016	$ (56)	$ (1,531)	$ (1,587)

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

	Cash Flow Hedges		
	Interest Rate and Foreign Currency	Pension and OPEB	Total
	(in thousands)		
Balance in AOCI as of June 30, 2015	$ (131)	$ (1,968)	$ (2,099)
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	—	35	35
Reclassifications from AOCI, before Income Tax (Expense) Credit	23	25	48
Income Tax (Expense) Credit	8	8	16
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	15	17	32
Net Current Period Other Comprehensive Income	15	17	32
Balance in AOCI as of September 30, 2015	$ (116)	$ (1,951)	$ (2,067)

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Nine Months Ended September 30, 2016

	Cash Flow Hedges		
	Interest Rate and Foreign Currency	Pension and OPEB	Total
	(in thousands)		
Balance in AOCI as of December 31, 2015	$ (101)	$ (1,544)	$ (1,645)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	70	—	70
Amortization of Prior Service Cost (Credit)	—	(166)	(166)
Amortization of Actuarial (Gains)/Losses	—	186	186
Reclassifications from AOCI, before Income Tax (Expense) Credit	70	20	90
Income Tax (Expense) Credit	25	7	32
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	45	13	58
Net Current Period Other Comprehensive Income	45	13	58
Balance in AOCI as of September 30, 2016	$ (56)	$ (1,531)	$ (1,587)

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Nine Months Ended September 30, 2015

	Cash Flow Hedges		
	Interest Rate and Foreign Currency	Pension and OPEB	Total
	(in thousands)		
Balance in AOCI as of December 31, 2014	$ (161)	$ (7,175)	$ (7,336)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	69	—	69
Amortization of Prior Service Cost (Credit)	—	(30)	(30)
Amortization of Actuarial (Gains)/Losses	—	106	106
Reclassifications from AOCI, before Income Tax (Expense) Credit	69	76	145
Income Tax (Expense) Credit	24	26	50
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	45	50	95
Net Current Period Other Comprehensive Income	45	50	95
Pension and OPEB Adjustment Related to Mitchell Plant	—	5,174	5,174
Balance in AOCI as of September 30, 2015	$ (116)	$ (1,951)	$ (2,067)

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

Noncurrent Regulatory Assets	September 30, 2016	December 31, 2015
	(in thousands)	
Regulatory Assets Currently Not Earning a Return		
Storm-Related Costs	$ 4,759	$ 4,377
Other Regulatory Assets Pending Final Regulatory Approval	36	—
Total Regulatory Assets Pending Final Regulatory Approval	$ 4,795	$ 4,377

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 $65.7 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 September 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 September 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 nine months ended September 30, 2016 and 2015:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended September 30,		Three Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Service Cost	$ 615	$ 670	$ 71	$ 86
Interest Cost	1,872	1,832	538	488
Expected Return on Plan Assets	(2,533)	(2,495)	(989)	(1,015)
Amortization of Prior Service Cost (Credit)	13	13	(606)	(606)
Amortization of Net Actuarial Loss	736	945	288	155
Net Periodic Benefit Cost (Credit)	$ 703	$ 965	$ (698)	$ (892)

	Pension Plans		Other Postretirement Benefit Plans	
	Nine Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Service Cost	$ 1,845	$ 2,010	$ 212	$ 258
Interest Cost	5,617	5,495	1,613	1,464
Expected Return on Plan Assets	(7,599)	(7,486)	(2,966)	(3,045)
Amortization of Prior Service Cost (Credit)	39	39	(1,818)	(1,818)
Amortization of Net Actuarial Loss	2,207	2,838	863	466
Net Periodic Benefit Cost (Credit)	$ 2,109	$ 2,896	$ (2,096)	$ (2,675)

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 September 30, 2016 and December 31, 2015:

Notional Volume of Derivative Instruments

Primary Risk Exposure	Volume: September 30, 2016	Volume: December 31, 2015	Unit of Measure
	(in thousands)		
Commodity:			
Power	13,026	7,864	MWhs
Natural Gas	8	64	MMBtus
Heating Oil and Gasoline	317	341	Gallons
Interest Rate	$ 22	$ 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 September 30, 2016 and December 31, 2015 balance sheets, KPCo netted $18 thousand and $0, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and $30 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 September 30, 2016 and December 31, 2015:

Fair Value of Derivative Instruments
September 30, 2016

Balance Sheet Location	Risk Management Contracts - Commodity (a)	Gross Amounts Offset in the Statement of Financial Position (b)	Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)
		(in thousands)	
Current Risk Management Assets - Nonaffiliated	$ 2,340	$ (1,700)	$ 640
Long-term Risk Management Assets - Nonaffiliated	179	(144)	35
Total Assets	2,519	(1,844)	675
Current Risk Management Liabilities - Nonaffiliated	2,872	(1,712)	1,160
Long-term Risk Management Liabilities - Nonaffiliated	205	(144)	61
Total Liabilities	3,077	(1,856)	1,221
Total MTM Derivative Contract Net Assets (Liabilities)	$ (558)	$ 12	$ (546)

Fair Value of Derivative Instruments
December 31, 2015

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

(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 nine months ended September 30, 2016 and 2015:

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
Location of Gain (Loss)	**2016**	**2015**	**2016**	**2015**
		(in thousands)		
Electric Generation, Transmission and Distribution Revenues	$ 243	$ 77	$ 191	$ 2,234
Sales to AEP Affiliates	5	728	434	977
Fuel and Other Consumables Used for Electric Generation	—	(7)	—	(20)
Purchased Electricity for Resale	463	758	1,902	3,331
Other Operation Expense	(9)	(23)	(42)	(75)
Maintenance Expense	(21)	(40)	(78)	(111)
Regulatory Assets (a)	(551)	624	(406)	944
Regulatory Liabilities (a)	681	(919)	237	(962)
Total Gain on Risk Management Contracts	$ 811	$ 1,198	$ 2,238	$ 6,318

(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 nine months ended September 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 nine months ended September 30, 2016 and 2015, KPCo did not apply cash flow hedging to outstanding interest rate derivatives.

During the three and nine months ended September 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 September 30, 2016 and December 31, 2015 were:

Impact of Cash Flow Hedges on the Condensed Balance Sheet

	Interest Rate	
	September 30, 2016	December 31, 2015
	(in thousands)	
AOCI Loss Net of Tax	$ (56)	$ (101)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(55)	(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 September 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 September 30, 2016 and December 31, 2015:

	September 30, 2016	December 31, 2015
	(in thousands)	
Amount of Collateral KPCo Would Have Been Required to Post Attributable to RTOs and ISOs	$ 859	$ 1,003
Amount of Collateral Attributable to Other Contracts	1,641	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 September 30, 2016 and December 31, 2015:

	September 30, 2016	December 31, 2015
	(in thousands)	
Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements	$ 261	$ 750
Amount of Cash Collateral Posted	—	—
Additional Settlement Liability if Cross Default Provision is Triggered	255	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 September 30, 2016 and December 31, 2015 are summarized in the following table:

	September 30, 2016		December 31, 2015	
	Book Value	Fair Value	Book Value	Fair Value
	(in thousands)			
Long-term Debt	$ 866,982	$ 1,002,085	$ 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 September 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
September 30, 2016

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in thousands)		
Risk Management Assets – Nonaffiliated					
Risk Management Commodity Contracts (a) (b)	$ 5	$ 1,609	$ 733	$ (1,672)	$ 675
Liabilities:					
Risk Management Liabilities – Nonaffiliated					
Risk Management Commodity Contracts (a) (b)	$ 5	$ 1,729	$ 1,171	$ (1,684)	$ 1,221

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

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

(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 nine months ended September 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:

Three Months Ended September 30, 2016	Net Risk Management Assets (Liabilities) (a)
	(in thousands)
Balance as of June 30, 2016	$ 284
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	844
Purchases, Issuances and Settlements (d)	(1,006)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	(560)
Balance as of September 30, 2016	$ (438)

Three Months Ended September 30, 2015	Net Risk Management Assets (Liabilities) (a)
	(in thousands)
Balance as of June 30, 2015	$ 5,774
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	34
Purchases, Issuances and Settlements (d)	(2,031)
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	(330)
Balance as of September 30, 2015	$ 3,447

Nine Months Ended September 30, 2016	Net Risk Management Assets (Liabilities) (a)
	(in thousands)
Balance as of December 31, 2015	$ 2,246
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	1,360
Purchases, Issuances and Settlements (d)	(3,393)
Transfers out of Level 3 (e) (f)	22
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	(673)
Balance as of September 30, 2016	$ (438)

Nine Months Ended September 30, 2015	Net Risk Management Assets (Liabilities) (a)
	(in thousands)
Balance as of December 31, 2014	$ 3,927
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	698
Purchases, Issuances and Settlements (d)	(4,076)
Transfers out of Level 3 (e) (f)	240
Changes in Fair Value Allocated to Regulated Jurisdictions (g)	2,658
Balance as of September 30, 2015	$ 3,447

(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 purchases, issuances and settlements 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 September 30, 2016 and December 31, 2015:

Significant Unobservable Inputs
September 30, 2016

	Fair Value		Valuation	Significant Unobservable	Forward Price Range		
	Assets	Liabilities	Technique	Input (a)	Low	High	Weighted Average
	(in thousands)						
Energy Contracts	$ 433	$ 51	Discounted Cash Flow	Forward Market Price	$ 16.51	$ 47.42	$ 34.85
FTRs	300	1,120	Discounted Cash Flow	Forward Market Price	(0.22)	10.63	0.74
Total	$ 733	$ 1,171					

Significant Unobservable Inputs
December 31, 2015

	Fair Value		Valuation	Significant Unobservable	Forward Price Range		
	Assets	Liabilities	Technique	Input (a)	Low	High	Weighted Average
	(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
Total	$ 2,338	$ 92					

(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 September 30, 2016 and December 31, 2015:

Sensitivity of Fair Value Measurements

Significant Unobservable Input	Position	Change in Input	Impact on Fair Value Measurement
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. The 2011 through 2013 audit was submitted to the Congressional Joint Committee on Taxation for approval. KPCo and other AEP subsidiaries were informed that the IRS expects the Joint Committee to refer the audit back to the IRS exam team for further consideration. 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 nine 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 September 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 nine months ended September 30, 2016 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	Borrowings from the Utility Money Pool as of September 30, 2016	Authorized Short-Term Borrowing Limit
		(in thousands)			
$ 39,102	$ 15,557	$ 13,910	$ 7,277	$ 11,384	$ 225,000

Maximum, minimum and average interest rates for funds either borrowed from or loaned to the Utility Money Pool are summarized in the following table:

Nine Months Ended September 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
2016	0.91%	0.69%	0.90%	0.75%	0.77%	0.87%
2015	0.59%	0.39%	0.54%	0.42%	0.46%	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 $45.2 million and $38 million as of September 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 September 30, 2016 and 2015 were $722 thousand and $814 thousand, respectively, and for the nine months ended September 30, 2016 and 2015 were $2.1 million and $2.4 million, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit for the three months ended September 30, 2016 and 2015 were $149.7 million and $127 million, respectively, and for the nine months ended September 30, 2016 and 2015 were $439.6 million and $400.5 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 September 30, 2016 and 2015 were $12.3 million and $15 million, respectively, and for the nine months ended September 30, 2016 and 2015 were $42.1 million and $43.8 million, respectively. The carrying amount of liabilities associated with AEPSC as of September 30, 2016 and December 31, 2015 was $4.1 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 September 30, 2016 and 2015 were $27.6 million and $28.8 million, respectively, and for the nine months ended September 30, 2016 and 2015 were $71.1 million and $78.1 million, respectively. The carrying amount of liabilities associated with AEGCo as of September 30, 2016 and December 31, 2015 was $7.9 million and $7.7 million, respectively. Management estimates the maximum exposure of loss to be equal to the amount of such liability.