Kentucky Power Company

2017 First Quarter Report

Financial Statements

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GLOSSARY OF TERMS

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

Term	Meaning
AEGCo	AEP Generating Company, an AEP electric utility subsidiary.
AEP	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.
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.
MTM	Mark-to-Market.
MW	Megawatt.
MWh	Megawatthour.
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.
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.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF INCOME
For the Three Months Ended March 31, 2017 and 2016
(in thousands)
(Unaudited)

	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016
REVENUES		
Electric Generation, Transmission and Distribution	$ 162,538	$ 164,295
Sales to AEP Affiliates	3,251	3,163
Other Revenues	224	213
TOTAL REVENUES	166,013	167,671
EXPENSES		
Fuel and Other Consumables Used for Electric Generation	23,436	28,840
Purchased Electricity for Resale	14,415	13,815
Purchased Electricity from AEP Affiliates	23,104	19,462
Other Operation	27,753	19,970
Maintenance	20,312	17,677
Depreciation and Amortization	22,095	21,066
Taxes Other Than Income Taxes	5,735	5,810
TOTAL EXPENSES	136,850	126,640
OPERATING INCOME	29,163	41,031
Other Income (Expense):		
Other Income	768	329
Interest Expense	(11,469)	(11,244)
INCOME BEFORE INCOME TAX EXPENSE	18,462	30,116
Income Tax Expense	6,349	10,313
NET INCOME	$ 12,113	$ 19,803

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 Months Ended March 31, 2017 and 2016
(in thousands)
(Unaudited)

	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016
Net Income	$ 12,113	$ 19,803
OTHER COMPREHENSIVE INCOME, NET OF TAXES		
Cash Flow Hedges, Net of Tax of $9 and $8 in 2017 and 2016, Respectively	16	15
Amortization of Pension and OPEB Deferred Costs, Net of Tax of $4 and $2 in 2017 and 2016, Respectively	8	4
TOTAL OTHER COMPREHENSIVE INCOME	24	19
TOTAL COMPREHENSIVE INCOME	$ 12,137	$ 19,822

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 Three Months Ended March 31, 2017 and 2016
(in thousands)
(Unaudited)

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2015	$ 50,450	$ 527,309	$ 86,960	$ (1,645)	$ 663,074
Common Stock Dividends			(11,000)		(11,000)
Net Income			19,803		19,803
Other Comprehensive Income				19	19
TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2016	$ 50,450	$ 527,309	$ 95,763	$ (1,626)	$ 671,896
TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2016	$ 50,450	$ 526,135	$ 93,170	$ (1,354)	$ 668,401
Common Stock Dividends			(8,750)		(8,750)
Net Income			12,113		12,113
Other Comprehensive Income				24	24
TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2017	$ 50,450	$ 526,135	$ 96,533	$ (1,330)	$ 671,788

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

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
ASSETS
March 31, 2017 and December 31, 2016
(in thousands)
(Unaudited)

	March 31, 2017	December 31, 2016
CURRENT ASSETS		
Cash and Cash Equivalents	$ 814	$ 859
Accounts Receivable:		
Customers	11,785	14,608
Affiliated Companies	22,799	29,519
Accrued Unbilled Revenues	3,948	4,542
Miscellaneous	368	380
Allowance for Uncollectible Accounts	(63)	(66)
Total Accounts Receivable	38,837	48,983
Fuel	19,727	19,823
Materials and Supplies	16,618	16,540
Risk Management Assets	418	457
Accrued Tax Benefits	502	574
Prepayments and Other Current Assets	6,753	8,347
TOTAL CURRENT ASSETS	83,669	95,583
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	1,184,395	1,182,212
Transmission	575,326	574,703
Distribution	790,373	783,283
Other Property, Plant and Equipment	68,178	67,248
Construction Work in Progress	30,147	27,380
Total Property, Plant and Equipment	2,648,419	2,634,826
Accumulated Depreciation and Amortization	893,661	879,253
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,754,758	1,755,573
OTHER NONCURRENT ASSETS		
Regulatory Assets	563,919	576,131
Long-term Risk Management Assets	28	—
Employee Benefits and Pension Assets	6,229	5,891
Deferred Charges and Other Noncurrent Assets	22,977	26,787
TOTAL OTHER NONCURRENT ASSETS	593,153	608,809
TOTAL ASSETS	$ 2,431,580	$ 2,459,965

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

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
LIABILITIES AND COMMON SHAREHOLDER'S EQUITY
March 31, 2017 and December 31, 2016
(Unaudited)

	March 31, 2017	December 31, 2016
	(in thousands)	
CURRENT LIABILITIES		
Advances from Affiliates	$ 12,172	$ 1,807
Accounts Payable:		
General	29,126	52,601
Affiliated Companies	23,822	28,579
Long-term Debt Due Within One Year – Nonaffiliated	390,000	390,000
Risk Management Liabilities	71	53
Customer Deposits	27,024	26,625
Accrued Taxes	20,082	28,379
Accrued Interest	6,415	8,127
Other Current Liabilities	36,380	44,302
TOTAL CURRENT LIABILITIES	545,092	580,473
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	477,345	477,164
Long-term Risk Management Liabilities	16	313
Deferred Income Taxes	672,589	666,902
Asset Retirement Obligations	45,284	46,657
Employee Benefits and Pension Obligations	13,376	14,516
Deferred Credits and Other Noncurrent Liabilities	6,090	5,539
TOTAL NONCURRENT LIABILITIES	1,214,700	1,211,091
TOTAL LIABILITIES	1,759,792	1,791,564
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	526,135	526,135
Retained Earnings	96,533	93,170
Accumulated Other Comprehensive Income (Loss)	(1,330)	(1,354)
TOTAL COMMON SHAREHOLDER'S EQUITY	671,788	668,401
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	$ 2,431,580	$ 2,459,965

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

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CASH FLOWS
For the Three Months Ended March 31, 2017 and 2016
(in thousands)
(Unaudited)

	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016
OPERATING ACTIVITIES		
Net Income	$ 12,113	$ 19,803
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	22,095	21,066
Deferred Income Taxes	5,842	10,561
Allowance for Equity Funds Used During Construction	(213)	(405)
Mark-to-Market of Risk Management Contracts	(268)	733
Property Taxes	3,777	3,822
Deferred Fuel Over/Under-Recovery, Net	(534)	(1,192)
Change in Other Noncurrent Assets	5,495	(10,441)
Change in Other Noncurrent Liabilities	(121)	(416)
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	10,146	(9,076)
Fuel, Materials and Supplies	233	104
Accounts Payable	(23,324)	(7,594)
Accrued Taxes, Net	(8,225)	30,201
Accrued Interest	(1,712)	(1,636)
Other Current Assets	2,158	(806)
Other Current Liabilities	(6,652)	(9,111)
Net Cash Flows from Operating Activities	20,810	45,613
INVESTING ACTIVITIES		
Construction Expenditures	(22,412)	(31,687)
Other Investing Activities	173	555
Net Cash Flows Used for Investing Activities	(22,239)	(31,132)
FINANCING ACTIVITIES		
Change in Advances from Affiliates, Net	10,365	(2,902)
Principal Payments for Capital Lease Obligations	(247)	(229)
Dividends Paid on Common Stock	(8,750)	(11,000)
Other Financing Activities	16	154
Net Cash Flows from (Used for) Financing Activities	1,384	(13,977)
Net Increase (Decrease) in Cash and Cash Equivalents	(45)	504
Cash and Cash Equivalents at Beginning of Period	859	867
Cash and Cash Equivalents at End of Period	$ 814	$ 1,371
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 12,938	$ 12,621
Net Cash Paid (Received) for Income Taxes	4	(38,806)
Noncash Acquisitions Under Capital Leases	109	402
Construction Expenditures Included in Current Liabilities as of March 31,	6,069	12,924

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 months ended March 31, 2017 is not necessarily indicative of results that may be expected for the year ending December 31, 2017. The condensed financial statements are unaudited and should be read in conjunction with the audited 2016 financial statements and notes thereto, which are included in KPCo's 2016 Annual Report.

Subsequent Events

Management reviewed subsequent events through April 27, 2017, the date that the first quarter 2017 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 with early adoption permitted.

Management continues to analyze the impact of the new revenue standard and related ASUs. During 2016 and continuing through the first quarter of 2017, revenue contract assessments were completed. Material revenue streams were identified within the AEP System and representative contract/transaction types were sampled. Performance obligations identified within each material revenue stream were evaluated to determine whether the obligations were satisfied at a point in time or over time. Contracts determined to be satisfied over time generally qualified for the invoicing practical expedient since the invoiced amounts reasonably represented the value to customers of performance obligations fulfilled to date. Based upon the completed assessments, management does not expect a material impact to the timing of revenue recognized or net income and plans to elect the modified retrospective transition approach upon adoption. Management also continues to monitor unresolved industry implementation issues, including items related to collectability, and will analyze the related impacts to revenue recognition. Management plans to adopt ASU 2014-09 effective January 1, 2018.

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.

Management continues to analyze the impact of the new lease standard. During 2016 and continuing through the first quarter of 2017, lease contract assessments were completed. The AEP System lease population was identified and representative lease contracts were sampled. Based upon the completed assessments, management prepared a system gap analysis to outline new disclosure compliance requirements compared to current system capabilities. Lease system options are currently being evaluated. Management plans to elect certain of the following practical expedients upon adoption:

Practical Expedient	Description
Overall Expedients (for leases commenced prior to adoption date and must be adopted as a package)	Do not need to reassess whether any expired or existing contracts are/or contain leases, do not need to reassess the lease classification for any expired or existing leases and do not need to reassess initial direct costs for any existing leases.
Lease and Non-lease Components (elect by class of underlying asset)	Elect as an accounting policy to not separate non-lease components from lease components and instead account for each lease and associated non-lease component as a single lease component.
Short-term Lease (elect by class of underlying asset)	Elect as an accounting policy to not apply the recognition requirements to short-term leases.
Lease term	Elect to use hindsight to determine the lease term.

Management expects the new standard to impact financial position, but not results of operations or cash flows. Management also continues to monitor unresolved industry implementation issues, including items related to renewables and PPAs, pole attachments, easements and right-of-ways, and will analyze the related impacts to lease accounting. 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.

Management adopted ASU 2016-09 effective January 1, 2017. As a result of the adoption of this guidance, management made an accounting policy election to recognize the effect of forfeitures in compensation cost when they occur. There was an immaterial impact on results of operations and financial position and no impact on cash flows at adoption.

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.

ASU 2016-18 "Restricted Cash" (ASU 2016-18)

In November 2016, the FASB issued ASU 2016-18 clarifying the treatment of restricted cash on the statements of cash flows. Under the new standard, amounts considered restricted cash will be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts on the statements of cash flows.

The new accounting guidance is effective for annual periods beginning after December 15, 2017. Early adoption is permitted in any interim or annual period. The guidance will be applied by means of a retrospective approach. Management is analyzing the impact of the new standard. Management plans to adopt ASU 2016-18 effective for the 2017 Annual Report.

ASU 2017-07 "Compensation - Retirement Benefits" (ASU 2017-07)

In March 2017, the FASB issued ASU 2017-07 requiring that an employer report the service cost component of pension and postretirement benefits in the same line item or items as other compensation costs. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside of a subtotal of income from operations. In addition, only the service cost component will be eligible for capitalization as applicable following labor.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2017. Early adoption is permitted as of the beginning of an annual period for which financial statements have not been issued or made available for issuance. Management is analyzing the impact of the new standard. Management plans to adopt ASU 2017-07 effective January 1, 2018.

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 months ended March 31, 2017 and 2016. 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 March 31, 2017

	Cash Flow Hedges		
	Interest Rate	Pension and OPEB	Total
	(in thousands)		
Balance in AOCI as of December 31, 2016	$ (41)	$ (1,313)	$ (1,354)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	23	—	23
Amortization of Prior Service Cost (Credit)	—	(55)	(55)
Amortization of Actuarial (Gains)/Losses	—	67	67
Reclassifications from AOCI, before Income Tax (Expense) Credit	23	12	35
Income Tax (Expense) Credit	7	4	11
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	16	8	24
Net Current Period Other Comprehensive Income	16	8	24
Balance in AOCI as of March 31, 2017	$ (25)	$ (1,305)	$ (1,330)

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Three Months Ended March 31, 2016

	Cash Flow Hedges		
	Interest Rate	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	23	—	23
Amortization of Prior Service Cost (Credit)	—	(55)	(55)
Amortization of Actuarial (Gains)/Losses	—	62	62
Reclassifications from AOCI, before Income Tax (Expense) Credit	23	7	30
Income Tax (Expense) Credit	8	3	11
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 March 31, 2016	$ (86)	$ (1,540)	$ (1,626)

4. RATE MATTERS

As discussed in KPCo's 2016 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within KPCo's 2016 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 2017 and updates KPCo's 2016 Annual Report.

Regulatory Assets Pending Final Regulatory Approval

Noncurrent Regulatory Assets	March 31, 2017	December 31, 2016
	(in thousands)	
Regulatory Assets Currently Not Earning a Return		
Storm Related Costs	$ 4,377	$ 4,377
Other Regulatory Assets Pending Final Regulatory Approval	68	52
Total Regulatory Assets Pending Final Regulatory Approval	$ 4,445	$ 4,429

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

FERC Transmission Complaint and Proposed Modifications to Transmission Rates

In October 2016, several parties filed a joint complaint with the FERC that states the base return on common equity used by various AEP affiliates in calculating formula transmission rates under the PJM OATT is excessive and should be reduced from 10.99% to 8.32%, effective upon the date of the complaint. Management believes its financial statements adequately address the impact of the complaint. If the FERC orders revenue reductions as a result of the complaint, including refunds from the date of the complaint filing, it could reduce future net income and cash flows and impact financial condition.

Modifications to AEP East Transmission Companies Rates

In November 2016, certain AEP affiliates filed an application with the FERC to modify the PJM OATT formula transmission rate calculation, including an adjustment to recover a tax-related regulatory asset and a shift from historical to estimated expenses, with a proposed effective date of January 1, 2017. The filing proposed that the rates would be implemented based upon the date provided in the resulting FERC order. In March 2017, the FERC accepted the proposed modifications effective January 1, 2017, subject to refund, and set this matter for hearing and settlement procedures. Effective January 1, 2017, the AEP East Transmission Companies implemented the modified PJM OATT formula rates subject to refund which are based on projected 2017 calendar year financial activity and projected plant balances. If the FERC determines that any of these costs are not 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 2016 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 March 31, 2017, 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 March 31, 2017, 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 table provides the components of KPCo's net periodic benefit cost (credit) for the plans for the three months ended March 31, 2017 and 2016:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended March 31,		Three Months Ended March 31,	
	2017	2016	2017	2016
	(in thousands)			
Service Cost	$ 729	$ 615	$ 83	$ 71
Interest Cost	1,787	1,872	539	538
Expected Return on Plan Assets	(2,575)	(2,533)	(960)	(989)
Amortization of Prior Service Cost (Credit)	12	13	(606)	(606)
Amortization of Net Actuarial Loss	719	736	348	287
Net Periodic Benefit Cost (Credit)	$ 672	$ 703	$ (596)	$ (699)

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:

Notional Volume of Derivative Instruments

Primary Risk Exposure	Volume: March 31, 2017	Volume: December 31, 2016	Unit of Measure
	(in thousands)		
Commodity:			
Power	6,251	10,562	MWhs
Heating Oil and Gasoline	241	339	Gallons
Interest Rate	$ —	$ 22	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 March 31, 2017 and December 31, 2016 balance sheets, KPCo netted $4 thousand and $119 thousand, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and $55 thousand and $134 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:

Fair Value of Derivative Instruments
March 31, 2017

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	$ 3,819	$ (3,401)	$ 418
Long-term Risk Management Assets	1,078	(1,050)	28
Total Assets	4,897	(4,451)	446
Current Risk Management Liabilities	3,468	(3,397)	71
Long-term Risk Management Liabilities	1,121	(1,105)	16
Total Liabilities	4,589	(4,502)	87
Total MTM Derivative Contract Net Assets	$ 308	$ 51	$ 359

Fair Value of Derivative Instruments
December 31, 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	$ 4,698	$ (4,241)	$ 457
Long-term Risk Management Assets	359	(359)	—
Total Assets	5,057	(4,600)	457
Current Risk Management Liabilities	4,306	(4,253)	53
Long-term Risk Management Liabilities	675	(362)	313
Total Liabilities	4,981	(4,615)	366
Total MTM Derivative Contract Net Assets	$ 76	$ 15	$ 91

(a) Derivative instruments within these categories 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:

Amount of Gain (Loss) Recognized on Risk Management Contracts

Location of Gain (Loss)	Three Months Ended March 31, 2017	2016
	(in thousands)	
Electric Generation, Transmission and Distribution Revenues	$ 38	$ (163)
Sales to AEP Affiliates	—	290
Other Operation Expense	3	(25)
Maintenance Expense	5	(37)
Purchased Electricity for Resale	1,502	729
Regulatory Assets (a)	14	42
Regulatory Liabilities (a)	325	189
Total Gain on Risk Management Contracts	$ 1,887	$ 1,025

(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."

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 months ended March 31, 2017 and 2016, 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 months ended March 31, 2017 and 2016, KPCo did not apply cash flow hedging to outstanding interest rate derivatives.

During the three months ended March 31, 2017 and 2016, 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.

The impact of cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo's balance sheets were:

	Interest Rate	
	March 31, 2017	December 31, 2016
	(in thousands)	
AOCI Loss Net of Tax	$ (25)	$ (41)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	(25)	(40)

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 March 31, 2017, 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:

	March 31, 2017	December 31, 2016
	(in thousands)	
Amount of Collateral KPCo Would Have Been Required to Post Attributable to RTOs and ISOs	$ 1,280	$ 195
Amount of Collateral Attributable to Other Contracts	1,677	1,657

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:

	March 31, 2017	December 31, 2016
	(in thousands)	
Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements	$ 2	$ 25
Amount of Cash Collateral Posted	—	—
Additional Settlement Liability if Cross Default Provision is Triggered	2	—

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 Vice Chairman, 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 are summarized in the following table:

	March 31, 2017		December 31, 2016	
	Book Value	**Fair Value**	**Book Value**	**Fair Value**
	(in thousands)			
Long-term Debt	$ 867,345	$ 968,232	$ 867,164	$ 965,423

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 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
March 31, 2017

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in thousands)		
Risk Management Assets					
Risk Management Commodity Contracts (a) (b)	$ —	$ 3,007	$ 696	$ (3,257)	$ 446
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a) (b)	$ —	$ 2,901	$ 494	$ (3,308)	$ 87

Assets and Liabilities Measured at Fair Value on a Recurring Basis
December 31, 2016

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in thousands)		
Risk Management Assets					
Risk Management Commodity Contracts (a) (b)	$ —	$ 4,395	$ 616	$ (4,554)	$ 457
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a) (b)	$ —	$ 4,517	$ 418	$ (4,569)	$ 366

(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 months ended March 31, 2017 and 2016.

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 March 31, 2017	Net Risk Management Assets (Liabilities)
	(in thousands)
Balance as of December 31, 2016	$ 198
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	1,381
Settlements	(1,730)
Changes in Fair Value Allocated to Regulated Jurisdictions (e)	353
Balance as of March 31, 2017	$ 202

Three Months Ended March 31, 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)	382
Settlements	(1,739)
Transfers out of Level 3 (d)	22
Changes in Fair Value Allocated to Regulated Jurisdictions (e)	459
Balance as of March 31, 2016	$ 1,370

(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) Transfers are recognized based on their value at the beginning of the reporting period that the transfer occurred.
(e) 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 assets/liabilities.

The following tables quantify the significant unobservable inputs used in developing the fair value of Level 3 positions:

Significant Unobservable Inputs
March 31, 2017

	Fair Value		Valuation	Significant Unobservable	Input/Range		
	Assets	Liabilities	Technique	Input (a)	Low	High	Weighted Average
	(in thousands)						
Energy Contracts	$ 118	$ 46	Discounted Cash Flow	Forward Market Price	$ 19.36	$ 46.45	$ 34.61
FTRs	578	448	Discounted Cash Flow	Forward Market Price	—	3.52	1.00
Total	$ 696	$ 494					

Significant Unobservable Inputs
December 31, 2016

	Fair Value		Valuation	Significant Unobservable	Input/Range		
	Assets	Liabilities	Technique	Input (a)	Low	High	Weighted Average
	(in thousands)						
Energy Contracts	$ 94	$ 81	Discounted Cash Flow	Forward Market Price	$ 19.68	$ 48.55	$ 36.34
FTRs	522	337	Discounted Cash Flow	Forward Market Price	0.01	8.91	0.96
Total	$ 616	$ 418					

(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 March 31, 2017 and December 31, 2016:

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 consolidated net operating loss of the AEP System is allocated to each company in the consolidated group with taxable losses. The tax benefit of the Parent is allocated to its subsidiaries with taxable income. With the exception of the allocation of the consolidated AEP System net operating loss and 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. AEP and 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. The Joint Committee referred 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 three months of 2017.

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 March 31, 2017 and December 31, 2016 are included in Advances from Affiliates on KPCo's balance sheets. KPCo's Utility Money Pool activity and corresponding authorized borrowing limits for the three months ended March 31, 2017 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 March 31, 2017	Authorized Short-Term Borrowing Limit
		(in thousands)			
$ 13,636	$ 20,852	$ 4,438	$ 6,338	$ 12,172	$ 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:

Three Months Ended March 31,	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
2017	1.27%	0.95%	1.15%	0.92%	1.14%	0.97%
2016	0.83%	0.69%	—%	—%	0.73%	—%

Securitized Accounts 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 $47 million and $49 million as of March 31, 2017 and December 31, 2016, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold were $793 thousand and $736 thousand for the three months ended March 31, 2017 and 2016, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit were $161 million and $155 million for the three months ended March 31, 2017 and 2016, respectively.