

# Kentucky Power Company

2019 Second Quarter Report

Financial Statements



An **AEP** Company

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**BOUNDLESS ENERGY**<sup>SM</sup>

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## GLOSSARY OF TERMS

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

Term	Meaning
AEP	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.
APCo	Appalachian Power Company, an AEP electric utility subsidiary.
ARAM	Average Rate Assumption Method, an IRS approved method used to calculate the reversal of Excess ADIT for ratemaking purposes.
ASU	Accounting Standards Update.
Excess ADIT	Excess accumulated deferred income taxes.
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.
KGPCo	Kingsport Power Company, an AEP electric utility subsidiary.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
KPSC	Kentucky Public Service Commission.
MMBtu	Million British Thermal Units.
MTM	Mark-to-Market.
MWh	Megawatt-hour.
OATT	Open Access Transmission Tariff.
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.
PJM	Pennsylvania – New Jersey – Maryland regional transmission organization.
Risk Management Contracts	Trading and non-trading derivatives, including those derivatives designated as cash flow and fair value hedges.
ROE	Return on Equity.
RTO	Regional Transmission Organization, responsible for moving electricity over large interstate areas.
Tax Reform	On December 22, 2017, President Trump signed into law legislation referred to as the “Tax Cut and Jobs Act” (the TCJA). The TCJA includes significant changes to the Internal Revenue Code of 1986, including a reduction in the corporate federal income tax rate from 35% to 21% effective January 1, 2018.
Utility Money Pool	Centralized funding mechanism AEP uses to meet the short-term cash requirements of certain utility subsidiaries.
WPCo	Wheeling Power Company, an AEP electric utility subsidiary.

**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF INCOME**  
**For the Three and Six Months Ended June 30, 2019 and 2018**  
**(in thousands)**  
**(Unaudited)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
<b>REVENUES</b>				
Electric Generation, Transmission and Distribution	\$ 137,135	\$ 148,779	\$ 302,671	\$ 322,277
Sales to AEP Affiliates	3,760	2,909	7,537	6,147
Other Revenues	198	259	479	539
<b>TOTAL REVENUES</b>	<u>141,093</u>	<u>151,947</u>	<u>310,687</u>	<u>328,963</u>
<b>EXPENSES</b>				
Fuel and Other Consumables Used for Electric Generation	21,653	22,941	51,347	38,846
Purchased Electricity for Resale	6,822	13,330	16,457	32,691
Purchased Electricity from AEP Affiliates	22,021	25,918	47,616	52,231
Other Operation	27,828	22,151	54,507	49,103
Maintenance	17,268	20,245	33,167	37,949
Depreciation and Amortization	21,742	21,232	45,981	49,526
Taxes Other Than Income Taxes	7,513	6,098	14,592	12,170
<b>TOTAL EXPENSES</b>	<u>124,847</u>	<u>131,915</u>	<u>263,667</u>	<u>272,516</u>
<b>OPERATING INCOME</b>	16,246	20,032	47,020	56,447
<b>Other Income (Expense):</b>				
Interest Income	6	8	21	24
Carrying Costs Income	1	5	4	10
Allowance for Equity Funds Used During Construction	588	587	847	988
Non-Service Cost Components of Net Periodic Benefit Cost	954	1,013	1,908	2,026
Interest Expense	<u>(9,739)</u>	<u>(9,519)</u>	<u>(18,605)</u>	<u>(18,893)</u>
<b>INCOME BEFORE INCOME TAX EXPENSE (BENEFIT)</b>	8,056	12,126	31,195	40,602
Income Tax Expense (Benefit)	<u>555</u>	<u>(1,898)</u>	<u>2,933</u>	<u>2,080</u>
<b>NET INCOME</b>	<u>\$ 7,501</u>	<u>\$ 14,024</u>	<u>\$ 28,262</u>	<u>\$ 38,522</u>

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

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

**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
**For the Three and Six Months Ended June 30, 2019 and 2018**  
**(in thousands)**  
**(Unaudited)**

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2019</b>	<b>2018</b>	<b>2019</b>	<b>2018</b>
Net Income	\$ 7,501	\$ 14,024	\$ 28,262	\$ 38,522
<b>OTHER COMPREHENSIVE LOSS, NET OF TAXES</b>				
Amortization of Pension and OPEB Deferred Costs, Net of Tax of \$(3) and \$(6) for the Three Months Ended June 30, 2019 and 2018, Respectively, and \$(5) and \$(12) for the Six Months Ended June 30, 2019 and 2018, Respectively	(9)	(22)	(18)	(44)
<b>TOTAL COMPREHENSIVE INCOME</b>	<b>\$ 7,492</b>	<b>\$ 14,002</b>	<b>\$ 28,244</b>	<b>\$ 38,478</b>

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

**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF CHANGES IN**  
**COMMON SHAREHOLDER'S EQUITY**  
**For the Six Months Ended June 30, 2019 and 2018**  
**(in thousands)**  
**(Unaudited)**

	<u>Common Stock</u>	<u>Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2017</b>	\$ 50,450	\$ 526,135	\$ 93,416	\$ 262	\$ 670,263
ASU 2018-02 Adoption			(56)	56	—
Net Income			24,498		24,498
Other Comprehensive Loss				(22)	(22)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2018</b>	50,450	526,135	117,858	296	694,739
Net Income			14,024		14,024
Other Comprehensive Loss				(22)	(22)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2018</b>	<u>\$ 50,450</u>	<u>\$ 526,135</u>	<u>\$ 131,882</u>	<u>\$ 274</u>	<u>\$ 708,741</u>
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – DECEMBER 31, 2018</b>	\$ 50,450	\$ 526,135	\$ 156,506	\$ (212)	\$ 732,879
Net Income			20,761		20,761
Other Comprehensive Loss				(9)	(9)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – MARCH 31, 2019</b>	50,450	526,135	177,267	(221)	753,631
Common Stock Dividends			(5,000)		(5,000)
Net Income			7,501		7,501
Other Comprehensive Loss				(9)	(9)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY – JUNE 30, 2019</b>	<u>\$ 50,450</u>	<u>\$ 526,135</u>	<u>\$ 179,768</u>	<u>\$ (230)</u>	<u>\$ 756,123</u>

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

**KENTUCKY POWER COMPANY**  
**CONDENSED BALANCE SHEETS**  
**ASSETS**  
**June 30, 2019 and December 31, 2018**  
**(in thousands)**  
**(Unaudited)**

	<b>June 30, 2019</b>	<b>December 31, 2018</b>
<b>CURRENT ASSETS</b>		
Cash and Cash Equivalents	\$ 591	\$ 1,168
Accounts Receivable:		
Customers	17,261	20,242
Affiliated Companies	22,172	29,018
Accrued Unbilled Revenues	9,745	8,931
Miscellaneous	227	57
Allowance for Uncollectible Accounts	(226)	(85)
Total Accounts Receivable	<u>49,179</u>	<u>58,163</u>
Fuel	22,306	10,621
Materials and Supplies	16,575	17,207
Risk Management Assets	14,693	5,722
Accrued Tax Benefits	9,774	2,732
Regulatory Asset for Under-Recovered Fuel Costs	—	2,379
Margin Deposits	898	882
Prepayments and Other Current Assets	<u>3,869</u>	<u>3,203</u>
<b>TOTAL CURRENT ASSETS</b>	<u>117,885</u>	<u>102,077</u>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Electric:		
Generation	1,204,790	1,195,701
Transmission	608,799	603,317
Distribution	864,630	845,821
Other Property, Plant and Equipment	98,747	98,280
Construction Work in Progress	<u>116,560</u>	<u>84,748</u>
<b>Total Property, Plant and Equipment</b>	2,893,526	2,827,867
Accumulated Depreciation and Amortization	<u>983,138</u>	<u>961,457</u>
<b>TOTAL PROPERTY, PLANT AND EQUIPMENT – NET</b>	<u>1,910,388</u>	<u>1,866,410</u>
<b>OTHER NONCURRENT ASSETS</b>		
Regulatory Assets	422,193	391,745
Long-term Risk Management Assets	67	159
Employee Benefits and Pension Assets	16,958	15,819
Operating Lease Assets	9,441	—
Deferred Charges and Other Noncurrent Assets	<u>26,429</u>	<u>36,221</u>
<b>TOTAL OTHER NONCURRENT ASSETS</b>	<u>475,088</u>	<u>443,944</u>
<b>TOTAL ASSETS</b>	<u>\$ 2,503,361</u>	<u>\$ 2,412,431</u>

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

**KENTUCKY POWER COMPANY**  
**CONDENSED BALANCE SHEETS**  
**LIABILITIES AND COMMON SHAREHOLDER'S EQUITY**  
**June 30, 2019 and December 31, 2018**  
**(Unaudited)**

	<b>June 30, 2019</b>	<b>December 31, 2018</b>
<b>(in thousands)</b>		
<b>CURRENT LIABILITIES</b>		
Advances from Affiliates	\$ 71,439	\$ 27,871
Accounts Payable:		
General	75,245	51,022
Affiliated Companies	19,516	30,615
Long-term Debt Due Within One Year – Nonaffiliated	65,000	—
Risk Management Liabilities	1,459	95
Customer Deposits	30,691	30,149
Accrued Taxes	21,679	30,479
Accrued Interest	8,251	6,550
Obligations Under Operating Leases	1,822	—
Regulatory Liability for Over-Recovered Fuel Costs	329	—
Asset Retirement Obligations	31,455	20,961
Other Current Liabilities	20,026	24,213
<b>TOTAL CURRENT LIABILITIES</b>	<b>346,912</b>	<b>221,955</b>
<b>NONCURRENT LIABILITIES</b>		
Long-term Debt – Nonaffiliated	802,340	867,128
Long-term Risk Management Liabilities	55	44
Deferred Income Taxes	412,509	402,070
Regulatory Liabilities and Deferred Investment Tax Credits	145,638	155,682
Asset Retirement Obligations	20,078	20,720
Employee Benefits and Pension Obligations	5,722	5,989
Obligations Under Operating Leases	7,603	—
Deferred Credits and Other Noncurrent Liabilities	6,381	5,964
<b>TOTAL NONCURRENT LIABILITIES</b>	<b>1,400,326</b>	<b>1,457,597</b>
<b>TOTAL LIABILITIES</b>	<b>1,747,238</b>	<b>1,679,552</b>
Rate Matters (Note 4)		
Commitments and Contingencies (Note 5)		
<b>COMMON SHAREHOLDER'S EQUITY</b>		
Common Stock – Par Value – \$50 Per Share:		
Authorized – 2,000,000 Shares		
Outstanding – 1,009,000 Shares	50,450	50,450
Paid-in Capital	526,135	526,135
Retained Earnings	179,768	156,506
Accumulated Other Comprehensive Income (Loss)	(230)	(212)
<b>TOTAL COMMON SHAREHOLDER'S EQUITY</b>	<b>756,123</b>	<b>732,879</b>
<b>TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY</b>	<b>\$ 2,503,361</b>	<b>\$ 2,412,431</b>

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



**KENTUCKY POWER COMPANY**  
**CONDENSED STATEMENTS OF CASH FLOWS**  
**For the Six Months Ended June 30, 2019 and 2018**  
**(in thousands)**  
**(Unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2019</b>	<b>2018</b>
<b>OPERATING ACTIVITIES</b>		
<b>Net Income</b>	\$ 28,262	\$ 38,522
<b>Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:</b>		
Depreciation and Amortization	45,981	49,526
Deferred Income Taxes	2,791	3,765
Allowance for Equity Funds Used During Construction	(847)	(988)
Mark-to-Market of Risk Management Contracts	(7,504)	(4,653)
Property Taxes	9,932	7,224
Deferred Fuel Over/Under-Recovery, Net	2,708	(2,755)
Change in Other Noncurrent Assets	(16,338)	(20,039)
Change in Other Noncurrent Liabilities	(18,797)	(3,100)
<b>Changes in Certain Components of Working Capital:</b>		
Accounts Receivable, Net	9,304	10,389
Fuel, Materials and Supplies	(10,987)	(2,852)
Accounts Payable	7,227	(7,409)
Accrued Taxes, Net	(15,842)	(7,938)
Other Current Assets	(691)	9,424
Other Current Liabilities	(1,819)	(5,990)
<b>Net Cash Flows from Operating Activities</b>	<u>33,380</u>	<u>63,126</u>
<b>INVESTING ACTIVITIES</b>		
Construction Expenditures	(72,578)	(69,079)
Other Investing Activities	304	523
<b>Net Cash Flows Used for Investing Activities</b>	<u>(72,274)</u>	<u>(68,556)</u>
<b>FINANCING ACTIVITIES</b>		
Change in Advances from Affiliates, Net	43,568	5,794
Principal Payments for Finance Lease Obligations	(327)	(455)
Dividends Paid on Common Stock	(5,000)	—
Other Financing Activities	76	38
<b>Net Cash Flows from Financing Activities</b>	<u>38,317</u>	<u>5,377</u>
<b>Net Decrease in Cash and Cash Equivalents</b>	(577)	(53)
<b>Cash and Cash Equivalents at Beginning of Period</b>	1,168	909
<b>Cash and Cash Equivalents at End of Period</b>	<u>\$ 591</u>	<u>\$ 856</u>
<b>SUPPLEMENTARY INFORMATION</b>		
Cash Paid for Interest, Net of Capitalized Amounts	\$ 16,541	\$ 18,532
Net Cash Paid (Received) for Income Taxes	7,049	(266)
Noncash Acquisitions Under Finance Leases	475	115
Construction Expenditures Included in Current Liabilities as of June 30,	26,896	17,123

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

## INDEX OF CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

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## **1. SIGNIFICANT ACCOUNTING MATTERS**

### ***General***

The unaudited condensed financial statements and footnotes were prepared in accordance with GAAP for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete annual financial statements.

In the opinion of management, the unaudited condensed interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three and six months ended June 30, 2019 is not necessarily indicative of results that may be expected for the year ending December 31, 2019. The condensed financial statements are unaudited and should be read in conjunction with the audited 2018 financial statements and notes thereto, which are included in KPCo's 2018 Annual Report.

### ***Subsequent Events***

Management reviewed subsequent events through July 25, 2019, the date that the second quarter 2019 report was available to be issued.

## 2. NEW ACCOUNTING PRONOUNCEMENTS

During the FASB's standard-setting process and upon issuance of final pronouncements, management reviews the new accounting literature to determine its relevance, if any, to KPCo's business. The following pronouncements will impact the financial statements.

### *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 sheets 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, capital leases are known as finance leases going forward. Leases with terms of 12 months or longer are also subject to the new requirements. Fundamentally, the criteria used to determine lease classification remains the same, but is more subjective under the new standard.

New leasing standard implementation activities included the identification of the lease population within the AEP System as well as the sampling of representative lease contracts to analyze accounting treatment under the new accounting guidance. Based upon the completed assessments, management also prepared a gap analysis to outline new disclosure compliance requirements.

Management adopted ASU 2016-02 effective January 1, 2019 by means of a cumulative-effect adjustment to the balance sheet. Management elected the following practical expedients upon adoption:

<u>Practical Expedient</u>	<u>Description</u>
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.
Existing and expired land easements not previously accounted for as leases	Elect optional transition practical expedient to not evaluate under Topic 842 existing or expired land easements that were not previously accounted for as leases under the current leases guidance in Topic 840.
Cumulative-effect adjustment in the period of adoption	Elect the optional transition practical expedient to adopt the new lease requirements through a cumulative-effect adjustment on the balance sheet in the period of adoption.

Management concluded that the result of adoption would not materially change the volume of contracts that qualify as leases going forward. The adoption of the new standard did not materially impact results of operations or cash flows, but did have a material impact on the balance sheet. See Note 10 - Leases for additional disclosures required by the new standard.

### *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, 2020, 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 results of operations, financial position or cash flows. Management plans to adopt ASU 2016-13 and related implementation guidance effective January 1, 2020.

***ASU 2018-15 “Internal-Use Software: Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract” (ASU 2018-15)***

In August 2018, the FASB issued ASU 2018-15 aligning the requirements for capitalizing implementation costs incurred in a cloud computing arrangement (hosting arrangement) that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The new standard requires an entity (customer) in a hosting arrangement that is a service contract to follow the accounting guidance for “Internal-Use Software” to determine which implementation costs to capitalize as an asset related to the service contract and which costs to expense. To eliminate diversity in practice, the new standard changes the presentation of implementation costs for cloud service arrangements that are service contracts without the purchase of a license. Implementation costs for cloud service contracts will be presented on the balance sheets in the same manner as a prepayment. KPCo currently presents implementation costs in property, plant and equipment on the balance sheets. Under the new standard, amortization of capitalized implementation costs of a hosting arrangement will be recorded in Operation and Maintenance expense over the term of the cloud service arrangement, rather than Depreciation and Amortization expense on the statements of income. Payments for capitalized implementation costs in the statement of cash flows will be classified in the same manner as payments made for fees associated with the hosting element.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2020, with early adoption permitted. The amendments may be applied either retrospectively or prospectively to applicable implementation costs incurred after the date of adoption. Management is analyzing the impact of this new standard and at this time, cannot estimate the impact of adoption on results of operations, financial position or cash flows. Management plans to adopt ASU 2018-15 prospectively, 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. The amortization of pension and OPEB AOCI components are included in the computation of net periodic pension and OPEB costs. See Note 6 - Benefit Plans for additional details.

<b>Three Months Ended June 30, 2019</b>	<b>Pension and OPEB (in thousands)</b>
<b>Balance in AOCI as of March 31, 2019</b>	\$ (221)
Change in Fair Value Recognized in AOCI	—
Amount of (Gain) Loss Reclassified from AOCI	
Amortization of Prior Service Cost (Credit)	(56)
Amortization of Actuarial (Gains) Losses	44
Reclassifications from AOCI, before Income Tax (Expense) Benefit	(12)
Income Tax (Expense) Benefit	(3)
Reclassifications from AOCI, Net of Income Tax (Expense) Benefit	(9)
Net Current Period Other Comprehensive Income (Loss)	(9)
<b>Balance in AOCI as of June 30, 2019</b>	<b>\$ (230)</b>

  

<b>Three Months Ended June 30, 2018</b>	<b>Pension and OPEB (in thousands)</b>
<b>Balance in AOCI as of March 31, 2018</b>	\$ 296
Change in Fair Value Recognized in AOCI	—
Amount of (Gain) Loss Reclassified from AOCI	
Amortization of Prior Service Cost (Credit)	(56)
Amortization of Actuarial (Gains) Losses	28
Reclassifications from AOCI, before Income Tax (Expense) Benefit	(28)
Income Tax (Expense) Benefit	(6)
Reclassifications from AOCI, Net of Income Tax (Expense) Benefit	(22)
Net Current Period Other Comprehensive Income (Loss)	(22)
<b>Balance in AOCI as of June 30, 2018</b>	<b>\$ 274</b>

  

<b>Six Months Ended June 30, 2019</b>	<b>Pension and OPEB (in thousands)</b>
<b>Balance in AOCI as of December 31, 2018</b>	\$ (212)
Change in Fair Value Recognized in AOCI	—
Amount of (Gain) Loss Reclassified from AOCI	
Amortization of Prior Service Cost (Credit)	(112)
Amortization of Actuarial (Gains) Losses	89
Reclassifications from AOCI, before Income Tax (Expense) Benefit	(23)
Income Tax (Expense) Benefit	(5)
Reclassifications from AOCI, Net of Income Tax (Expense) Benefit	(18)
Net Current Period Other Comprehensive Income (Loss)	(18)
<b>Balance in AOCI as of June 30, 2019</b>	<b>\$ (230)</b>

  

<b>Six Months Ended June 30, 2018</b>	<b>Pension and OPEB (in thousands)</b>
<b>Balance in AOCI as of December 31, 2017</b>	\$ 262
Change in Fair Value Recognized in AOCI	—
Amount of (Gain) Loss Reclassified from AOCI	
Amortization of Prior Service Cost (Credit)	(112)
Amortization of Actuarial (Gains) Losses	56
Reclassifications from AOCI, before Income Tax (Expense) Benefit	(56)
Income Tax (Expense) Benefit	(12)
Reclassifications from AOCI, Net of Income Tax (Expense) Benefit	(44)
Net Current Period Other Comprehensive Income (Loss)	(44)
ASU 2018-02 Adoption	56
<b>Balance in AOCI as of June 30, 2018</b>	<b>\$ 274</b>

#### 4. RATE MATTERS

As discussed in KPCo's 2018 Annual Report, KPCo is involved in rate and regulatory proceedings at the FERC and the KPSC. The Rate Matters note within KPCo's 2018 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 2019 and updates KPCo's 2018 Annual Report.

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

<b>Noncurrent Regulatory Assets</b>	<b>June 30, 2019</b>	<b>December 31, 2018</b>
	<b>(in thousands)</b>	
<u>Regulatory Assets Currently Earning a Return</u>		
Kentucky Deferred Purchased Power Expenses	\$ 22,260	\$ 14,477
<u>Regulatory Assets Currently Not Earning a Return</u>		
Other Regulatory Assets Pending Final Regulatory Approval	1,272	1,148
<b>Total Regulatory Assets Pending Final Regulatory Approval</b>	<u>\$ 23,532</u>	<u>\$ 15,625</u>

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 - AEP's PJM Participants*

In October 2016, seven parties filed a complaint at the FERC that alleged the base return on common equity used by AEP's transmission owning subsidiaries within PJM, including KPCo, 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. In March 2018, AEP's transmission owning subsidiaries within PJM and six of the complainants filed a settlement agreement with the FERC (the seventh complainant abstained). The settlement agreement: (a) establishes a base ROE for AEP's transmission owning subsidiaries within PJM of 9.85% (10.35% inclusive of the RTO incentive adder of 0.5%), effective January 1, 2018, (b) requires AEP's transmission owning subsidiaries within PJM to provide a one-time refund of \$50 million, attributable from the date of the complaint through December 31, 2017, which was credited to customer bills in the second quarter of 2018 and (c) increases the cap on the equity portion of the capital structure to 55% from 50%. As part of the settlement agreement, AEP's transmission owning subsidiaries within PJM, including KPCo, also filed updated transmission formula rates incorporating the reduction in the corporate federal income tax rate due to Tax Reform, effective January 1, 2018 and providing for the amortization of the portion of the Excess ADIT that is not subject to the normalization method of accounting, ratably over a ten-year period through credits to the federal income tax expense component of the revenue requirement. In May 2019, the FERC approved the settlement agreement.

## **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 2018 Annual Report should be read in conjunction with this report.

### **GUARANTEES**

Liabilities for guarantees are recorded in accordance with the accounting guidance for "Guarantees." There is no collateral held in relation to any guarantees. In the event any guarantee is drawn, there is no recourse to third-parties unless specified below.

#### ***Indemnifications and Other Guarantees***

##### ***Contracts***

KPCo enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of June 30, 2019, there were no material liabilities recorded for any indemnifications.

AEPSC conducts power purchase and sale activity on behalf of APCo, I&M, KPCo and WPCo, who are jointly and severally liable for activity conducted on their behalf.



## 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:

	<b>Pension Plans</b>		<b>OPEB</b>	
	<b>Three Months Ended June 30, 2019</b>	<b>2018</b>	<b>Three Months Ended June 30, 2019</b>	<b>2018</b>
	<b>(in thousands)</b>			
Service Cost	\$ 711	\$ 703	\$ 66	\$ 82
Interest Cost	1,823	1,686	464	432
Expected Return on Plan Assets	(2,728)	(2,652)	(910)	(986)
Amortization of Prior Service Credit	—	—	(606)	(606)
Amortization of Net Actuarial Loss	505	755	212	90
<b>Net Periodic Benefit Cost (Credit)</b>	<b>\$ 311</b>	<b>\$ 492</b>	<b>\$ (774)</b>	<b>\$ (988)</b>

  

	<b>Pension Plans</b>		<b>OPEB</b>	
	<b>Six Months Ended June 30, 2019</b>	<b>2018</b>	<b>Six Months Ended June 30, 2019</b>	<b>2018</b>
	<b>(in thousands)</b>			
Service Cost	\$ 1,422	\$ 1,406	\$ 131	\$ 164
Interest Cost	3,646	3,372	928	863
Expected Return on Plan Assets	(5,455)	(5,303)	(1,820)	(1,972)
Amortization of Prior Service Credit	—	—	(1,212)	(1,212)
Amortization of Net Actuarial Loss	1,010	1,510	426	181
<b>Net Periodic Benefit Cost (Credit)</b>	<b>\$ 623</b>	<b>\$ 985</b>	<b>\$ (1,547)</b>	<b>\$ (1,976)</b>

## 7. 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, coal, 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 may also utilize derivative contracts to manage interest rate risk associated with debt financing. For disclosure purposes, these risks are grouped as “Interest Rate.” 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		Unit of Measure
	June 30, 2019	December 31, 2018	
	(in thousands)		
Commodity:			
Power	23,722	12,140	MWhs
Natural Gas	—	698	MMBtus
Heating Oil and Gasoline	351	329	Gallons

## *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 may utilize a variety of interest rate derivative transactions in order to manage interest rate risk exposure. KPCo may also utilize interest rate derivative contracts to manage interest rate exposure related to future borrowings of fixed-rate debt. KPCo does not hedge all interest rate exposure.

## **ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND THE IMPACT ON KPCo’s FINANCIAL STATEMENTS**

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

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

According to the accounting guidance for “Derivatives and Hedging,” KPCo reflects the fair values of derivative instruments subject to netting agreements with the same counterparty net of related cash collateral. For certain risk management contracts, KPCo is required to post or receive cash collateral based on third-party contractual agreements and risk profiles. For the June 30, 2019 and December 31, 2018 balance sheets, KPCo netted \$88 thousand and \$227 thousand, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and \$635 thousand and \$117 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  
June 30, 2019**

<u>Balance Sheet Location</u>	<u>Risk Management Contracts – Commodity (a)</u>	<u>Gross Amounts Offset in the Statement of Financial Position (b)</u>	<u>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</u>
		(in thousands)	
Current Risk Management Assets	\$ 25,732	\$ (11,039)	\$ 14,693
Long-term Risk Management Assets	1,299	(1,232)	67
<b>Total Assets</b>	<u>27,031</u>	<u>(12,271)</u>	<u>14,760</u>
Current Risk Management Liabilities	13,026	(11,567)	1,459
Long-term Risk Management Liabilities	1,306	(1,251)	55
<b>Total Liabilities</b>	<u>14,332</u>	<u>(12,818)</u>	<u>1,514</u>
<b>Total MTM Derivative Contract Net Assets</b>	<u>\$ 12,699</u>	<u>\$ 547</u>	<u>\$ 13,246</u>

**Fair Value of Derivative Instruments  
December 31, 2018**

<u>Balance Sheet Location</u>	<u>Risk Management Contracts – Commodity (a)</u>	<u>Gross Amounts Offset in the Statement of Financial Position (b)</u>	<u>Net Amounts of Assets/Liabilities Presented in the Statement of Financial Position (c)</u>
		(in thousands)	
Current Risk Management Assets	\$ 15,430	\$ (9,708)	\$ 5,722
Long-term Risk Management Assets	546	(387)	159
<b>Total Assets</b>	<u>15,976</u>	<u>(10,095)</u>	<u>5,881</u>
Current Risk Management Liabilities	9,694	(9,599)	95
Long-term Risk Management Liabilities	430	(386)	44
<b>Total Liabilities</b>	<u>10,124</u>	<u>(9,985)</u>	<u>139</u>
<b>Total MTM Derivative Contract Net Assets (Liabilities)</b>	<u>\$ 5,852</u>	<u>\$ (110)</u>	<u>\$ 5,742</u>

- (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) All derivative contracts subject to a master netting arrangement or similar agreement are 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**

<u>Location of Gain (Loss)</u>	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2019</u>	<u>2018</u>	<u>2019</u>	<u>2018</u>
		(in thousands)		
Electric Generation, Transmission and Distribution Revenues	\$ 37	\$ (123)	\$ 44	\$ (289)
Purchased Electricity for Resale	23	37	60	96
Other Operation	—	17	(15)	30
Maintenance	(4)	22	(18)	36
Regulatory Assets (a)	(224)	—	(102)	—
Regulatory Liabilities (a)	2,268	3,551	554	7,731
<b>Total Gain on Risk Management Contracts</b>	<u>\$ 2,100</u>	<u>\$ 3,504</u>	<u>\$ 523</u>	<u>\$ 7,604</u>

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

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

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

For contracts that have not been designated as part of a hedging relationship, the accounting for changes in fair value depends on whether the derivative instrument is held for trading purposes. Unrealized and realized gains and losses on derivative instruments held for trading purposes are included in revenues on a net basis on KPCo’s statements of income. Unrealized and realized gains and losses on derivative instruments not held for trading purposes are included in revenues or expenses on KPCo’s statements of income depending on the relevant facts and circumstances. Certain derivatives that economically hedge future commodity risk are recorded in the same expense line item on the statements of income as that of the associated risk. However, unrealized and some realized gains and losses for both trading and non-trading derivative instruments are recorded as regulatory assets (for losses) or regulatory liabilities (for gains), in accordance with the accounting guidance for “Regulated Operations.”

### ***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 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.

Realized gains and losses on derivative contracts for the purchase and sale of power designated as cash flow hedges are included in Total Revenues or Purchased Electricity for Resale on KPCo’s statements of income, or in Regulatory Assets or Regulatory Liabilities on KPCo’s balance sheets, depending on the specific nature of the risk being hedged. During the three and six months ended June 30, 2019 and 2018, KPCo did not apply cash flow hedging to outstanding power derivatives.

KPCo reclassifies gains and losses on interest rate derivative hedges related to debt financings from Accumulated Other Comprehensive Income (Loss) on its balance sheets into Interest Expense on its statements of income in those periods in which hedged interest payments occur. During the three and six months ended June 30, 2019 and 2018, KPCo did not apply cash flow hedging to outstanding interest rate derivatives.

There was no impact of cash flow hedges included in Accumulated Other Comprehensive Income (Loss) on KPCo’s balance sheets as of June 30, 2019 and December 31, 2018.

The actual amounts that KPCo reclassifies from Accumulated Other Comprehensive Income (Loss) to Net Income can differ due to market price changes. As of June 30, 2019, 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 mitigates 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 credit agency ratings 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. Some master agreements include margining, which requires a counterparty to post cash or letters of credit in the event 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 default including failure or inability to post collateral when required.

## ***Collateral Triggering Events***

### *Credit Downgrade Triggers*

A limited number of derivative contracts include collateral triggering events, which include a requirement to maintain certain credit ratings. On an ongoing basis, AEP's risk management organization assesses the appropriateness of these collateral triggering events in contracts. KPCo has not experienced a downgrade below a specified credit rating threshold that would require the posting of additional collateral. As of June 30, 2019 and December 31, 2018, KPCo did not have derivative contracts with collateral triggering events in a net liability position.

### *Cross-Default Triggers*

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:

	<b>June 30, 2019</b>	<b>December 31, 2018</b>
	<b>(in thousands)</b>	
Liabilities for Contracts with Cross-Default Provisions Prior to Contractual Netting Arrangements	\$ 1,114	\$ 165
Additional Settlement Liability if Cross-Default Provision is Triggered	100	4

## 8. FAIR VALUE MEASUREMENTS

### *Fair Value Hierarchy and Valuation Techniques*

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

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 derivatives 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:

	<u>June 30, 2019</u>		<u>December 31, 2018</u>	
	<u>Book Value</u>	<u>Fair Value</u>	<u>Book Value</u>	<u>Fair Value</u>
	(in thousands)			
Long-term Debt	\$ 867,340	\$ 960,854	\$ 867,128	\$ 903,690

## ***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 June 30, 2019**

<b>Assets:</b>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
<b>Risk Management Assets</b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ —</u>	<u>\$ 11,868</u>	<u>\$ 15,093</u>	<u>\$ (12,201)</u>	<u>\$ 14,760</u>
<b>Liabilities:</b>					
<b>Risk Management Liabilities</b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ —</u>	<u>\$ 12,450</u>	<u>\$ 1,812</u>	<u>\$ (12,748)</u>	<u>\$ 1,514</u>

### **Assets and Liabilities Measured at Fair Value on a Recurring Basis December 31, 2018**

<b>Assets:</b>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Other</u>	<u>Total</u>
	(in thousands)				
<b>Risk Management Assets</b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ 23</u>	<u>\$ 10,083</u>	<u>\$ 5,867</u>	<u>\$ (10,092)</u>	<u>\$ 5,881</u>
<b>Liabilities:</b>					
<b>Risk Management Liabilities</b>					
Risk Management Commodity Contracts (a) (b)	<u>\$ 34</u>	<u>\$ 10,024</u>	<u>\$ 63</u>	<u>\$ (9,982)</u>	<u>\$ 139</u>

(a) Amounts in "Other" column primarily represent counterparty netting of risk management and hedging contracts and associated cash collateral under the accounting guidance for "Derivatives and Hedging."

(b) Substantially comprised of power contracts.

There were no transfers between Level 1 and Level 2 during the three and six months ended June 30, 2019 and 2018.



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

<b>Three Months Ended June 30, 2019</b>		<b>Net Risk Management Assets (Liabilities) (in thousands)</b>
<b>Balance as of March 31, 2019</b>		\$ 1,367
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)		2,689
Settlements		(3,651)
Changes in Fair Value Allocated to Regulated Jurisdictions (d)		12,876
<b>Balance as of June 30, 2019</b>		<u>\$ 13,281</u>
<b>Three Months Ended June 30, 2018</b>		<b>Net Risk Management Assets (Liabilities) (in thousands)</b>
<b>Balance as of March 31, 2018</b>		\$ 1,134
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)		1,687
Settlements		(2,466)
Changes in Fair Value Allocated to Regulated Jurisdictions (d)		5,723
<b>Balance as of June 30, 2018</b>		<u>\$ 6,078</u>
<b>Six Months Ended June 30, 2019</b>		<b>Net Risk Management Assets (Liabilities) (in thousands)</b>
<b>Balance as of December 31, 2018</b>		\$ 5,804
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)		1,399
Settlements		(6,600)
Transfers out of Level 3 (c)		(120)
Changes in Fair Value Allocated to Regulated Jurisdictions (d)		12,798
<b>Balance as of June 30, 2019</b>		<u>\$ 13,281</u>
<b>Six Months Ended June 30, 2018</b>		<b>Net Risk Management Assets (Liabilities) (in thousands)</b>
<b>Balance as of December 31, 2017</b>		\$ 1,813
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (a) (b)		6,790
Settlements		(8,429)
Changes in Fair Value Allocated to Regulated Jurisdictions (d)		5,904
<b>Balance as of June 30, 2018</b>		<u>\$ 6,078</u>

- (a) Included in revenues on KPCo's statements of income.
- (b) Represents the change in fair value between the beginning of the reporting period and the settlement of the risk management commodity contract.
- (c) Transfers are recognized based on their value at the beginning of the reporting period that the transfer occurred.
- (d) 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 or accounts payable.

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

**Significant Unobservable Inputs  
June 30, 2019**

	<u>Fair Value</u>		<u>Valuation Technique</u>	<u>Significant Unobservable Input (a)</u>	<u>Input/Range</u>		
	<u>Assets</u>	<u>Liabilities</u>			<u>Low</u>	<u>High</u>	<u>Weighted Average</u>
	(in thousands)						
Energy Contracts	\$ 1,820	\$ 457	Discounted Cash Flow	Forward Market Price	\$ 12.55	\$ 45.35	\$ 27.56
FTRs	13,273	1,355	Discounted Cash Flow	Forward Market Price	(0.42)	4.16	1.38
<b>Total</b>	<u>\$ 15,093</u>	<u>\$ 1,812</u>					

**Significant Unobservable Inputs  
December 31, 2018**

	<u>Fair Value</u>		<u>Valuation Technique</u>	<u>Significant Unobservable Input (a)</u>	<u>Input/Range</u>		
	<u>Assets</u>	<u>Liabilities</u>			<u>Low</u>	<u>High</u>	<u>Weighted Average</u>
	(in thousands)						
Energy Contracts	\$ 430	\$ 63	Discounted Cash Flow	Forward Market Price	\$ 16.82	\$ 62.65	\$ 37.00
FTRs	5,437	—	Discounted Cash Flow	Forward Market Price	0.05	6.21	1.62
<b>Total</b>	<u>\$ 5,867</u>	<u>\$ 63</u>					

(a) Represents market prices in dollars per MWh.

The following table provides sensitivity of fair value measurements to increases (decreases) in significant unobservable inputs related to Energy Contracts and FTRs as of June 30, 2019 and December 31, 2018:

**Sensitivity of Fair Value Measurements**

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

## 9. INCOME TAXES

### *Effective Tax Rates (ETR)*

The interim ETR for KPCo reflects the estimated annual ETR for 2019 and 2018 adjusted for tax expense associated with certain discrete items. The interim ETR differs from the federal statutory tax rate of 21% primarily due to state income taxes, increased amortization of Excess ADIT and other book/tax differences which are accounted for on a flow-through basis. KPCo includes the amortization of Excess ADIT not subject to normalization requirements in the annual estimated ETR when regulatory proceedings instruct KPCo to provide the benefits of Tax Reform to customers over multiple interim periods. Certain regulatory proceedings may instruct KPCo to provide the benefits of Tax Reform to customers in a single period (e.g. by applying the Excess ADIT not subject to normalization requirements against an existing regulatory asset balance) and in these circumstances, KPCo recognizes the tax benefit discretely in the period recorded.

The ETR for KPCo are included in the following table. Significant variances in the ETR are described below.

<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
<b>2019</b>	<b>2018</b>	<b>2019</b>	<b>2018</b>
6.9%	(15.7)%	9.4%	5.1%

### *Three Months Ended June 30, 2019 Compared to Three Months Ended June 30, 2018*

The increase in ETR was primarily due to \$2.7 million of decreased amortization of Excess ADIT not subject to normalization requirements and \$346 thousand of Excess ADIT subject to normalization requirements which impacted the ETR by 19.8% and 1.6%, respectively. Amortization of Excess ADIT not subject to normalization requirements for the three months ended June 30, 2018 reflects Tax Reform elements of the June 2018 KPSC Tax Reform order.

### *Six Months Ended June 30, 2019 Compared to Six Months Ended June 30, 2018*

The increase in ETR was primarily due to \$892 thousand of decreased amortization of Excess ADIT not subject to normalization requirements, \$686 thousand of decreased amortization of Excess ADIT subject to normalization requirements and \$478 thousand of increased state income taxes which impacted the ETR by 0.4%, 0.8% and 1.7%, respectively.

### *Federal and State Income Tax Audit Status*

The IRS has completed its examination of KPCo and other AEP subsidiaries for all years through 2016.

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, local or non-U.S. income tax examinations by tax authorities for years before 2007.

### *State Tax Legislation*

In April 2018, the Kentucky legislature enacted House Bill (H.B.) 487. H.B. 487 adopts mandatory unitary combined reporting for state corporate income tax purposes applicable for taxable years beginning on or after January 1, 2019. H.B. 487 also adopts the 80% federal net operating loss (NOL) limitation under Internal Revenue Code Sec. 172(a) for NOLs generated after January 1, 2018 and the federal unlimited carryforward period for unused NOLs generated after January 1, 2018. In addition, H.B. 366 was also enacted in April 2018, which among other things, replaces the graduated corporate tax rate structure with a flat 5% tax rate for business income and adopts a single-sales factor apportionment formula for apportioning a corporation's business income to Kentucky. The enacted legislation did not materially impact KPCo's net income.

## 10. LEASES

KPCo leases property, plant and equipment including, but not limited to, fleet, information technology and real estate leases. These leases require payments of non-lease components, including related property taxes, operating and maintenance costs. As of the adoption date of ASU 2016-02, management elected not to separate non-lease components from associated lease components in accordance with the accounting guidance for “Leases.” Many of these leases have purchase or renewal options. Leases not renewed are often replaced by other leases. Options to renew or purchase a lease are included in the measurement of lease assets and liabilities if it is reasonably certain that KPCo will exercise the option.

Lease obligations are measured using the discount rate implicit in the lease when that rate is readily determinable. When the implicit rate is not readily determinable, KPCo measures its lease obligation using its estimated secured incremental borrowing rate. Incremental borrowing rates are comprised of an underlying risk free rate and a secured credit spread relative to the lessee on a matched maturity basis.

Lease rentals for both operating and finance leases are generally charged to Other Operation and Maintenance expense in accordance with rate-making treatment for regulated operations. Additionally, for regulated operations with finance leases, a finance lease asset and offsetting liability are recorded at the present value of the remaining lease payments for each reporting period. Finance leases for nonregulated property are accounted for as if the assets were owned and financed. The components of rental costs for were as follows:

Lease Rental Costs	Three Months Ended June 30, 2019	Six Months Ended June 30, 2019
	(in thousands)	
Operating Lease Cost	\$ 596	\$ 1,171
Finance Lease Cost:		
Amortization of Right-of-Use Assets	159	312
Interest on Lease Liabilities	29	58
<b>Total Lease Rental Costs (a)</b>	<b>\$ 784</b>	<b>\$ 1,541</b>

(a) Excludes variable and short-term lease costs, which were immaterial for the three and six months ended June 30, 2019.

Supplemental information related to leases as of and for the six months ended June 30, 2019 are shown in the tables below.

Lease Type	Weighted-Average Remaining Lease Term (years):	Weighted-Average Discount Rate
Operating Leases	6.43	3.79%
Finance Leases	5.91	4.57%
		<b>Six Months Ended June 30, 2019</b>
		(in thousands)
<b>Cash paid for amounts included in the measurement of lease liabilities:</b>		
Operating Cash Flows from Operating Leases	\$	1,135
Operating Cash Flows from Finance Leases		58
Financing Cash Flows from Finance Leases		327
Non-cash Acquisitions Under Operating Leases	\$	1,368

The following tables show the property, plant and equipment under finance leases and noncurrent assets under operating leases and related obligations recorded on KPCo's balance sheets. Unless shown as a separate line on the balance sheets due to materiality, net operating lease assets are included in Deferred Charges and Other Noncurrent Assets, current finance lease obligations are included in Other Current Liabilities and long-term finance lease obligations are included in Deferred Credits and Other Noncurrent Liabilities on the balance sheets. Lease obligations are not recognized on the balance sheets for lease agreements with a lease term of less than twelve months.

	<b>June 30, 2019</b>
	<b>(in thousands)</b>
<b>Property, Plant and Equipment Under Finance Leases</b>	
Generation	\$ 1,949
Other Property, Plant and Equipment	2,853
<b>Total Property, Plant and Equipment Under Finance Leases</b>	<b>4,802</b>
Accumulated Amortization	2,123
<b>Net Property, Plant and Equipment Under Finance Leases</b>	<b>\$ 2,679</b>
<b>Obligations Under Finance Leases</b>	
Noncurrent Liability	\$ 2,077
Liability Due Within One Year	602
<b>Total Obligations Under Finance Leases</b>	<b>\$ 2,679</b>
<b>Operating Lease Assets</b>	
	<b>\$ 9,441</b>
<b>Obligations Under Operating Leases</b>	
Noncurrent Liability	\$ 7,603
Liability Due Within One Year	1,822
<b>Total Obligations Under Operating Leases</b>	<b>\$ 9,425</b>

Future minimum lease payments as of June 30, 2019 are presented on a rolling 12-month basis as shown in the table below:

<b>Future Minimum Lease Payments</b>	<b>Finance Leases</b>	<b>Operating Leases</b>
	<b>(in thousands)</b>	
Year 1	\$ 718	\$ 2,193
Year 2	621	2,004
Year 3	513	1,743
Year 4	345	1,425
Year 5	283	1,097
Later Years	668	2,441
<b>Total Future Minimum Lease Payments</b>	<b>3,148</b>	<b>10,903</b>
Less Imputed Interest	469	1,478
<b>Estimated Present Value of Future Minimum Lease Payments</b>	<b>\$ 2,679</b>	<b>\$ 9,425</b>

Future minimum lease payments consisted of the following as of December 31, 2018:

<u>Future Minimum Lease Payments</u>	<u>Finance Leases</u>	<u>Operating Leases</u>
	<b>(in thousands)</b>	
2019	\$ 703	\$ 2,196
2020	552	2,024
2021	473	1,743
2022	325	1,456
2023	220	1,165
Later Years	649	2,367
<b>Total Future Minimum Lease Payments</b>	<u>2,922</u>	<u>\$ 10,951</u>
Less Imputed Interest	391	
<b>Estimated Present Value of Future Minimum Lease Payments</b>	<u>\$ 2,531</u>	

### ***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 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 amount guaranteed. As of June 30, 2019, 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.

### ***Lessor Activity***

KPCo's lessor activity was immaterial as of and for the three and six months ended June 30, 2019.

## 11. FINANCING ACTIVITIES

### *Long-term Debt*

KPCo did not have any long-term debt issuances or retirements during the first six months of 2019.

### *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.

All of the dividends declared by KPCo are subject to a Federal Power Act restriction that prohibits the payment of dividends out of capital accounts without regulatory approval; payment of dividends is allowed out of retained earnings only.

KPCo has credit agreements that contain a covenant that limit its debt to capitalization ratio to 67.5%. As of June 30, 2019, KPCo did not exceed its debt to capitalization limit. The method for calculating outstanding debt and capitalization is contractually-defined in the credit agreements.

The Federal Power Act restriction does not limit the ability of KPCo to pay dividends out of retained earnings.

### *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 its agreement filed with the FERC. The amounts of outstanding borrowings from the Utility Money Pool as of June 30, 2019 and December 31, 2018 are included in Advances from Affiliates on KPCo's balance sheets. KPCo's Utility Money Pool activity and corresponding authorized borrowing limit for the six months ended June 30, 2019 are described in the following table:

<u>Maximum Borrowings from the Utility Money Pool</u>	<u>Average Borrowings from the Utility Money Pool</u>	<u>Borrowings from the Utility Money Pool as of June 30, 2019</u>	<u>Authorized Short-Term Borrowing Limit</u>
(in thousands)			
\$ 71,439	\$ 30,383	\$ 71,439	\$ 180,000

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

<u>Six Months Ended June 30,</u>	<u>Maximum Interest Rate for Funds Borrowed from the Utility Money Pool</u>	<u>Minimum Interest Rate for Funds Borrowed from the Utility Money Pool</u>	<u>Maximum Interest Rate for Funds Loaned to the Utility Money Pool</u>	<u>Minimum Interest Rate for Funds Loaned to the Utility Money Pool</u>	<u>Average Interest Rate for Funds Borrowed from the Utility Money Pool</u>	<u>Average Interest Rate for Funds Loaned to the Utility Money Pool</u>
2019	3.02%	2.68%	—%	—%	2.78%	—%
2018	2.52%	1.83%	2.51%	1.84%	2.33%	1.93%

### ***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 includes a \$125 million and a \$625 million facility which expire in July 2020 and 2021, respectively.

KPCo's amounts of accounts receivable and accrued unbilled revenues sold under the sale of receivables agreement were \$36.5 million and \$43.2 million as of June 30, 2019 and December 31, 2018, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold for the three months ended June 30, 2019 and 2018 were \$1 million and \$899 thousand, respectively, and for the six months ended June 30, 2019 and 2018 were \$2.1 million and \$1.8 million, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit for the three months ended June 30, 2019 and 2018 were \$125.8 million and \$145.2 million, respectively, and for the six months ended June 30, 2019 and 2018 were \$282.7 million and \$312.1 million, respectively.



## 12. PROPERTY, PLANT AND EQUIPMENT

### *Asset Retirement Obligations (ARO)*

KPCo records ARO in accordance with the accounting guidance for “Asset Retirement and Environmental Obligations” for the retirement of ash disposal facilities and asbestos removal.

The following is a reconciliation of the aggregate carrying amounts of ARO for KPCo:

<u>ARO as of</u> <u>December 31, 2018</u>	<u>Accretion</u> <u>Expense</u>	<u>Liabilities</u> <u>Incurred</u>	<u>Liabilities</u> <u>Settled</u>	<u>Revisions in Cash</u> <u>Flow Estimates (a)</u>	<u>ARO as of</u> <u>June 30, 2019</u>
(in thousands)					
\$ 41,681	\$ 1,212	\$ —	\$ (12,788)	\$ 21,428	\$ 51,533

(a) Primarily related to ash pond closure and asbestos abatement.

### 13. REVENUE FROM CONTRACTS WITH CUSTOMERS

#### *Disaggregated Revenues from Contracts with Customers*

The table below represents KPCo's revenues from contracts with customers, net of respective provisions for refund, by type of revenue:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
<b>Retail Revenues:</b>				
Residential Revenues	\$ 50,001	\$ 58,895	\$ 124,233	\$ 139,878
Commercial Revenues	36,441	39,809	75,114	80,547
Industrial Revenues	38,476	43,518	77,699	82,490
Other Retail Revenues	480	493	991	996
<b>Total Retail Revenues</b>	<u>125,398</u>	<u>142,715</u>	<u>278,037</u>	<u>303,911</u>
<b>Wholesale Revenues:</b>				
Generation Revenues (a)	5,445	4,740	12,605	10,492
Transmission Revenues (b)	5,051	3,500	9,869	9,870
<b>Total Wholesale Revenues</b>	<u>10,496</u>	<u>8,240</u>	<u>22,474</u>	<u>20,362</u>
Other Revenues from Contracts with Customers (a)	4,069	4,179	8,120	9,196
<b>Total Revenues from Contracts with Customers</b>	<u>139,963</u>	<u>155,134</u>	<u>308,631</u>	<u>333,469</u>
<b>Other Revenues:</b>				
Alternative Revenues	1,130	(3,187)	2,056	(4,506)
<b>Total Other Revenues</b>	<u>1,130</u>	<u>(3,187)</u>	<u>2,056</u>	<u>(4,506)</u>
<b>Total Revenues</b>	<u>\$ 141,093</u>	<u>\$ 151,947</u>	<u>\$ 310,687</u>	<u>\$ 328,963</u>

(a) Amounts included affiliated and nonaffiliated revenues.

(b) Amounts included affiliated and nonaffiliated revenues. The affiliated revenues were \$2.5 million and \$1.3 million for the three months ended June 30, 2019 and June 30, 2018, respectively and \$4.8 million and \$4.3 million for the six months ended June 30, 2019 and June 30, 2018, respectively.

#### *Fixed Performance Obligations*

The following table represents KPCo's remaining fixed performance obligations satisfied over time as of June 30, 2019. Fixed performance obligations primarily include wholesale transmission services, electricity sales for fixed amounts of energy and stand ready services into PJM's RPM market. The amounts shown in the table below include affiliated and nonaffiliated revenues.

2019	2020-2021	2022-2023	After 2023	Total
(in thousands)				
\$ 12,381	\$ 4,364	\$ 4,153	\$ 1,435	\$ 22,333

### ***Contract Assets and Liabilities***

Contract assets are recognized when KPCo has a right to consideration that is conditional upon the occurrence of an event other than the passage of time, such as future performance under a contract. KPCo did not have any material contract assets as of June 30, 2019 and December 31, 2018.

When KPCo receives consideration, or such consideration is unconditionally due from a customer prior to transferring goods or services to the customer under the terms of a sales contract, they recognize a contract liability on the balance sheet in the amount of that consideration. Revenue for such consideration is subsequently recognized in the period or periods in which the remaining performance obligations in the contract are satisfied. KPCo's contract liabilities typically arise from advanced payments of services provided primarily with respect to joint use agreements for utility poles. KPCo did not have any material contract liabilities as of June 30, 2019 and December 31, 2018.

### ***Accounts Receivable from Contracts with Customers***

Accounts receivable from contracts with customers are presented on KPCo's balance sheets within the Accounts Receivable - Customers line item. KPCo's balances for receivables from contracts that are not recognized in accordance with the accounting guidance for "Revenue from Contracts with Customers" included in Accounts Receivable - Customers were not material as of June 30, 2019. See "Securitized Accounts Receivable - AEP Credit" section of Note 11 for additional information related to AEP Credit's securitized accounts receivable.

The amount of affiliated accounts receivable from contracts with customers included in Accounts Receivable - Affiliated Companies on KPCo's balance sheets were \$6 million and \$8.4 million, respectively, as of June 30, 2019 and December 31, 2018.