Kentucky Power Company

2017 Third Quarter Report

Financial Statements

KENTUCKY POWER

An AEP Company

BOUNDLESS ENERGY

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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.
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.
IRS	Internal Revenue Service.
KPCo	Kentucky Power Company, an AEP electric utility subsidiary.
KPSC	Kentucky Public Service Commission.
MMBtu	Million British Thermal Units.
MTM	Mark-to-Market.
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.
PJM	Pennsylvania – New Jersey – Maryland regional transmission organization.
Risk Management Contracts	Trading and nontrading derivatives, including those derivatives designated as cash flow and fair value hedges.
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 and Nine Months Ended September 30, 2017 and 2016
(in thousands)
(Unaudited)

	Three Months Ended September 30, 2017	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
REVENUES				
Electric Generation, Transmission and Distribution	$ 158,963	$ 166,654	$ 462,665	$ 475,267
Sales to AEP Affiliates	3,964	1,636	12,443	6,457
Other Revenues	218	249	665	686
TOTAL REVENUES	163,145	168,539	475,773	482,410
EXPENSES				
Fuel and Other Consumables Used for Electric Generation	36,216	32,722	85,566	85,367
Purchased Electricity for Resale	5,211	8,224	27,642	33,185
Purchased Electricity from AEP Affiliates	26,759	27,653	71,256	71,116
Other Operation	26,768	23,838	87,645	66,681
Maintenance	16,763	18,259	54,387	52,703
Depreciation and Amortization	22,042	21,689	65,466	63,030
Taxes Other Than Income Taxes	6,240	4,741	17,645	15,766
TOTAL EXPENSES	139,999	137,126	409,607	387,848
OPERATING INCOME	23,146	31,413	66,166	94,562
Other Income (Expense):				
Other Income (Expense)	(84)	(578)	1,286	476
Interest Expense	(11,228)	(11,808)	(35,060)	(34,108)
INCOME BEFORE INCOME TAX EXPENSE	11,834	19,027	32,392	60,930
Income Tax Expense	5,373	7,542	12,443	20,755
NET INCOME	$ 6,461	$ 11,485	$ 19,949	$ 40,175

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

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

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Three and Nine Months Ended September 30, 2017 and 2016
(in thousands)
(Unaudited)

	Three Months Ended September 30, 2017	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
Net Income	$ 6,461	$ 11,485	$ 19,949	$ 40,175
OTHER COMPREHENSIVE INCOME, NET OF TAXES				
Cash Flow Hedges, Net of Tax of $6 and $8 for the Three Months Ended September 30, 2017 and 2016, Respectively, and $22 and $24 for the Nine Months Ended September 30, 2017 and 2016, Respectively	11	15	41	45
Amortization of Pension and OPEB Deferred Costs, Net of Tax of $3 and $2 for the Three Months Ended September 30, 2017 and 2016, Respectively, and $12 and $7 for the Nine Months Ended September 30, 2017 and 2016, Respectively	7	4	23	13
TOTAL OTHER COMPREHENSIVE INCOME	18	19	64	58
TOTAL COMPREHENSIVE INCOME	$ 6,479	$ 11,504	$ 20,013	$ 40,233

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

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CHANGES IN
COMMON SHAREHOLDER'S EQUITY
For the Nine Months Ended September 30, 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			(33,000)		(33,000)
Net Income			40,175		40,175
Other Comprehensive Income				58	58
TOTAL COMMON SHAREHOLDER'S EQUITY - SEPTEMBER 30, 2016	$ 50,450	$ 527,309	$ 94,135	$ (1,587)	$ 670,307
TOTAL COMMON SHAREHOLDER'S EQUITY - DECEMBER 31, 2016	$ 50,450	$ 526,135	$ 93,170	$ (1,354)	$ 668,401
Common Stock Dividends			(26,250)		(26,250)
Net Income			19,949		19,949
Other Comprehensive Income				64	64
TOTAL COMMON SHAREHOLDER'S EQUITY - SEPTEMBER 30, 2017	$ 50,450	$ 526,135	$ 86,869	$ (1,290)	$ 662,164

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

KENTUCKY POWER COMPANY
CONDENSED BALANCE SHEETS
ASSETS
September 30, 2017 and December 31, 2016
(in thousands)
(Unaudited)

	September 30, 2017	December 31, 2016
CURRENT ASSETS		
Cash and Cash Equivalents	$ 770	$ 859
Accounts Receivable:		
Customers	10,726	14,608
Affiliated Companies	22,939	29,519
Accrued Unbilled Revenues	2,052	4,542
Miscellaneous	88	380
Allowance for Uncollectible Accounts	(57)	(66)
Total Accounts Receivable	35,748	48,983
Fuel	13,134	19,823
Materials and Supplies	16,940	16,540
Risk Management Assets	2,406	457
Accrued Tax Benefits	3,195	574
Prepayments and Other Current Assets	16,692	8,347
TOTAL CURRENT ASSETS	88,885	95,583
PROPERTY, PLANT AND EQUIPMENT		
Electric:		
Generation	1,189,339	1,182,212
Transmission	578,503	574,703
Distribution	801,103	783,283
Other Property, Plant and Equipment	74,900	67,248
Construction Work in Progress	39,930	27,380
Total Property, Plant and Equipment	2,683,775	2,634,826
Accumulated Depreciation and Amortization	915,672	879,253
TOTAL PROPERTY, PLANT AND EQUIPMENT – NET	1,768,103	1,755,573
OTHER NONCURRENT ASSETS		
Regulatory Assets	550,933	576,131
Long-term Risk Management Assets	160	—
Employee Benefits and Pension Assets	6,888	5,891
Deferred Charges and Other Noncurrent Assets	15,905	26,787
TOTAL OTHER NONCURRENT ASSETS	573,886	608,809
TOTAL ASSETS	$ 2,430,874	$ 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
September 30, 2017 and December 31, 2016
(Unaudited)

	September 30, 2017	December 31, 2016
	(in thousands)	
CURRENT LIABILITIES		
Advances from Affiliates	$ 12,209	$ 1,807
Accounts Payable:		
General	34,117	52,601
Affiliated Companies	24,374	28,579
Long-term Debt Due Within One Year – Nonaffiliated	—	390,000
Risk Management Liabilities	263	53
Customer Deposits	27,876	26,625
Accrued Taxes	15,085	28,379
Accrued Interest	9,103	8,127
Other Current Liabilities	37,676	44,302
TOTAL CURRENT LIABILITIES	160,703	580,473
NONCURRENT LIABILITIES		
Long-term Debt – Nonaffiliated	867,107	477,164
Long-term Risk Management Liabilities	73	313
Deferred Income Taxes	683,418	666,902
Asset Retirement Obligations	37,683	46,657
Employee Benefits and Pension Obligations	11,145	14,516
Deferred Credits and Other Noncurrent Liabilities	8,581	5,539
TOTAL NONCURRENT LIABILITIES	1,608,007	1,211,091
TOTAL LIABILITIES	1,768,710	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	86,869	93,170
Accumulated Other Comprehensive Income (Loss)	(1,290)	(1,354)
TOTAL COMMON SHAREHOLDER'S EQUITY	662,164	668,401
TOTAL LIABILITIES AND COMMON SHAREHOLDER'S EQUITY	$ 2,430,874	$ 2,459,965

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

KENTUCKY POWER COMPANY
CONDENSED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2017 and 2016
(in thousands)
(Unaudited)

	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
OPERATING ACTIVITIES		
Net Income	$ 19,949	$ 40,175
Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities:		
Depreciation and Amortization	65,466	63,030
Deferred Income Taxes	16,026	22,592
Allowance for Equity Funds Used During Construction	(679)	(743)
Mark-to-Market of Risk Management Contracts	(2,139)	2,588
Pension Contributions to Qualified Plan Trust	(2,226)	(1,509)
Property Taxes	11,367	11,863
Deferred Fuel Over/Under-Recovery, Net	1,260	(5,825)
Change in Other Noncurrent Assets	1,700	(25,438)
Change in Other Noncurrent Liabilities	1,593	(3,966)
Changes in Certain Components of Working Capital:		
Accounts Receivable, Net	13,235	81
Fuel, Materials and Supplies	6,744	680
Accounts Payable	(19,329)	5,513
Accrued Taxes, Net	(15,915)	23,118
Other Current Assets	(9,598)	(356)
Other Current Liabilities	(6,030)	(11,269)
Net Cash Flows from Operating Activities	81,424	120,534
INVESTING ACTIVITIES		
Construction Expenditures	(64,429)	(80,687)
Other Investing Activities	462	1,078
Net Cash Flows Used for Investing Activities	(63,967)	(79,609)
FINANCING ACTIVITIES		
Issuance of Long-term Debt – Nonaffiliated	388,809	—
Change in Advances from Affiliates, Net	10,402	(7,308)
Retirement of Long-term Debt – Nonaffiliated	(390,000)	—
Principal Payments for Capital Lease Obligations	(743)	(736)
Dividends Paid on Common Stock	(26,250)	(33,000)
Other Financing Activities	236	165
Net Cash Flows Used for Financing Activities	(17,546)	(40,879)
Net Increase (Decrease) in Cash and Cash Equivalents	(89)	46
Cash and Cash Equivalents at Beginning of Period	859	867
Cash and Cash Equivalents at End of Period	$ 770	$ 913
SUPPLEMENTARY INFORMATION		
Cash Paid for Interest, Net of Capitalized Amounts	$ 32,714	$ 34,905
Net Cash Paid (Received) for Income Taxes	1,018	(35,715)
Noncash Acquisitions Under Capital Leases	623	571
Construction Expenditures Included in Current Liabilities as of September 30,	7,608	5,963

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

INDEX OF CONDENSED NOTES TO CONDENSED FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING MATTERS

General

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

In the opinion of management, the unaudited condensed interim financial statements reflect all normal and recurring accruals and adjustments necessary for a fair presentation of the net income, financial position and cash flows for the interim periods. Net income for the three and nine months ended September 30, 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 October 26, 2017, the date that the third quarter 2017 report was available to be issued.

2. <u>NEW ACCOUNTING PRONOUNCEMENTS</u>

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, 2018 with early adoption permitted.

Management continues to analyze the impact of the new revenue standard and related ASUs. During 2016 and 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. The evaluation of revenue streams, new contracts and the new revenue standard's disclosure requirements continues during the fourth quarter of 2017, in particular with respect to various ongoing industry implementation issues. Management will continue to analyze the related impacts to revenue recognition and monitor any new industry implementation issues that arise. Further, given industry conclusions related to implementation issues, including contributions in aid of construction and collectability, management does not anticipate changes to current accounting systems. 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 sheets 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, 2018 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 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, 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, 2019 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 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. Multiple lease system options were also 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.

Evaluation of new lease contracts continues and the process of implementing a compliant lease system solution began in the third quarter of 2017. 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 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, 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 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, 2018. 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 statements of income 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. For 2016, KPCo's actual non-service cost components were a credit of $2.7 million, of which approximately 34% was capitalized.

The new accounting guidance is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. 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 plans to adopt ASU 2017-07 effective January 1, 2018.

ASU 2017-12 "Derivatives and Hedging" (ASU 2017-12)

In August 2017, the FASB issued ASU 2017-12 amending the recognition and presentation requirements for hedge accounting activities. The objectives are to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements and reduce the complexity of applying hedge accounting. Under the new standard, the concept of recognizing hedge ineffectiveness within the statements of income for cash flow hedges, which has historically been immaterial to AEP, will be eliminated. In addition, certain required tabular disclosures relating to fair value and cash flow hedges will be modified.

The new accounting guidance is effective for interim and annual periods beginning after December 15, 2019 with early adoption permitted for any interim or annual period after August 2017. Management is analyzing the impact of this new standard, including the possibility of early adoption, and at this time, cannot estimate the impact of adoption on net income.

3. COMPREHENSIVE INCOME

Presentation of Comprehensive Income

The following tables provide the components of changes in AOCI and details of reclassifications from AOCI for the three and nine months ended September 30, 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 September 30, 2017

	Cash Flow Hedges		
	Interest Rate	Pension and OPEB	Total
	(in thousands)		
Balance in AOCI as of June 30, 2017	$ (11)	$ (1,297)	$ (1,308)
Change in Fair Value Recognized in AOCI	—	—	—
Amount of (Gain) Loss Reclassified from AOCI			
Interest Expense	16	—	16
Amortization of Prior Service Cost (Credit)	—	(55)	(55)
Amortization of Actuarial (Gains)/Losses	—	67	67
Reclassifications from AOCI, before Income Tax (Expense) Credit	16	12	28
Income Tax (Expense) Credit	5	5	10
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	11	7	18
Net Current Period Other Comprehensive Income	11	7	18
Balance in AOCI as of September 30, 2017	$ —	$ (1,290)	$ (1,290)

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

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

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Nine Months Ended September 30, 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	62	—	62
Amortization of Prior Service Cost (Credit)	—	(166)	(166)
Amortization of Actuarial (Gains)/Losses	—	202	202
Reclassifications from AOCI, before Income Tax (Expense) Credit	62	36	98
Income Tax (Expense) Credit	21	13	34
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	41	23	64
Net Current Period Other Comprehensive Income	41	23	64
Balance in AOCI as of September 30, 2017	$ —	$ (1,290)	$ (1,290)

Changes in Accumulated Other Comprehensive Income (Loss) by Component
For the Nine Months Ended September 30, 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	70	—	70
Amortization of Prior Service Cost (Credit)	—	(166)	(166)
Amortization of Actuarial (Gains)/Losses	—	186	186
Reclassifications from AOCI, before Income Tax (Expense) Credit	70	20	90
Income Tax (Expense) Credit	25	7	32
Reclassifications from AOCI, Net of Income Tax (Expense) Credit	45	13	58
Net Current Period Other Comprehensive Income	45	13	58
Balance in AOCI as of September 30, 2016	$ (56)	$ (1,531)	$ (1,587)

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	September 30, 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	103	52
Total Regulatory Assets Pending Final Regulatory Approval	$ 4,480	$ 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.

2017 Kentucky Base Rate Case

In June 2017, KPCo filed a request with the KPSC for a $66 million annual increase in Kentucky base rates based upon a proposed 10.31% return on common equity with the increase to be implemented no later than January 2018. The proposed increase includes: (a) lost load since KPCo last changed base rates in July 2015, (b) incremental costs related to OATT charges from PJM not currently recovered from retail ratepayers, (c) increased depreciation expense including updated Big Sandy, Unit 1 depreciation rates using a proposed retirement date of 2031, (d) recovery of other Big Sandy, Unit 1 generation costs currently recovered through a retail rider and (e) incremental purchased power costs. Additionally, KPCo requested a $4 million annual increase in environmental surcharge revenues.

In August 2017, KPCo submitted a supplemental filing with the KPSC that decreased the proposed annual base rate revenue request to $60 million. The modification is due to a lower interest expense related to June 2017 debt refinancings. In October 2017, various intervenors filed testimony that included annual net revenue increase recommendations ranging from $13 million to $40 million. Intervenors recommended returns on common equity ranged from 8.6% and 8.85%. Intervenors also recommended significant delays in KPCo's proposed recoveries of: (a) depreciation expense related to Big Sandy, Unit 1 (gas unit), suggesting a 30-year depreciable life instead of KPCo's proposed 15-year life and (b) lease expense on Rockport Plant, Unit 2 billed from AEGCo, proposing that the approximate $100 million of lease expense for the period 2018 through 2022 be deferred with a WACC carrying charge for recovery over 10 years beginning 2023. Testimony on behalf of the Attorney General also discussed that the KPSC could consider disallowing all or a portion of the costs currently being recovered over 25 years through the Big Sandy Unit 2 Retirement rider. As of September 30, 2017, KPCo's regulatory asset related to the retired Big Sandy Unit 2 was $289 million. A hearing at the KPSC is scheduled for December 2017.

If 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.

Indemnifications and Other Guarantees

Contracts

KPCo enters into certain types of contracts which require indemnifications. Typically these contracts include, but are not limited to, sale agreements, lease agreements, purchase agreements and financing agreements. Generally, these agreements may include, but are not limited to, indemnifications around certain tax, contractual and environmental matters. With respect to sale agreements, exposure generally does not exceed the sale price. As of September 30, 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 September 30, 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 tables provide the components of KPCo's net periodic benefit cost (credit) for the plans:

	Pension Plans		Other Postretirement Benefit Plans	
	Three Months Ended September 30,		Three Months Ended September 30,	
	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	288
Net Periodic Benefit Cost (Credit)	$ 672	$ 703	$ (596)	$ (698)

	Pension Plans		Other Postretirement Benefit Plans	
	Nine Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(in thousands)			
Service Cost	$ 2,187	$ 1,845	$ 249	$ 212
Interest Cost	5,361	5,617	1,618	1,613
Expected Return on Plan Assets	(7,725)	(7,599)	(2,880)	(2,966)
Amortization of Prior Service Cost (Credit)	36	39	(1,818)	(1,818)
Amortization of Net Actuarial Loss	2,158	2,207	1,043	863
Net Periodic Benefit Cost (Credit)	$ 2,017	$ 2,109	$ (1,788)	$ (2,096)

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, 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 September 30, 2017	Volume December 31, 2016	Unit of Measure
	(in thousands)		
Commodity:			
Power	14,370	10,562	MWhs
Natural Gas	376	—	MMBtus
Heating Oil and Gasoline	355	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 September 30, 2017 and December 31, 2016 balance sheets, KPCo netted $104 thousand and $119 thousand, respectively, of cash collateral received from third parties against short-term and long-term risk management assets and $54 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
September 30, 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	$ 7,379	$ (4,973)	$ 2,406
Long-term Risk Management Assets	1,030	(870)	160
Total Assets	8,409	(5,843)	2,566
Current Risk Management Liabilities	5,183	(4,920)	263
Long-term Risk Management Liabilities	946	(873)	73
Total Liabilities	6,129	(5,793)	336
Total MTM Derivative Contract Net Assets (Liabilities)	$ 2,280	$ (50)	$ 2,230

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 this category are reported gross. These instruments are subject to master netting agreements and are presented on the balance sheets on a net basis in accordance with the accounting guidance for "Derivatives and Hedging."
(b) Amounts include counterparty netting of risk management and hedging contracts and associated cash collateral in accordance with the accounting guidance for "Derivatives and Hedging."
(c) There are no derivative contracts subject to a master netting arrangement or similar agreement which are not offset in the statement of financial position.

The table below presents KPCo's activity of derivative risk management contracts:

Amount of Gain (Loss) Recognized on
Risk Management Contracts

Location of Gain (Loss)	Three Months Ended September 30, 2017	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
	(in thousands)			
Electric Generation, Transmission and Distribution Revenues	$ 62	$ 243	$ 144	$ 191
Sales to AEP Affiliates	—	5	—	434
Purchased Electricity for Resale	500	463	2,834	1,902
Other Operation	5	(9)	13	(42)
Maintenance	4	(21)	14	(78)
Regulatory Assets (a)	20	(551)	14	(406)
Regulatory Liabilities (a)	(326)	681	636	237
Total Gain on Risk Management Contracts	$ 265	$ 811	$ 3,655	$ 2,238

(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 and nine months ended September 30, 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 and nine months ended September 30, 2017 and 2016, KPCo did not apply cash flow hedging to outstanding interest rate derivatives.

During the three and nine months ended September 30, 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	
	September 30, 2017	**December 31, 2016**
	(in thousands)	
AOCI Loss Net of Tax	$ —	$ (41)
Portion Expected to be Reclassified to Net Income During the Next Twelve Months	—	(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 September 30, 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

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 September 30, 2017 and December 31, 2016, 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:

	September 30, 2017	December 31, 2016
	(in thousands)	
Liabilities for Contracts with Cross Default Provisions Prior to Contractual Netting Arrangements	$ 7	$ 25
Amount of Cash Collateral Posted	—	—
Additional Settlement Liability if Cross Default Provision is Triggered	1	—

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 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:

	September 30, 2017		December 31, 2016	
	Book Value	Fair Value	Book Value	Fair Value
	(in thousands)			
Long-term Debt	$ 867,107	$ 969,268	$ 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
September 30, 2017

	Level 1	Level 2	Level 3	Other	Total
Assets:			(in thousands)		
Risk Management Assets					
Risk Management Commodity Contracts (a) (b)	$ 6	$ 5,193	$ 2,543	$ (5,176)	$ 2,566
Liabilities:					
Risk Management Liabilities					
Risk Management Commodity Contracts (a) (b)	$ 6	$ 5,260	$ 195	$ (5,125)	$ 336

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 and nine months ended September 30, 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 September 30, 2017	Net Risk Management Assets (Liabilities)
	(in thousands)
Balance as of June 30, 2017	$ 3,122
Realized Gain (Loss) Included in Net Income (or Changes in Net Assets) (b) (c)	567
Settlements	(1,423)
Changes in Fair Value Allocated to Regulated Jurisdictions (e)	82
Balance as of September 30, 2017	$ 2,348

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

Nine Months Ended September 30, 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)	2,295
Settlements	(2,543)
Changes in Fair Value Allocated to Regulated Jurisdictions (e)	2,398
Balance as of September 30, 2017	$ 2,348

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

(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 liabilities/assets or accounts payable.

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

Significant Unobservable Inputs
September 30, 2017

	Fair Value		Valuation	Significant Unobservable	Forward Price Range		
	Assets	**Liabilities**	**Technique**	**Input (a)**	**Low**	**High**	**Weighted Average**
	(in thousands)						
Energy Contracts	$ 197	$ 68	Discounted Cash Flow	Forward Market Price	$ 14.85	$ 45.72	$ 33.99
FTRs	2,346	127	Discounted Cash Flow	Forward Market Price	(0.36)	6.36	0.52
Total	$ 2,543	$ 195					

Significant Unobservable Inputs
December 31, 2016

	Fair Value		Valuation	Significant Unobservable	Forward Price 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 September 30, 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)

9. INCOME TAXES

Effective Tax Rates (ETR)

The interim ETR for KPCo reflects the estimated annual ETR for 2017 and 2016, adjusted for tax expense associated with certain discrete items. The interim ETR differs from the federal statutory tax rate of 35% primarily due to tax adjustments, state income taxes and other book/tax differences which are accounted for on a flow-through basis.

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

Three Months Ended September 30,		Nine Months Ended September 30,	
2017	2016	2017	2016
45.4%	39.6%	38.4%	34.1%

Three Months Ended September 30, 2017 Compared to Three Months Ended September 30, 2016

The increase in the ETR is primarily due to the recording of unfavorable federal income tax adjustments in 2017 and a decrease in pretax book income.

Nine Months Ended September 30, 2017 Compared to Nine Months Ended September 30, 2016

The increase in the ETR is primarily due to the recording of favorable state income tax adjustments in 2016 and unfavorable federal income tax adjustments in 2017.

Federal and State Income Tax Audit Status

KPCo and other AEP subsidiaries are no longer subject to U.S. federal examination for years before 2011. The IRS examination of years 2011, 2012 and 2013 started in April 2014. KPCo and other AEP subsidiaries received a Revenue Agents Report in April 2016, completing the 2011 through 2013 audit cycle indicating an agreed upon audit. The 2011 through 2013 audit was submitted to the Congressional Joint Committee on Taxation for approval. 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.

State Tax Legislation

Legislation was enacted in the state of Illinois in July 2017 increasing the corporate income tax rate from 5.25% to 7% effective July 1, 2017, with the increased rate applied to the portion of the tax year falling on or after that date. With the inclusion of the 2.5% Illinois Replacement Tax, the total Illinois corporate income tax rate increased from 7.75% to 9.5%, effective July 1, 2017. The legislation is not expected to materially impact KPCo's net income, cash flows or financial condition.

10. FINANCING ACTIVITIES

Long-term Debt

Long-term debt issued, retired and principal payments made during the first nine months of 2017 are shown in the tables below:

Type of Debt	Principal Amount (a)	Interest Rate	Due Date
Issuances:	**(in thousands)**	**(%)**	
Pollution Control Bonds	$ 65,000	2.00	2020
Senior Unsecured Notes	65,000	3.13	2024
Senior Unsecured Notes	40,000	3.35	2027
Senior Unsecured Notes	165,000	3.45	2029
Senior Unsecured Notes	55,000	4.12	2047

(a) Amounts indicated on the statements of cash flows are net of issuance costs and premium or discount and will not tie to the issuance amounts.

Type of Debt	Principal Amount Paid	Interest Rate	Due Date
Retirements and Principal Payments:	**(in thousands)**	**(%)**	
Pollution Control Bonds	$ 65,000	Variable	2017
Senior Unsecured Notes	$ 325,000	6.00	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

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.

Leverage Restrictions

KPCo has credit agreements that contain a covenant that limit its debt to capitalization ratio to 67.5%. As of September 30, 2017, KPCo did not exceed its debt to capitalization limit. The payment of cash dividends indirectly results in an increase in the percentage of KPCo's debt to total capitalization. The method for calculating outstanding debt and capitalization is contractually defined in the credit agreements.

As of September 30, 2017, 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 the AEP System Utility Money Pool agreement filed with the FERC. The amounts of outstanding borrowings from the Utility Money Pool as of September 30, 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 limit for the nine months ended September 30, 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 September 30, 2017	Authorized Short-Term Borrowing Limit
		(in thousands)			
$ 24,612	$ 332,983	$ 7,990	$ 16,020	$ 12,209	$ 225,000

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

Nine Months Ended September 30,	Maximum Interest Rate for Funds Borrowed from the Utility Money Pool	Minimum Interest Rate for Funds Borrowed from the Utility Money Pool	Maximum Interest Rate for Funds Loaned to the Utility Money Pool	Minimum Interest Rate for Funds Loaned to the Utility Money Pool	Average Interest Rate for Funds Borrowed from the Utility Money Pool	Average Interest Rate for Funds Loaned to the Utility Money Pool
2017	1.49%	0.95%	1.49%	0.92%	1.34%	1.36%
2016	0.91%	0.69%	0.90%	0.75%	0.77%	0.87%

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 2019.

KPCo's amounts of accounts receivable and accrued unbilled revenues sold under the sale of receivables agreement were $39.5 million and $49.3 million as of September 30, 2017 and December 31, 2016, respectively.

The fees paid by KPCo to AEP Credit for customer accounts receivable sold for the three months ended September 30, 2017 and 2016 were $811 thousand and $722 thousand, respectively, and for the nine months ended September 30, 2017 and 2016 were $2.4 million and $2.1 million, respectively.

KPCo's proceeds on the sale of receivables to AEP Credit for the three months ended September 30, 2017 and 2016 were $139.5 million and $149.7 million, respectively, and for the nine months ended September 30, 2017 and 2016 were $436.9 million and $439.6 million, respectively.